I’ve often heard that “form follows function” and “art imitates life” but while that may be true, I’ve never found a way to make money from it. Maybe I could have invented the beanbag chair for couch potatoes, or taken a brush to palate in an attempt to replicate Jasper Johns, but I didn’t, or couldn’t and most assuredly won’t, so those dollars never showed up. Still I think I have discovered a third and equally melodious euphemism that nearly guarantees a fast buck or two for anyone willing to believe. All of us at PIMCO, in fact, have already done so, and so, too, have you dear client, without, I suppose, ever having known it. There are more bucks, believe me, in this euphemism than in all the “.coms” combined and it reads as follows: “movies predict the economy.” Now before you send us our thirty-day pink slip, let me remind you of the initial Star Wars trilogy and how it subsequently led to the Reagan defense buildup of the 1980’s, the ascendancy of the dollar and budget deficits more massive than the Milky Way. Right, right? Aren’t I on to something here? And didn’t PIMCO’s two previous Secular Forums in May of 1997 and ‘98 take the themes of the Hollywood blockbusters Titanic and Godzilla and parlay them into our current Morningstar Portfolio Managers of the Year Award? Sure we did. Before we even began our Secular debates we plunked ourselves down in front of that silver screen, saw those icebergs and giant lizards and knew something horrific was gonna happen: government bonds were the obvious answer. Too bad Long Term Capital Management didn’t put flicks into their computer models, but PIMCO has for many years. And with that frank, honest, and perhaps Nobel Prize winning self-serving and obviously fallacious admission, let me introduce PIMCO’s most recent secular forecast, a forecast made during three days of camping out in front of the theater intensive discussions, a forecast assisted by the likes of guest speakers Steven Spielberg and George Lucas, Stephen Roach, Fred Bergsten, and Marc Faber, and a forecast...
that should last at least until July 4th when the next piece of garbage is introduced for the next 3-5 years. The theme and therefore the forecast for our global economy and financial markets is none other than - The Phantom Menace.

Of course you already knew that by looking at the cartoon or perhaps brilliantly reading the title. We knew it, too, though, all 85 PIMCO professionals strong, before we even started our discussions; it was you see, the only flick to choose from. How can you forecast the economy with the likes of Shakespeare In Love? No way. Not this economy anyway. So we were stuck with The Phantom Menace and it was our job to get out of the 11:00am matinee and hightail it back to work before the market closed to interpret just what that menace was and to decide if in fact it truly was a phantom.

Secular Review

To do that we first saw 5 or 6 previews of coming attractions reviewed where we’d been for the past several years and the picture wasn’t especially pretty for much of the global economy. Prior to June of 1997, the world had moved progressively and dynamically in the direction of free trade and worldwide competition. Rapid economic growth, increasing productivity, and consistent disinflation produced a “Goldilocks/Butler Creek” environment that led to prosperity in most global financial markets, especially those in the United States. But then Thailand, South Korea, and ultimately default in Russia hit the radar screens, and risk markets collapsed with them: only U.S. Treasuries prospered during the long Autumn of 1998. What had really occurred, despite the pinpointing of, and nit-picking on individual foreign economies was a financial panic initiated and fed by the over-exuberance of capitalism itself - an oversupply of goods and services inappropriately financed with too much short term debt. Structural imbalances (crony capitalism, cartelish chaebols, etc.) contributed to the mess, but the world simply had produced too many things. When their bankers and the hedge funds pulled the plug, those countries closest to insolvency had a devaluation-led fire-sale while holding out their hand to the IMF and others at the same time. The world of May 1999, however, seems a better, less risky place as rationale and reason or perhaps just hibernating greed has returned to the marketplace. Asia is on the mend, the U.S. never caught the fever, the inflationary consequences of Brazil’s devaluation are being contained, and America Online is finally making a profit. What’s to worry? Where be the phantoms, or if they’re out there, are they particularly menacing?

What’s New

PIMCO’S answer, dear reader, is that Darth Vader or Darth Maul or whoever, is more than just a figment of George Lucas’ imagination. Despite George Soros’ and Bob Rubin’s proclamation that our global crisis is conveniently and tidily now “over,” we believe the world is still a riskier place than it was in the mid-90’s but less risky than late last year. That’s not to conclude that the forces of evil are about to overwhelm the planet and create a global recession, but it does say that its recovery will be gradual at best and that the next few years will be fraught with that now familiar term called “volatility.”

The world is still full of “menaces” for several reasons. First of all, the dynamic of global capitalism is by its inherent nature risk-producing and therefore periodically menacing. Joseph Schumpeter’s process of “creative de-
struction” is alive and well as we approach the millennium, and the periodic over and underreach of capitalism will undoubtedly be with us during our Secular time frame. Guest speaker Marc Faber suggested that risks have increased not just because of systemic dangers emanating from global capitalism, but because of the rate of change of the global economy itself. Technological changes in transportation, telecommunications, etc. all entail additional risks to capital holders because of the rapidity of change and therefore obsolescence. And too, as Morgan Stanley Dean Witter’s Stephen Roach suggested, developing markets have small “capitalizations” relative to their more advanced competitors, and are not able to intermediate funds as efficiently. This produces currency and other market bubbles which were symptomatic of the Asian and Brazilian crises and which will pop up again, perhaps in Argentina, China, or again in some other country that took part in the first debacle. The world is also menacing because the policy responses of governments and global agencies such as the IMF are oftentimes tardy and frequently self-defeating. If governments have learned any lesson from the last go around, I’m not sure what it is - save for editors splashing the picture of Greenspan, Rubin and Summers on the cover of Time Magazine and prematurely congratulating all three on their efforts to save the world.

Despite these hazards, the global economy is a safer place than it was six months ago for several reasons. The October 1998/Long Term Capital Management crisis has squeezed some of the previous financial leverage out of the system or at least redistributed it. How much is hard to know, but one sign is that the cost of capital to proprietary trading desks is still relatively expensive and another is that monetary regulators such as our Fed and the Hong Kong Monetary Authority are exercising increasing scrutiny on bank balance sheet and activities of hedge funds. Still, the world’s financial leverage remains substantial as stock market capitalizations as a percentage of GDP reach record highs, U.S. home loan-to-equity ratios skyrocket, and domestic savings rates approach zero. We are therefore less levered, but not by much.

In addition, the global lack of liquidity has been alleviated by something close to 300 separate central bank easings around the world during the past six months. Lower interest rates can in most cyclical environments provide the fuel for recovery not only for investors’ confidence but for economic growth itself. And lower yields we have, not only in G7 nations but dramatically in Pacific Rim economies as well, as shown in the two charts below.
These lower interest rates, however, while stabilizing the current economic environment, may not be enough to promote a return to the more vigorous growth rates required for a “Phantom Menaceless” world. The globe is awash with what economists call “structural rigidities” which inhibit a proper balance of supply and demand, and these rigidities typically take years if not decades to shrink to reasonable proportions. Europe, for instance, has wage and employment rigidities which inhibit the assimilation of new technologies into their economies. Downsizing trends which have increased productivity in the United States are underway now in Europe but their impact will be muted until European governments can clear the way for labor and welfare-oriented policies to become substantially less inhibiting.

High savings rates in Asia are another example of structural impediments to increasing demand. Initiated in Japan as a response to WWII reconstruction mandates from the United States, this “save to the grave” mentality is partially responsible for Japan’s current “liquidity trap” recession that will not end. Its Asian neighbors caught the same disease long ago and all of them as a block continue to emphasize exports as opposed to what Rubin characterizes as “domestic led” consumption, a euphemism in turn for “start spending money.” Such structurally embedded savings rates are themselves exacerbated by demographics that steer Asian, European, and eventually even U.S. citizens in the direction of putting money into mattresses or markets instead of things. In combination, these structural rigidities are a significant impediment to robust global growth despite monetary or fiscal policies that attempt to counter the downward cycle.

It is also becoming painfully apparent that the ability of global governments (ex the United States) to stimulate their own economies with such policies is approaching a level of impotence that may require a radical Viagra-like solution such as the one advocated by MIT economist Paul Krugman towards Japan. 0% interest rates there have lost their ability to stimulate unless accompanied perhaps by Krugman’s rocket-fueled money supply policy proposal. And with budget deficits exceeding 10% of GDP annually, Japan can afford only a few more years of fiscal stimulation until the rest of the world trashes its currency or bonds or perhaps both. Europe is hamstrung, too, by the mandates of the Maastricht Treaty which restrict deficit levels, and is beginning to mimic Japan with its closer and closer-to-zero interest rates. Only in the U.S. is there room on both fiscal and monetary fronts to ease substantially, but our trade deficit points to trouble should we need to. Our dollar, stock market, and long-term interest rates might not digest such changes as quietly and smoothly as some now expect.

The willing endorsement, and potency of global monetary and fiscal stimulation, therefore, is very much in doubt as a prospective stabilizing force in future crises. There is strong evidence in Japan, for instance, that lowering their interest rates from 8% in the early 90’s to ½% in 1999, led to consumption going down, not up - their savings rate for instance jumped from 12 to 20% plus in order to compensate for lower amounts of interest income. In an Alice in Wonderland way, it might also be possible that lower global interest rates, instead of stimulating consumption, might perversely be adding to the capacity glut which started the crisis in the first place. Overcapacity is symptomatic of monetary easing because lower yields reduce return on investment thresholds which lead to more and more investment, thus increasing supplies of goods and services.
The only short term prop to global consumption appears to be the financial markets themselves as the temporary wealth effect allows stockholders to transform portions of their paper profits into increasing amounts of high-end consumer products. Such adrenaline has worked marvelously well in the United States and goes a long way to explain our economic strength versus the fragility of that in Asia and Europe. This 1990’s phenomena has led to the staggering proposition that the real economy does not determine the level of today’s financial markets but vice versa. It is no wonder that ex-Fed chairman Paul Volcker recently said that the health of the U.S. economy depends on the price of the S&P 500, and that in turn depends on the fortunes of its 50 largest-cap stocks.

There are bubbles and menacing phantoms aplenty in the global economy, from 0% Japanese interest rates, to structural rigidities, to an 11,000 Dow, most of which lead to an imbalance of global supply and demand that promotes deflationary global conditions and reflationary markets and institutional policies. It’s hard to judge the winner between these two menaces over the next few years. Deflationary conditions still have considerable momentum worldwide and the potency of monetary and fiscal policy is waning. Yet reflation is a possibility as well because as long as the markets stay strong, it’s difficult to imagine a collapse in final demand and that demand may in turn raise inflation. An answer is, I suppose, that we wait to see what happens, all the while recognizing the danger of bubbles approaching what inevitably must be a climactic stage. While consumer price inflation has long been recognized as a persistent and insidious menace because it can erode the value of a currency and national savings over time, asset price inflation taking the form of a bubble is by far a more dangerous phantom. The danger exists in the bubble popping, as we’ve seen over the past five years in Japan, and with the inability of policy responses to redirect an economy once real interest rates reach zero and can go down no further. So while PIMCO may be walking a temporary fence as to the inevitable conclusion of this blockbuster movie, make no mistake as to the preferable conclusion. The menace of 3-4% inflation pales in comparison to the ferocity of the deflationary phantom. Whichever one triumphs, we should know the winner within a few years. Goldilocks and Butler Creek are approaching old age.

Investment Conclusions

Our interest rate forecast for long term U.S. Treasury bonds over the next 3 years is therefore as follows: 5-6 ½ % - but watch it. This range bound interest rate world depends importantly on the direction and level of the U.S. stock market and the effect of governmental policy responses to it. If stocks keep going up at 10% + a year, then a strong economy leads to Fed tightening and the top of our secular range at 6 ½ %. If they decline but don’t crash, then 5% should form the bottom of our secular range. But if they continue to go up at 20+% or plunge at the same rate or more, and if central bank policy responses are either too much, too little, too late, or simply impotent, then most bets are off and the range bound world is out. We shall have to see, we shall have to see. There are a lot of “ifs” there.

It is entirely possible, in fact more than 50% probable, that inflation remains low, the stock market cools off instead of popping, and that central bank and government policies continue their winning streaks. The “new” paradigm argument, after all, is one which PIMCO
has heartily endorsed long before new paradigms were even cool. The information revolution has led to an apparent smoothing of business cycles by minimizing inventory levels to name just one major benefit. Productivity may have shot up by ½ to 1% annually as we mentioned last year. All of this and more forms the basis for our 5-6½% interest rate and 2% inflationary U.S. and global economy forecast over the next few years. But the odds are increasing for alternative scenarios and reinvigorated phantoms.

This is obviously not a comfortable position from which to manage $160 billion but it is what you hired us for. We continue to welcome the responsibility and the challenge. Our job is to get out of those lines and into the theater as quickly as possible, to bypass the snack bar and start checking for phantoms before we even sit down. Wherever they may be, we hope to find enough of them to keep your portfolio above absolute and relative zero for years to come, because if you prosper we make more money too. Until next year when we decide enough already with these stupid movie analogies meet again, may the force be with you and with us as well.

William H. Gross
Managing Director