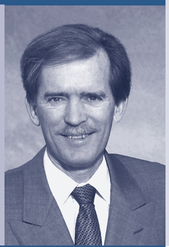


Bill
Gross

Investment Outlook

PIMCO

April 2002

Brandies

Well now, who in their right mind would have thought that this could happen? Just two days after web-siting the 321st *Investment Outlook* of my ignominious writing career, I finally got what I had been secretly coveting all along. I was labeled by three entirely different sources in the financial press as 1) a bond geek, 2) the financial world's equivalent of Britney Spears (along with a request to not bare my midriff) and 3) a heinous knockoff of Joseph McCarthy. Uh, let's see, will the real Bill Gross please standup? I guess I'll be the bond geek, except geekiness implies a certain level of intelligence that I've never really possessed. Mensa is beyond my reach I'm afraid, especially at 57 after having lost half of my brain cells. So I guess I'll just be a bond guy, go home at 5pm, kiss my wife hello, and write *Investment Outlooks* at night that sometimes express an opinion or two. Sure these IO's are well thought out, and yes, there is a certain amount of responsibility that goes with my treasured station in the financial world, but Britney Spears? Nah, this stuff's just printed on paper, not gold leaf. I do thank you though for being interested enough to peruse these monthlies. What's an actor without an audience; what's an author without a reader? I'm a lucky guy for having you. Still, I hope you know that I put my pants on one leg at a time just like everybody else.

The aftermath of the GE thing reminded me of my teenage years when I used to hunt for golf balls on the links rolling through the hills of Los Altos, California. My dad was a golfer and would pay me 50 cents each for what he called a "brandie," which meant in those days any ball without a two-inch gash in its side. Brandies were most easily found on the thirteenth hole, a short but devilishly difficult par four that was bordered by a near stagnant creek that could suck up a golf ball faster than Davy Jones locker could swallow a ship. That creek paid for my first car as well as a $29.95 paint job at Earl Scheib, but I digress somewhat. The point of the tale is that I learned a life's lesson on that 13th hole – which was to not let the excitement of the moment blind me to even greater opportunities around the corner. You see, my initial tendency was to run straight to that ball in the creek, get it into my pocket just as fast as I could, and start counting the quarters my dad was gonna have to shell out. What I soon realized though, was that the ball wasn't going anywhere, anytime soon. It would be there if I sat down to a basket lunch; it would be there if I took a nap and woke up 30 minutes later. Rushing to the ball with eyes fixated on the creek, then, might be costing me the potential discovery of another one lying just to my right that was hidden in the tall grass. So I devised a new routine that permitted heart thumping excitement when spying a brandie, but directed my eyes everywhere but at the creek immediately thereafter. Davy Jones (not Bobby) had already swallowed its prey and it would be there when I was ready. The focus of the moment was to be on what else I could find along the way.

Cut to the PIMCO trading room over forty years later as I and my associates fine-tuned our ears to the TV audio offering GE CEO Jeffrey Immelt's rebuttal to the furor of the past few days. My heart was thumping just like during those days of brandie hunting, and brandie finding. What's he gonna say about me, is he gonna "dis" PIMCO, was of course my immediate concern. That was the golf ball in the creek, the priority of the moment. But, then I began to look around or in this case, listen up for some new information that might be helpful; something that might put some quarters in our clients' pockets at some future date. And lo and behold, there in the grass just to the right of my black high-top Converse sneaker of four decades past was another brandie.

Now this brandie, dear readers, is not some new revelation, nor should it sink GE's stock another two points. Besides, this whole affair was never a "GE" thing to me, it was a Corporate America thing. We never lost money on GE bonds, but I just thought it was time to chip in a little, to add to the efforts of icons such as Peter Bernstein, Warren Buffett, John Bogle and new pioneers such as The New York Times' Gretchen Morgenson (recent winner of a Pulitzer Prize for Journalism) in their attempts to get corporations to hit the accounting and disclosure ball down the fairway instead of into that stagnant creek. Mr. Immelt actually seemed like a pretty nice guy – dressed in that Jimmy Carter sweater and all. But in addition to sticking up for his company and not "dissing" PIMCO, he said the following: "And so while, you know, a move into long-term debt will increase our funding costs slightly,...it has nothing to do with the spread between commercial paper and long-term debt because we swap into matching funds. So you know the incremental cost is de minimus." De minimus? How could moving $11 billion from 1 3/4% commercial paper to 6 1/2% debt be "de minimus?" At first blush, it appears to be an annual increase in interest expense of about $500 million dollars, which as Everett Dirksen might have said is "real money." But Immelt could be right if in fact they "swap" that long-term debt back into short-term floating rate paper - but only he and his Treasurer know that. This stuff is complicated folks, so I will go no further down this "swappy" trail other than to say that GE's actual increase in interest expense might temporarily be limited to say $70 or 80 million not

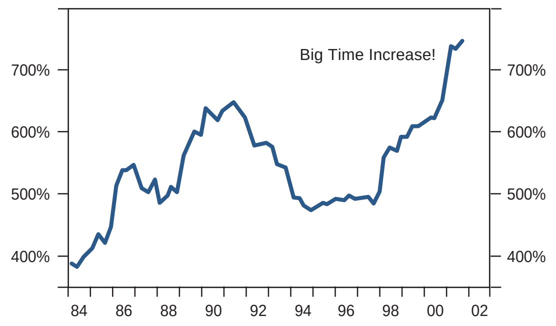
$500 million – if in fact they're using interest rate swaps.

And that is where I came upon what might be another brandie – and this too is where I shall leave the GE saga and move on to the broader context of Corporate America which is what I intended to do in the first place. The fresh idea (although it's been lying in the grass for years now) was that if lots of corporations were doing the same thing, then the short-term Fed Funds rate is driving the economy. Now that of course is no brilliant observation, it has been thus for eight decades or so with a temporary disconnect in the 1940s for wartime finance. But when a creation of the last 10 years – the interest rate swap – makes it possible for Corporate America to term out their debt and still pay near commercial paper rates, then that's a revelation – or better yet, a revolution. It means that short-term rates are even more critical to the profitability of Corporate America - to the level of the stock market - to the growth rate of the American economy than ever before. It means that Alan Greenspan dare not raise interest rates too much or risk sinking the stock market and the economy once again; it means that because his ability to raise short rates is limited, that ultimately inflation may be higher than it otherwise would be in a still near deflationary world; it means that bond investors should do certain things and not do others. And that, dear readers, is a bagful of brandies – not in the creek, but lying half-hidden in the tall grass.

Explain please. Well, explanations should include proof but when it comes to the interest rate swap/derivatives market, the evidence is nearly impossible to come by. According to recent data by the Bank for International Settlements (BIS), worldwide swaps outstanding (mainly U.S.) total over $43 trillion. That's a hunk-a-hunk of love folks: love for derivatives that in the corporations' case may serve to reduce interest rate costs in the short run, but increase exposure/risk in the long run. Try finding these swaps detailed by amount and purpose in a 10K or annual report though. Even Sherlock Holmes couldn't find something that wasn't there.

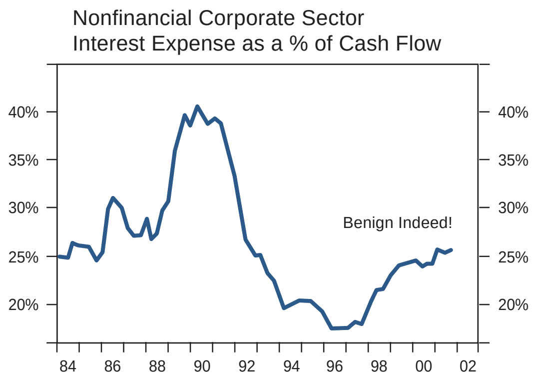
So I sleuthed in a different way. The following two charts show nonfinancial corporate debt and nonfinancial corporate interest expense – both as a function of annual corporate cash flow. It seems reasonable to me that if recent debt levels have risen to record highs

Nonfinancial Corporate Sector
Debt as a % of Cash Flow



Source: The Bank Credit Analyst

while interest expense remains well below 1990 peaks,



Source: The Bank Credit Analyst

then corporations have got to be loaded with lots of short-term debt exposure even as they supposedly "term out" their commercial paper. Short rates have dropped from 8% to 2% since 1990 while long rates have only declined 200 basis or so. The dampening influence which permits corporate interest expense as a percentage of cash flow to appear so benign in Chart 2 has got to have come from lower short, not long rates, which in turn have resulted from large amounts of commercial paper/bank debt/ or – which is the hidden link - long-term debt "swapped" back into floating. Corporate interest expense truly does appear to be "de minimus" and probably because of swapped liabilities into the front-end of the yield curve.

De minimus is as de minimus does, or better yet, de minimus is as long as short rates stay low. But corporations, which load up on the short side with visible CP, bank debt, or invisible swap lines, are truly taking an open-ended risk of loss. Swaps hold no magic really – if short rates move up, one side loses while the other gets paid and if corporations with short-term liabilities are on the losing side of that trade then profits, the stock market, and the economy all feel it when the Fed marches upward. An increase of 175 basis points in short rates from 1999 to the fourth quarter of 2000 was a factor in causing a mild recession in 2001. Does Greenspan dare do more in this next tightening cycle? Nay – he will do less once the 9/11 emergency reductions have been taken back to a more normal 3% or so. Too many big time "players" on the short side. The systemic risk is certainly anything but de minimus.

And because Greenspan must keep short rates relatively low, the risk of inflation in future years will be greater than otherwise, the yield curve will remain more positively sloped than otherwise, and the dollar will ultimately be weaker than otherwise. Bond investors should therefore continue to emphasize the front-end of the yield curve, avoid long-term bonds and keep durations close to index levels. As explained in the January *Investment Outlook*, the bond bull market is over and "spread" strategies employing mortgage, corporate and emerging market debt should dominate near term. These are the brandies of the moment. Intelligent investors will know how to cash them in, but the price these days has moved far beyond the fifty cents standard of my vanished youth.

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Each sector of the bond market entails some risk. Treasuries & Government Bonds guarantee 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. CP is short-term unsecured debt, issued primarily by corporations, with a maximum maturity of 270 days and is subject to the risk of the issuer's inability to meet principal and interest payments.

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