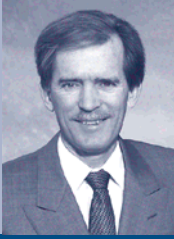


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Investment Outlook

P I M C O

August 2003

Hot Tips

Last month's *Outlook* entitled "Happiness Running" seems a little bit prescient and perhaps just a touch ironic at this very moment. With July having witnessed one of the sharpest bear markets in modern financial history, it may seem like a bond manager's happiness is not only running, but is galloping at flank speed straight out of Dodge City. With the fixed income bull market over, it's good to see the bond geeks back on the second page where they belong, I suppose. But wait! Some bond market good tidings have left the planet, but there's a booby prize of not insignificant proportions still to be won.

You see bond managers are the only capitalists who root for the price of their product to go down. I dare say you wouldn't catch the Board of General Motors clinking wine glasses to toast a newly announced \$500 discount for a Chevy Suburban. I betcha you wouldn't find Jeffrey Immelt with a huge grin on his face just after GE cut the price of a power turbine by \$200,000 a crack. But bond

managers are different. Ask them about the Fed reducing the price of money by 50/100/500 basis points and you'd think their team had just won the Super Bowl on a last second Hail Mary pass. They do this of course with just a smidgeon of logic and a complete void of long-term common sense. The logical part is that lowering interest rates raises bond prices – the longer the maturity the better. Hurray! But since the total market of bonds has an average maturity of around 5 years, their exuberance is short lived. A half a decade down the road, if yields remain low, then the earning power of their assets will be anemic as well. My point in all of this, of course, is that high interest rates, not low interest rates should be a bond managers' friend. We should root for the price of our product to go up not down, just like any other rational capitalist. Because while an increase temporarily depresses "total returns," in the long run the apparent booby prize is really a diamond in the rough, a silk purse not a sow's ear. So come on, take that frown and turn it upside down bondholders! Your future

earnings power has just increased by 150 basis points annually.

Do I really believe this? Of course I do, although the pain in getting to the promised land can be significant and it helps to shoot some low duration Novocain into your portfolio before prices plummet and clients howl in revulsion. But this Alice in Wonderland phenomenon is really a game between buyer and bond issuers when it comes to long-term and intermediate maturity bonds. If the buyer demands higher yields at the expense of repricing his existing portfolio then at least the sellers – corporations, governments, homeowners – will have to pick up a larger tab down the road. Money market securities, however, with maturities inside of 1 year are a different story. There's nothing the buyer can do with 30-day commercial paper because the price of this money is fixed – by the Federal Reserve. It is not a free market. And should the Fed choose to fix an interest rate so low that it is less than inflation, then holders of money market funds and overnight deposits will suffer mightily. Such is the case right now with Fed Funds at 1% and inflation at 2% - short-term yields are a negative 1% on a real, or inflation adjusted basis.

In last month's *Outlook*, on the first of my little "Crystal Harmony" notes to

myself, I mentioned that in a financed based economy with reflation as a stated goal, "the Fed must use all means, including 'ceilings' to keep the cost of financing low"...and that "the Fed's (goal) is to cap the returns of bondholders." They do this not by spooking the market ala this July and driving yields higher but by sweet-talking it and most importantly maintaining a negative or extremely low real short-term interest rate. It seems as of now that they have failed at the sweet talk but succeeded famously at reducing and maintaining low short-term interest rates. They can and probably will keep Fed Funds extraordinarily low for a long time – it is their primary reflationary weapon.

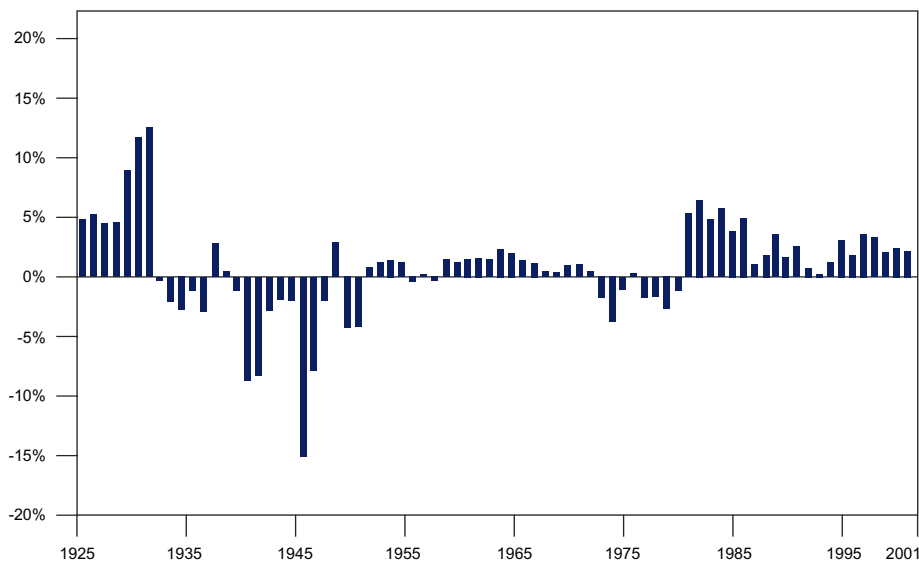
My point, however is that this environment is not a bondholder's friend. Not only do short-term money market and bondholders receive close to nothing in after-inflation or real terms, but the extended period of low real yields ultimately creates a reflationary environment which further erodes the prices of intermediate and long-term bonds. The Fed, in effect is double-teaming the bond market – first by keeping short rates low and second by forcing bond prices down via inflation. This assertion is aptly displayed in the two charts below, the first which displays a 75-year history of real short-term rates and the second

which shows the same time period for real total returns for intermediate government bonds.

As Chart 1 statistically depicts, real short rates were extremely low or even negative for a period of some 45 years from 1935 to 1980. Obviously money market or Treasury Bill holders were earning next to nothing (or less) on an inflation adjusted basis but Chart 2 tells a more frightening tale. Over the same time period – a stretch of nearly half a century – holders of intermediate maturity government bonds wound up with less money after inflation than they began with. Suckers! Those 50 years as you’ll recall included two major wars with enormous deficit spending and interest rate caps from

1939–1951 in order to help finance WWII. It was an extended period during which the Fed and government spending drained wealth on an inflation adjusted basis from banks, insurance companies, and individual savers, and relieved/reinvigorated industrial corporations. While the parallels are not perfect, today’s environment is strikingly similar. War, deficits, low real interest rates, and Bernanke-style threats to lower long-term bond yields would/will help to mend corporate America, reduce their onerous pension liabilities, and reflate away much of the accumulated debt burden of the past several decades, but it will do little for bond holders on an inflation adjusted basis. We thrive on higher rates – yes – but higher real

Chart 1 Annual Real Riskless Rates of Return



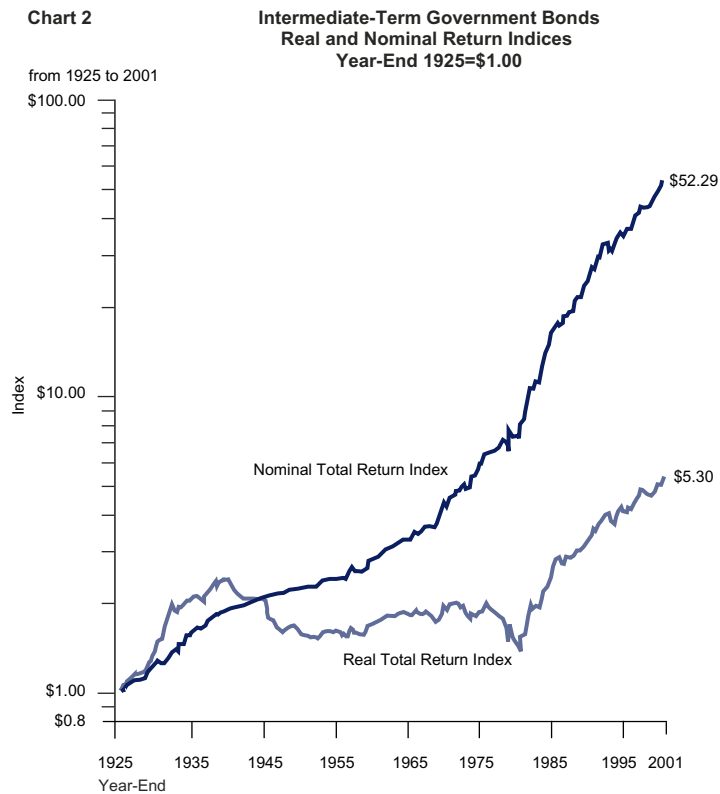
Source: Ibbotson Associates.

rates. If bond market vigilantes are no longer vigilant, if the negative real short rates now targeted by the Fed lull them to sleep when they buy 5, 10 and 30-year bonds, then a repeat, or at least a Mark Twain rhyming of 1930-1980 is likely in store.

What I'm suggesting is that since the Fed sets the price of short-term money and that since other yields are significantly influenced by today's 1% Fed Funds mark, that there's not much a bondholder can do. First of all, yields are extremely low on an inflation-adjusted basis. In addition, bond prices

and therefore total returns are at risk if deflation takes hold or – heaven forbid, if foreign creditors begin to unload their sizeable holdings. And, of course, sitting out the dance by staying in money market funds earns you that confiscatory negative real interest rate. What, poor babies, are we bondholders to make of all this?

The way to attack this seemingly hopeless conundrum is by holding TIPS – Treasury Inflation Protected Securities. At first blush this solution seems obvious. If the government is bound and determined to reflate the



Source: Ibbotson Associates

This chart is not indicative of the past or future performance of any PIMCO product.

economy and inflate bondholders down the river, then something with “inflation protected” in its name seems a reasonable bet. These TIPS, as almost all of you know, match the CPI one for one, three for three, or ten for ten. Whatever inflation is, you get compensated for it plus a permanent coupon to boot. These bonds with varying maturities and varying coupons today yield 1% “real” for the shortest maturities and 2.8% “real” for the 30-year TIP. That is, whatever future inflation is, you get that return plus the real yield. Does this beat the negative real rates on money market securities? By a landslide. Does that real return protect you against the reflationary erosion of your principal? Of course. Does that mean you can buy these things, stuff them in your mental vault, and sleep soundly at night? Probably – but not quite. Their prices do go up and down as “real” interest rates change so that over time periods less than the stated maturity, you could be looking at a “book” loss.

But having said that, the door becomes wide open for the third and final kicker

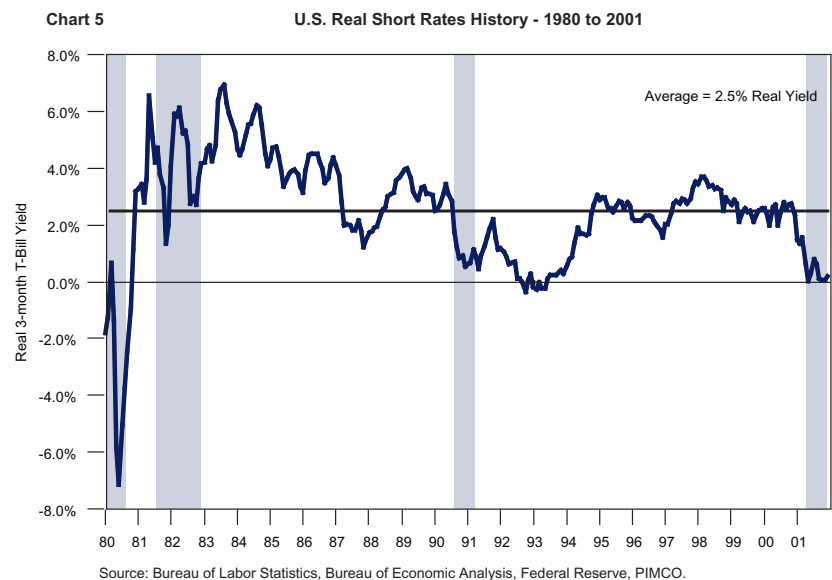
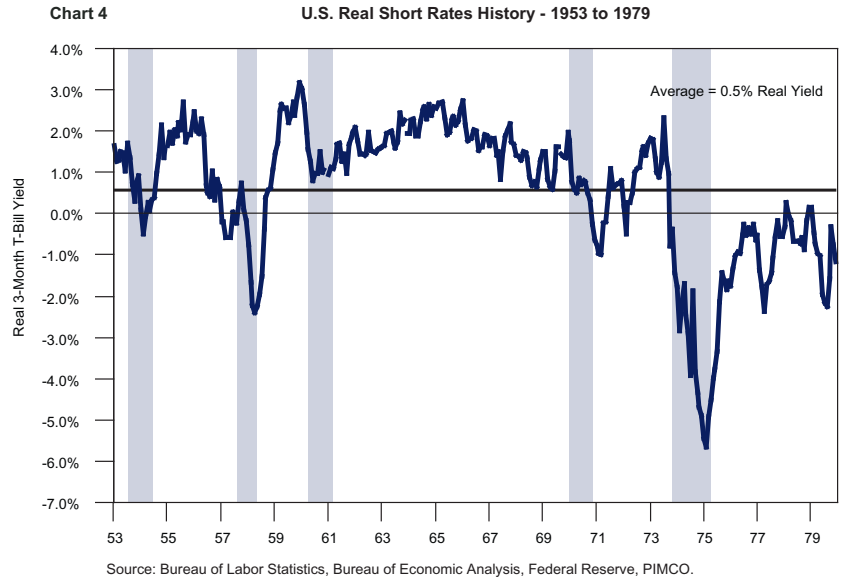
in this bond...àge à trois. First, TIPS beat the onus currently imposed by the Fed via negative real short-term interest rates. Second they compensate the holder for future changes in the CPI thus avoiding the reflationary intentions of Greenspan himself. And third, TIPS are one of the few fixed income sectors that actually stand a chance of appreciating in price as the Fed attempts to reflate. The key to this third potential kicker lies with history and the understanding that real interest rates in an average (or even reflationary) economy have been much lower than current existing levels. The current real rate for the 30-year TIP at 2.8% and the real rate of 2.25% for the 10-year TIP are slightly above historical norms. Thus they have the potential to appreciate in price if real yields fall in future months and years. Take a gander at the following charts.



Chart 3 displays a 50-year history of real short-term interest rates, while Chart 4 and Chart 5 break that history into two parts 1953-1979, and 1980-2001. The reason for the split is that the previous 20 years ending in 2001 were characterized by disinflationary monetary policies initiated by Paul Volcker and continued by Alan Greenspan until just recently. Disinflationary monetary policies seeking to promote a downward path in inflation

necessarily require a high average real interest rate, in this case 2.5%. Average secular periods of Fed behavior such as that of 1953-1979 promote something far different. While the rate fluctuated substantially, the average was only .5%. And while the mean yield for 1973-1979 is not calculated, it's more than

obvious that those reflationary years produced negative real short rates of substantial proportions. For those of you aficionados of really long-term secular charts, my May/June Secular Forum Outlook displayed a 100-year chart showing an average .7% short-term real yield for the entire period.



My objective is not to bore but to convince. I will move to the concluding point. Almost all long-term time periods in the United States save the Volcker/Greenspan disinflationary years in the last two decades of the twentieth century, produced real short-rates with an average of .5% to perhaps 1%. Today's TIPS can be purchased to yield between 2.25% and 2.8% for 10-30 year maturities. Even after adding a 1.5% historical risk adjusting premium* to the 30-year TIP to account for its price volatility, the long TIP and undoubtedly any other TIP on the yield curve spectrum appears "over yielded" and undervalued. There is in fact, no way that a diversified portfolio of TIPS can retrace the pathetic "suckers" negative real return from 1930-1980 reproduced in Chart 2. Since TIPS can be bought at positive real yields of 2%+, that's what they will return for at least the next 30 years if held to maturity.

My summary thoughts are these: The Fed and the U.S. government are attempting to reflate the U.S. economy in order to relieve the deflationary burden of excessive debt. Politicians do this via deficit spending. Fed governors do it by enforcing low/negative real short-term rates that strip savers and bondholders of their wealth and then erode long-term bond prices through the effects of higher inflation. You/we can fight back. By some egregious folly, the Treasury began to offer a safety valve back in 1997. They began to issue TIPS. These securities won't make you rich, but they'll protect your principal in the ensuing years and even stand a chance of going up in price over the near term. Buy all you can. We have and will continue to do so.

William H. Gross
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** This assumption and this amount are critical to my entire argument for TIPS valuation. The 1.5% risk premium for 30-year bonds vs. 3-month Treasury Bills is a 75-year historical average published by Ibbotson Associates.*

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