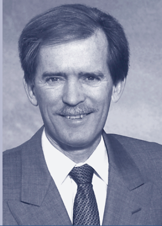

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Gross

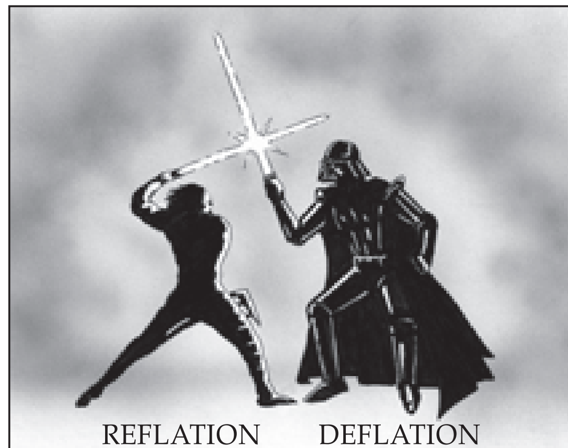
Investment Outlook

PIMCO

May/June 2002

Episode II

I'm not above pulling a "Milton Berle" and stealing a good idea or two – especially if it's from myself. Fact is, this cartoon highlighted my review of PIMCO's 1999 *Secular Forum*. George Lucas was coming to market with the second trilogy in the Star Wars series; and the battle between good/evil, Luke Skywalker/Darth Vader, and reflation/deflation all seemed to meld into one simple picture posing one giant dilemma: would the global economy sink into Japanese-style deflation or would "asset" – aka "stock market"-inflation propel it forward into a New Age. Well three years hence, we've answered both alternatives in the negative, but Mr. Lucas is back for another round aptly titled Episode II, and darn if Luke and Darth as well as reflation/deflation aren't still going at it, to say nothing of good and evil. Timeless I suppose. That the themes fascinate us should come as no surprise. The fragile fortunes of the bond market (and other markets as well) depend upon the secular undulations of prices – almost always up in recent decades, but over the long course of history, downward too. So like Mr. Lucas, we thought it apropos to bring the topic front and center for another analysis – a "Second Episode" – and if there be an attack of economic-like "clones" then so be it. The fact is, investors over the past 5 – maybe 10 – years or so have gotten quite comfy with the notion of 2% or so inflation; higher at the peak of recoveries, lower towards the end of recessions but nothing that would really fall into either the reflationary or deflationary camps. "Whichever one triumphs," I wrote back in 1999, "we should know the winner within a few years. Goldilocks and Butler Creek (PIMCO's term for a mild inflationary economy) are approaching old age." Well, the standoff continues, but there may be changes ahead. Let's take a look at this Second Episode, fresh from last week's Secular



Forum discussion which included the likes of legendary thinkers Peter Bernstein and Henry Kaufman, relative newcomer on the block Stephen King, as well as a myriad of global-minded PIMCO participants.

Historical Secular Summary

Having introduced Peter Bernstein, an author more noted for his commentary on risk than secular economic trends, let's lead off with a paragraph from his Economics and Portfolio Strategy summarizing his thoughts in 1999 that closely mirrored our own "Star Wars" concerns:

> *"We then identified those (dominant secular) forces as 'the extended and persistent patterns of disinflation, deregulation, intense competition, and a shrinking share of government in GDP. The global character of the economic environment has contributed to its durability and suggests that (these forces) are not going to be easily dislodged..."*

Now for his update, written pre 9/11 in early 2001:

> *"Every one of these forces is now on the defensive, exacerbated by spreading international frictions and questions about the quality of American world leadership,...a looming energy crisis, and the apparent end of health care disinflation."*

We couldn't have said it much better ourselves, which is why I suppose, I just let Peter do it. I will however resummarize the dilemma - adding a little PIMCO flavor along the way.

Since the fall of the Iron Curtain in the late 1980s and until 2001, the global economy (and the U.S. in particular) experienced a period of sustained disinflationary prosperity based upon the following:

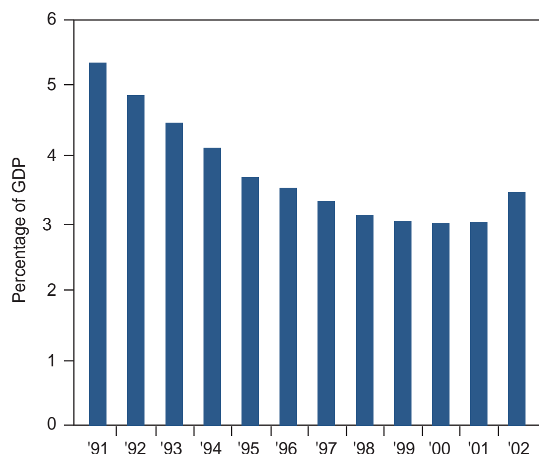
1) Globalization – Globalization has induced competition, limited pricing power, and promoted a strong dollar as the primary beneficiary of cheap emerging market labor.
2) Technology/Innovation – Led by the Internet mania, the 1990s promoted a rarely seen surge in investment and related equity market prices. Productivity may have moved slightly higher but corporate profits did not directly benefit – the consumer did via lower prices. It was, as we headlined last year, the New Age Economy's "Weakest Link" but disinflationary nonetheless.
3) Shrinking Government/Defense Expenditures – With the Cold War gone and capital gains on the rise, the private sector surged while citizens and Presidents questioned the need for big government. Supply-side economics reigned supreme, inflation melted away.
4) Favorable Demographics – The ascendancy and maturation of the

boomers in their quest for early/ comfortable retirement, fed 401(k)s, markets, and a wealth effect unparalleled since the roaring '20s.

5) Financial Engineering – Technology, innovation, and the greed for Wall Street investment banking profits revolutionized finance, transferred control of money creation from the Fed to private/ semi-private entities and in the process, lowered the cost of credit to almost every U.S. homeowner while creating a corporate and consumer debt bubble in the process.

The Peace Dividend?

U.S. Defense Outlays as a % of GDP



Source: Congressional Budget Office

Together, these five secular forces form/formed the foundation of our New Age Economy, now partially discredited by 2001's recession and equity market hangover, but by no means dead and buried, especially with regards to their disinflationary/deflation effects on prices and interest rates. And as Bernstein questioned last year, we in turn put it to our other guest speakers and the PIMCO Forum – Are these disinflationary forces on the defensive? Have we reached an inflection point from which deflation or reflation will dominate? Is this the beginning of a Second Episode representing demonstrable change?

Current Outlook

Our answer was YES. Over the past twelve months, there have been changes in secular forces so obvious that it will be difficult to elaborate on all of them here without losing your focused attention. September 11th and its myriad of ramifications comes immediately to the forefront, but it unfortunately must share the limelight with ENRONITIS and what PIMCO's own Chris Dialynas labeled "fiduciary enlightenment" which encompasses Andersen, GE/corporate disclosure, and potential changes in SEC and FASB regulations. Because of ENRON and its aftermath, reregulation instead of deregulation now seems to be gaining the upper hand. To that must be added the quick and unexpected reversal in the Federal fiscal surpluses into three-figured deficits, and increased moves towards protectionism ushered in by U.S. tariffs on foreign steel and Canadian lumber, as well as the entry of China to the WTO with potentially deflationary impact in the opposite direction. To ice this secular cake, how about the high probability that we will

experience additional domestic terrorist attacks and the perhaps 50/50 odds for an invasion of Iraq over the next 12-18 months. See what I mean? Talk about a Second Episode! This is a first-rate secular blockbuster in its own right, an instance where the sequel stands to rank right up there with the original screenplay.

As with any movie however, the characters do not all wear the same colored hats – and that is the case with the aforementioned secular changes. What we called the "China card," for instance, might visually resemble a face card, but in this tale a "Jedi" not a Jack with a very large deflationary sword at its side. Guest speakers Jonathan Spence and Andy Xie forecasted that over the next 5+ years, China will become the largest exporter in the world – upwards of one trillion dollars – and that their goods will remain cheap if only because of the 300 million agricultural workers that may migrate from farm to factory over the next decade or so. The China card will keep a lid on prices for globally manufactured goods for years on end if trade wars and tariff increases can be avoided.

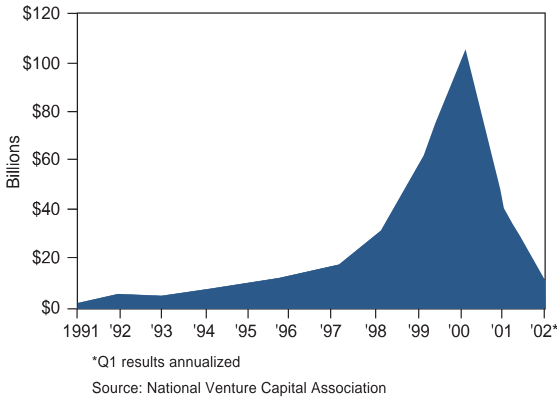
But almost all of the other secular cards fall into the reflationary, as opposed to the deflation camp. Their "Jedis" bear the swords of potential inflation. September 11th, domestic terrorism, a potential Iraqi invasion, and the upward reversal in defense expenditures as a percentage of GDP are perhaps the easiest to agree upon. War, or preparation for war, is inflationary – always has been, always will be.

The "fiduciary enlightenment" card is a little bit harder to categorize but becomes easier when it is melded into an observation on the overall reversal of public attitudes towards control of our economy – from the trust in the infinite beneficence of capitalism, to the reliance on the more protective benevolence of government. With ENRON, the Dot.com and telecom busts, the failure of the "markets" to rally substantially off their recessionary bottoms, and the ongoing reverberations from the 1990's corporate debt overhang (evidenced by headline bankruptcies and last minute terming out of commercial paper), U.S. citizens and in fact global stock and bond holders are becoming a lot less confident in the American model of laissez-faire capitalism. While reregulation may eventually restore order to the asylum over the next several years, the net result of the growing suspicions will be an increasing cost of capital for U.S. corporations: lower stock prices than at previous peaks; wider bond spreads than at the ridiculously narrow margins of several years past; more long-term debt that is two or three times more expensive than three month commercial paper, to say nothing of the magnified cost of venture capital and business start-ups. When the cost of finance goes up for a finance-based economy such

as the U.S., then so do prices to the eventual consumer.

Venture Capital Dries Up, Cost of Capital Goes Up

Inflows into venture capital funds



*Q1 results annualized

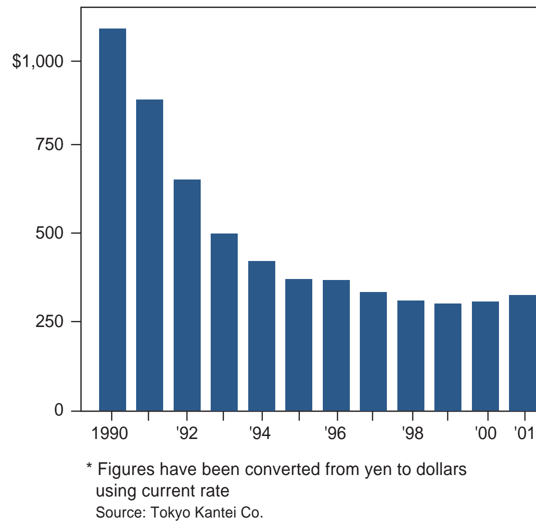
Source: National Venture Capital Association

Another inflationary card in the global economic deck bears the image of G3 central bankers standing right behind Luke Skywalker and acting in unison to save the world from deflation. They do this by putting interest rates down to near 0% levels and keeping them there for what seems like an inordinate amount of time. This is not a PIMCO forecast for Greenspan and the ECB to mimic The Bank of Japan – they don't have to do anything more than they've done already – but it is a recognition that central bankers understand that the battle against inflation has been won and that a little bit of mild inflationary pressure might actually do this system - characterized by low pricing power and too much debt – a little good. After all, think of the obvious – how does a government ease its way out of a debt crisis? By eroding the real value of debt with a bit of unanticipated inflation; by cheapening its currency; by bolstering nominal corporate profits; by levering up the public sector (federal deficits) and in so doing delevering the relative debt of the private sector. Bingo.

The fact is that every G3 central bank – and there are only three – has seen the specter of Japanese 1990's style deflation, and will make all efforts to avoid a replay. The invigorated monetary ease of the Japanese over the past year or so is evidence of that; as is the stabilization of their property market deflation in Tokyo as shown in the following chart.

Leveling Off

Average per-unit sale price of existing condos in central Tokyo, in thousands of U.S. dollars.*



* Figures have been converted from yen to dollars using current rate

Source: Tokyo Kantei Co.

While the ECB has been the mildest mannered and most conservative of the three, the near inevitable and almost immediate inclusion of a host of Central European countries into the Eurozone will require the ECB's inflation target to move higher if only because Poland, Hungary, and the Czech Republic have

higher inflation rates themselves. This will be a disguised form of monetary ease.

In sum, the secular evidence falls significantly in the reflationary camp symbolized in our cartoon by Luke Skywalker. China and Darth Vader's deflation are formidable foes, but movie goers and global citizens love to see the good guy win and so it should be this time, at least for the next 3-5 years. While the global recovery will be anemic by historical standards, a recovery it will be, and that will at least buy the financial system some more time. Still, there will be negative consequences over the same period from this superficially successful reflationary Episode II. Although inflation itself should be contained at 3-4% levels, new bubbles, particularly in housing, are a distinct possibility. Lengthy periods of low, short-term interest rates are an inducement to lever and take risk that may or may not bear fruit. We and others see potential bubble risk in housing prices, and the growing dominance of the GSE's. We see risk in the increasing use of hedge funds to stretch returns in what is really only a 6-7% asset return environment. We see the risk of a U.S. current account deficit "unwind" from near historic levels, which may be precipitated by a more than gradual decline in the dollar. This reflationary world of Luke Skywalker is by no means a safe and secure one economically, to say nothing of the increasing risk to life itself. It has morphed through the years from an economy primarily based on production, to one substantially reliant on growth via debt and new derivative life forms. We now live in an age of paper, and this paper maché facade is not a permanent nor lasting one.

Investment Policy

How should one invest in such an environment? First and foremost, reflationary economies are rarely the bond market's friend. Although inflation should stop at 4% at the peak of our next cyclical upturn, current long bond yields do not reflect this risk. We may see 6½% long Treasury yields or more before we are done, but remember this is a 3-5 year forecast so bond price erosion should be mild and barely resemble a "bear" market. Still, PIMCO durations should be at index or shorter over most of the time period with a recognition that "carry" and "rolldown" are potent mathematical constructs during periods of sharply positive yield curves. Barbell strategies, dear reader, fall into Darth Vader's camp, not Luke Skywalker's, and Luke prefers "bullets" for that Star Wars gun of his. We must be cognizant as well of the risk that a significant decline in the dollar leads to a withdrawal of foreign investment in Treasury and corporate holdings. Reduced durations and front-end strategies are an excellent hedge for that possibility, assuming the Fed doesn't rise to the challenge and defend the dollar via rate hikes instead of the more likely O'Neill-style rhetoric. And potential financial accidents ala LTCM

in 1998 are of course a significant possibility in such a levered-up, finance dependent economy.

Speaking of the dollar, should it decline (as we think it will) by over 10% during the forecast period due to 1) its current purchasing power mispricing, 2) the inevitability of a current account deficit reversal, and 3) the shaken faith in U.S. stock market dominance, then international/non-dollar denominated bonds should do relatively well. As of this writing, they yield almost exactly what U.S. Treasuries do and should therefore benefit from their relatively lower (strong currency induced) inflation as well as financial flow reversals when foreign investors return to their own markets.

Lastly, in terms of macro secular bond strategies, the next few years should be an attractive period for "safe" spread products. That critical adjective, of course, opens up a piece of the galaxy so wide that you could steer a starship "freighter" through it. "Safe" these days means companies that will not only remain solvent, but will not be subject to SEC investigations or overnight ratings downgrades by the major rating agencies. Hard to find. Nonetheless, on-site credit research, and an investor's sense of value can hopefully help ferret out the good guys from the Darth Vaders of the bond universe. We shall see. Due to wide current spreads we recommend an average index weighting of corporate bonds for now but remain cautious of the sector long term, due to the ongoing rapidity of technological change which produces too many "black hole" losers when compared to "par at maturity" winners. Mortgages will continue to fulfill the "safe" spread dictum as will emerging market bonds of the highest caliber.

Farewell

And as we wrap-up our rendition of the Episode II, we readily acknowledge that there will be a Third, Fourth, and an Umpteenth Episode if God in his wisdom will permit. That's the movies folks, and so it is with life, economies and investing as well. Cycle after cycle, cycle within cycle, an enormous spiraled galaxy of moments, strategies, and secular dialogue leading to what hopefully results in stellar performance within a universe of star-like managers – some of them Novas, some of them Dwarfs, but all trying to capture your eye and ultimately, of course, your confidence. We hope to be your North Star for years to come, an object so visible and constant in the sky that you can steer by us, as well as sleep soundly under the illuminated nighttime sky. Until next year when we meet again, may the Force be with you, and with us as well.

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