

The Hours

*What happens when we die?
We go back to where we came from.*

*And where is that?
I can't remember.*

– Dialogue from *The Hours*

One of the benefits of writing a book is that it serves as a snapshot of time. Thoughts, feelings, philosophies of living change as we funnel down through the hourglass and the printed word is near immutable proof of such transformations. One thing that strikes me about “me” as I infrequently pick up *Everything You’ve Heard About Investing Is Wrong* is how absorbed I was in my late forties and early fifties with religion and the meaning of life. My stories describing St. Catherine’s Church and the fictional Father Guido Sarducci were numerous, and filled with frequent references to religion and the search for a higher authority. Nearly a decade later in 2003, I must confide that I am no nearer to resolving the conundrum. Like Virginia Woolf in *The Hours*, I cannot remember where I came from, and I lack certainty in where I am going. We have company – Virginia and I. Still there are those who have found answers to their individual quests and I accept their certitude if not their conclusions. In the absence of personal resolution, I fall back on the thinking of Tennyson:

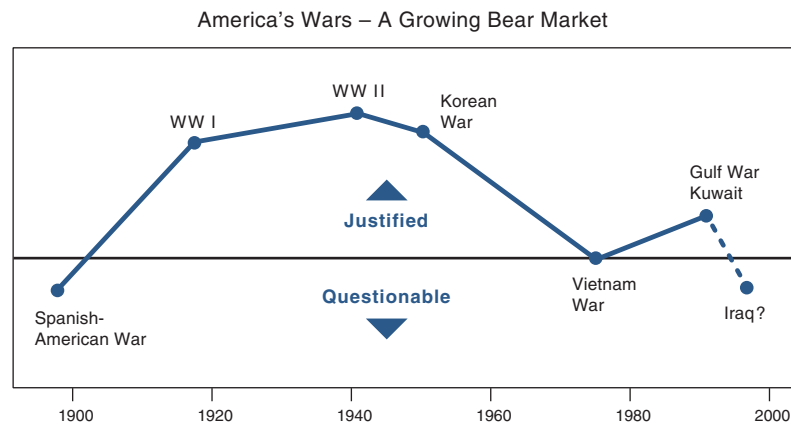
“There lives more faith in honest doubt,” he wrote, “than in half the creeds.” Perhaps. My life seems sprinkled with such self-consolations as the conclusion to my multi-act play comes rushing towards me faster than I care to acknowledge. And my current faith, if it could be described as such, would be a near resignation, suggesting that in the absence of certainty, the best we can do is to encircle our loved ones, display empathy and compassion to the billions that share a world with us, and hold on tight as we descend into the maelstrom. Answers, if any, await in the density of that great black hole beyond.

While I’m in the emoting mood let me tread into even more dangerous waters and speak to the impending conflict with Iraq. For those of you who have already had enough, please skip this paragraph and proceed to the actual investment outlook. I am not a geopolitical expert, but I have an opinion founded on what hopefully is a healthy dose of common sense and historical perspective. I speak now, and

risk client, public, and press censure because I was silent 35 years ago. I sailed off to Vietnam, came back and collected my Veteran's benefits and was none the worse for the experience. But hundreds of thousands, including some friends – were – and that is the point I suppose, in speaking out now. The crux of the current argument involving Iraq is this: All would agree, especially since 9/11 that America has a right to defend herself. The question is how far we can go in that defense and in the process what cost to the American spirit and the American soul. President Bush and others say that we must take almost every step to insure our internal safety. He argues that, in addition, those steps will bring positive changes in regimes dominated by oppression; Afghanistan, Iraq, North Korea and Iran are but steppingstones towards a new democratic world order with America at the center. I know the arguments – I'm even temporarily persuaded by them during emotional speeches such

as Bush's State of the Union. I suspect, however, that by invading "evil doer" nations, we may lessen our vulnerability but lose a piece of our soul in the process. Yes, I'm aware that Iraq is in noncompliance with UN resolutions and that its leader is a near madman. I'm also aware, however, of how absolute power corrupts and how we may be crossing a thin line. Preemptive attacks? Kill them before they kill us? No one has experienced such Hours in the United States before. I am heartbroken that it has come to this and I fear for my country's proud heritage and even more for its future.

And now finally, it is time for the investment Hour. Readers may remember my *Investment Outlook* remarks of recent months suggesting that the U.S. Treasury market's "salad days" are over. If short rates can't go down from here, then further price increases for intermediate and long-term Treasuries are unlikely, especially



Source: Yours Truly.
This chart is not based on any statistical information and represents the current opinions of the manager.

under the threat of accelerating fiscal deficits and Fed Governor Bernanke's vow to use any and all means to defeat deflation. "I believe him," I suggested, and I still do. 2-4% inflation beginning in 2004 and continuing for at least several years beyond is the most likely outcome, which would seem to lead to an "overvalued" Treasury market. After all, if inflation a few years hence almost matches existing yields, then real interest rates, at least for nominal as opposed to TIPS related Treasuries, are close to 0%. Overvalued indeed.

I have also cautioned, however, that just because a 20-year bull market in bonds is likely now complete, it is not necessarily the case that a new bear market has begun. 10-year Treasury yields at 4% do not exactly resemble "NASDAQ 5000." I cite two primary reasons for this bear market "hibernation" of uncertain duration. First of all, it is important to remember that during our last secular transition from inflation to disinflation it took several years for intermediate and long-term yields to adjust. Return with me to the Volcker years of 1979-81 during which he vowed to raise short rates as high as necessary to reverse America's inflationary spiral. He did – raise rates – eventually producing a prime of 20%+. He did – initiate a 20-year trend of disinflation – starting at a CPI peak of 14.8% in March of 1980 and culminating at an ebb of 1.2% in June of 2002. But it was not until mid-1984

that long-term bond investors began to catch on. 30-year Treasuries were still at 14% in June of that year. There is no reason to suspect anything different this time around in terms of the pace of secular transformation from "dis" to "re" inflation. It may take many more quarters of abysmally low short rates to begin to throw cold water in the face of bond investors used to a Caesar Salad and near double-digit annual total returns. In the meantime, Treasury yields could stay at overvalued levels, reflecting not only disbelief in the ability of the Fed and the Congress to reflate, but the remarkably attractive "carry" during this sleepy time period of hibernation. With money market funds yielding less than 1%, a 4% Treasury undoubtedly has considerable appeal to some investors despite its downside price risk.

There is a second reason to suspect continued overvaluation in U.S. Treasuries. If current reflationary tactics do not gain traction, if 1¼% Fed funds and \$300+ billion deficits do not sustain a satisfactory growth rate in nominal GDP, then Fed Governor Bernanke has hinted at using additional weapons in the Fed's arsenal. While those extraordinary measures are numerous, the bulk of Bernanke's "promises" center on the purchase of 1-year to perhaps 3-year Treasuries in order to "guarantee" a minimum return for holders over a future period of time. In the process, the Fed would presumably

inject liquidity sufficient to reflate the economy. These tactics, which involve capping yields, at first blush appear to offer investors few favors, but the implicit promise of price stability allows for an extension of risk further out on the yield curve which would serve to limit the downside price risk of 10 to 30-year Treasuries as well. In addition, the mortgage market would continue to thrive, refis and equity takeouts would stimulate consumer spending, and the housing bubble, if real, would be granted a stay of execution. And if for some reason, 30-year fixed rate mortgage yields did not decline, Bernanke has hinted at the possibility of outright purchases of GNMA's, which would accomplish the same thing. Like the movement of U.S. troops to the borders of Iraq in anticipation of an early March invasion, the Fed and the Treasury may have begun preparation to do just that in the GNMA market. The messiness of purchasing thousands upon thousands of small GNMA pools has been reduced by GNMA's recent lowering of the cost of what are known as "platinum" or mega-sized mortgage pools. The Fed, with just slight exaggeration, could now buy one trillion dollars of GNMA's and have but one accounting entry per month. Bernanke's war may not be imminent but the logistics are falling into place.

Typically, inflation is the primary driver of bond yields, and when the word "reflation" begins to characterize the outlooks of bond managers such as PIMCO, investors tend to fear the worst. I suspect however, a delay of bond market Armageddon until the U.S. and perhaps even the global economy regains sufficient traction to grow on its own – without the benefit of extraordinarily low interest rates or Bernanke's troops in reserve. A run on the dollar is perhaps the only substantial fly in this scenario's ointment. While total returns should approximate only a bond's coupon in 2003 (4-5%), the imminent demise of bonds just as investors are beginning to love them, has been exaggerated. I still prefer an overvalued Treasury to an overvalued stock.

And so the Hours go ticking by: Hours to our individual deaths – Hours to the demise of a country's soul – Hours before our financial markets may be employed in a high stakes game of Bernanke poker. Like Virginia Woolf, I wish to remember where we came from. For now, I can at least remember where we have been, but a few years hence, a new world order filled with fresh, more virulent memories may mask the contentment of my first 58 years.

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