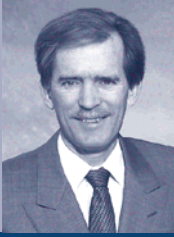


Bill
Gross



Investment Outlook

P I M C O

February 2003

Hegemonic Decay

Vocabulary is a power builder. Every time I use the word “concomitant” in a conversation I see my listener’s eyebrows go up as if to say, “what does this guy know that I don’t?” Then again, maybe they’re just signaling that I’m full of more than just baked beans. I suspect the latter, but either way it creates an impression. I sensed the power of the almighty word late in my teens as I was preparing for my SAT tests as a foreign exchange student in Germany. Missing the normal study manuals available in the U.S., I turned to my Funk & Wagnalls and began with “abhor,” working my way through the Gs before test-time called “time out.” Later, serving “midwatch” in the Navy off Vietnam in 1969, I continued the game in reverse, starting with “zymurgy” and regressing to “kinetics” by the time we sailed home to San Diego. There had been lots of midwatches, but not enough it seems to cover all 26 letters; I was missing H I J.

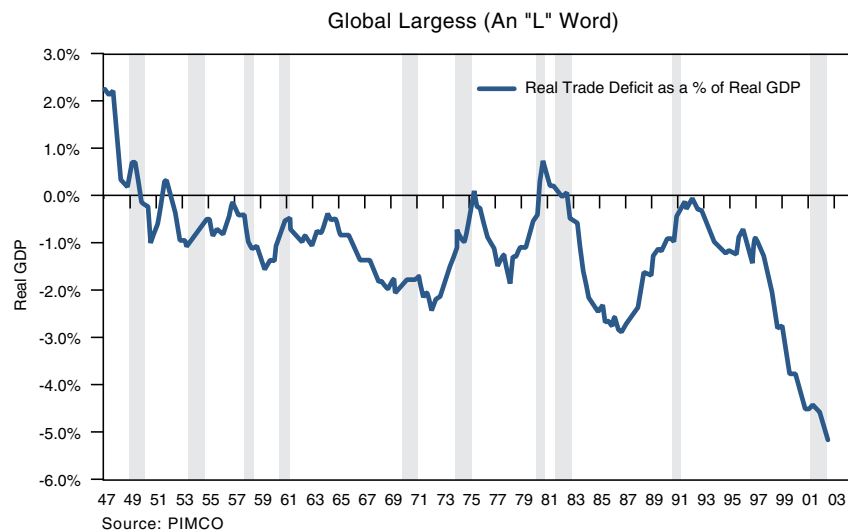
This deficiency never seemed to affect my career much until the last few months when I began reading in *The New York Times* and *The Wall Street Journal* about U.S. “hegemony” in connection with post 9/11 maneuverings

in Afghanistan, Iraq, and North Korea. This was an “H” word I had read before but never really bothered to think about. Well a “hegemony” it seems, is the dominance of one country over others not only militarily but economically as well, and as fitting a word as any of my A through Gs and Zs to Ks to describe the world’s current state of affairs. There can be little doubt that we have an American hegemony. But while the United States rules the waves as well as turf and sky, I’m not so sure that we are, or perhaps will be the economic powerhouse we once were. Three years of stock market declines, a 20% devaluation of the dollar over 10 months, and an inability to serve as the global economy’s locomotive despite massive monetary and fiscal stimulation suggests America’s “shining city on a hill” may have lost some of its sheen of late. The US of A it seems is becoming less wealthy by the minute as foreign investment is withheld and in some cases redirected to Chinese and other more attractive ports of call. Economically, we may have begun a process of hegemonic decay and if true, at some point we will have to put that in our Funk & Wagnalls and smoke it. Let’s see why.

The initiation of U.S. hegemonic decline can't be blamed on any single source. Excessive build up of private debt, which in part led to an investment and stock market bubble, has been a primary culprit. Our overvalued dollar and a near historic trade deficit are in the running for the hegemonic Oscar as well. But if all of these be ingredients, there is no doubt that 9/11 was the significant catalyst, despite its coming more than a year after several of these economic and financial trends experienced their peaks. In the aftermath of 9/11 it became apparent to George Bush and the Washington defense establishment that future conflict would perhaps be not only near perpetual, but of a nature quite different from Desert Storm over a decade ago. While the eradication of Iraq from Kuwait was a single purpose conflict, today's potential invasion of Iraq is but one of a multitude of steps that hopefully leads to terrorist containment

as opposed to the eradication of Islamic extremism. Bush has in no uncertain terms said that our future struggle will be a never-ending story as opposed to a single shot kill. If so, investors must know that perpetual containment entails costs – not just monetary but those involving potential policy reversals that have formed the backbone of America's economic hegemony for nearly seven decades.

That such a hegemony has been based upon (1) America's military domination and (2) America's superior economy as reflected by the dollar's ascension to the top of the pile as the world's reserve currency – is undeniable. All hegemonies including Britannia's (since the fall of Napoleon to the end of WWI), have shared similar characteristics. As current leader of the pack, America has been able to implement policies (free trade, open capital markets, and a strong currency) which have not only reflected



its political heritage and philosophy but have added dollars and cents to its citizens' pocket books, as well as SUVs to their driveways. But the U.S., unlike the British Empire rests on a fragile foundation built upon consumer spending and trade deficits as opposed to mercantilism and trade surpluses, which characterized Britannia's rule. These deficits, coming at a time of American military expansion in pursuit of terrorist containment, threaten to reverse our hegemonic benefits and end our economic domination. Our SUVs, as well as our top cat near-monopoly of the good times are at risk.

Although I may have absorbed part of the dictionary, I by no means am a policy wonk from some Washington think tank. Perhaps I've confused either you or myself in the last few paragraphs by reference to containment and hegemony based on military power and economic efficiency. Let me get a little more basic – exchange my Funk & Wagnalls for the abridged office edition of the American Heritage dictionary. Because of 9/11 and our necessity to fight a new kind of war, America is losing its peace dividend at a time when – because of our high debt, over-consumption, and reflective trade deficit – we cannot afford to. Guns and butter will soon extend our global credit card to its limit. Our foreign lenders are beginning to make some increasingly urgent phone calls to pay up or else and they are enforcing their demands

by selling the dollar and buying almost any other currency that represents the economic philosophy of Ben Franklin as opposed to George Bush.

The end to the strong dollar is but the most visible reversal of U.S. hegemonic policies in recent months. Our promotion of free trade and open capital markets is suffering as well. Last year's U.S. steel and lumber tariffs are being supplemented by an embargo of Chinese containers in Hong Kong and Shanghai due to their possible hiding of terrorist weapons and armaments. Mexican trucks are being halted at the Texas border on the age-old allegation of vehicle safety violations. We are becoming a trade repressor as opposed to trade advocate and other countries no doubt will fight back.

In addition, our advocacy of open capital markets is falling increasingly by the wayside. Global financial controls are now seen as a bonafide weapon in the war against terrorism. Prominent economists such as Paul Krugman and Joseph Stiglitz are wondering whether or not – in the example of Malaysian Prime Minister Mahathir Mohamad during 1998's Asian crisis – there might not be a stronger case for controlling international capital flows. And if these policy reversals don't sound warning alarms, how about Fed Governor Bernanke threatening to support any asset market decline that threatens to reinforce deflation. Come to think

of it, Fed Chairman Greenspan by encouraging the belief in a Greenspan “put” has been interfering in our and other countries’ stock markets for several years now. Open markets? The door appears to be closing fast.

The reversal of these policies which in the past have promoted U.S. economic hegemony are a natural reaction by foreign creditors and the U.S. debtor nation alike to its future new emphasis on terrorist containment and the costs thereof. Foreigners have and will continue to sell the dollar and U.S. investments in fear of guns and butter bills to come. America will attempt to preserve its hegemony by biasing, and in some cases reversing, free trade and open financial market policies that do not favor the U.S. All of this implies that our peace dividend, not only in the terms of lower defense expenditures, but U.S. domination of (and benefits from) free capital markets and free trade, are nearing an end. We will experience a somewhat vicious cycle of policy reversal instead of the virtuous circle of recent decades, which led to higher profits and lower inflation. In the reversal’s wake will come subdued profits, higher inflation, a lower dollar and anemic financial returns.

While that may not qualify as a trip to the poor house, I have no doubt that such events signify to at least some Americans a trip to a poorer house. Many of us will have to adjust, either in the form of higher unemployment, an increased price for imported goods, or heavier indirect taxes in the form of higher inflation and interest rates. Investment strategies, both bond and equity, should put these secular reversals at the top of their A list when considering opportunities to make relative and absolute returns. Hegemonic decay will impose costs unimagined just 16 months ago during the innocent hours of September 10th, 2001.

William H. Gross
Managing Director

P I M C O

840 Newport Center Drive
Suite 300
Newport Beach, CA 92660
949.720.6000

Past performance is no guarantee of future results. All data is as of 12/31/02 unless otherwise indicated and is subject to change. Investment return will fluctuate and the value of an investor's shares will fluctuate and may be worth more or less than original cost when redeemed. This article contains the current opinions of the author but necessarily PIMCO, and does not represent a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission. This article is distributed for educational purposes and should not be considered investment advice.

Each sector of the bond market entails some risk. Municipals may realize gains & may incur a tax liability from time to time. Treasuries & Government Bonds guarantee is to the timely repayment of interest and does not eliminate market risk, shares of the funds are not guaranteed. Mortgage-backed securities & Corporate Bonds may be sensitive to interest rates, when they rise the value generally declines and there is no assurance that private guarantors or insurers will meet their obligations. An investment in high yield securities, lower rated securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in foreign securities may entail risk due to foreign economic and political developments and may be enhanced when investing in emerging markets. P/E is a ratio of security price to earnings per share.