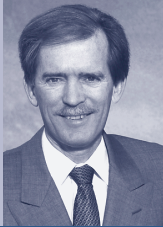


Bill
Gross



Investment Outlook

P I M C O

September 2001

The Bells

*Ring the bells that still can ring
Forget the perfect offering
There is a crack in everything
That's how the light shines through.*

Leonard Cohen

This month's *Outlook* is being written on the Sunday after the ATTACK, and the day before the battle begins on the floor of the NYSE. It is, therefore, unbiased by hundred point swings on either the downside or the upside although European market action last week certainly hints at sizeable losses when the bell is rung tomorrow by Treasury Secretary O'Neill and some bonafide American heroes. The odds are not totally stacked to the downside, however. There are efforts being made to support stocks not only as a patriotic gesture, but out of fear that a crash might seriously disrupt this nation's ability to fight back. Although a financial debacle would certainly not help, what I find most revealing is how much we as a nation have changed since I was born at the tail end of WWII. Back then, instead of stocks, the plea went out to buy bonds – war bonds, savings bonds, Treasury bonds. In the early 50s my parents still had a half-filled book of savings stamps, which resembled the S&H and Blue

Chip era that was to follow in the 1960s. People bought them at the post office for 10 cents apiece and when filled they had a \$25 investment, and Uncle Sam had a little more money to fight Hitler.

Now, instead of savings bonds, we equate patriotism with supporting the price of CISCO at \$14 a share and making sure the malls are full of shoppers pushing each other aside in order to purchase the newest upgrade of Nintendo. Strange isn't it – how we've changed, what we consider to be important, how dependent we've become on consumerism and the "market." As an aging American with Eisenhower roots, I lament that transformation, although I've done more than my fair share to support it. As an investor and quasi economist, however, I accept it as a modern day reality and must analyze its future without passion or even a hint of patriotism. If America is indeed going to war, will its citizens buy a share of CISCO and

another Nintendo, or will they buy a savings bond? Spend or save? Or better yet, when will we as a nation be willing to take chances again, to take risk – which is and has been the essence of our capitalistic society for centuries.

Tough questions and not immediately answerable on the day before Wall Street reawakens, let alone two or four weeks hence. We must watch, observe, and tap the spirit of Americans on an ongoing basis. The historical observation that Americans always come together in a crisis fails to answer the question of “buy or save?” and how much risk we as a nation are willing to take in the private economy. The Gulf War and even Vietnam were different examples because American citizens themselves were never threatened. Now that we have been attacked, do our private armies build moats or do they charge on to the battlefield? I lean in the direction of moat building but we shall see. The direction of the U.S. and global economy as well as its financial markets depends upon the answers to such questions.

Several observations can be made, however. Importantly, the U.S. and in fact global economy is already in a weakened, recessionary state of health. Its condition is similar to a human body that has been overworked, underslept, and whose resistance to infection is perilously

low. Without fiscal and monetary antibiotics, a hospital would inevitably be the economy’s destination. With them and in connection with the private sector’s willingness to take risk as opposed to build financial fortresses, a sharp recovery down the road is a possible scenario. The patient, however, is already in his recessionary bed sheets, and because of that fact, the economy is at risk of a substantial further downturn.

Secondly, the question of whether investors as opposed to consumers and businesses should buy or save/sell has already been answered – at least in the Treasury market. Unlike stocks, the U.S. bond market reopened on Thursday and Friday with a stunning although not unexpected rally. The bond markets’ answer, then, has been to buy, and buy as many as you can – as an old bond acquaintance of mine used to say. But being the classic value-based contrarians that we are at PIMCO, such rallies call into question the sustainability of prices and yields that may reflect more fear than common sense. Two-year Treasury yields of 2.9% can be justified only if the Federal Reserve drops Fed Funds to the vicinity of 2%. That’s 150 basis points away. Five-year Treasuries at 3.8% speak to the same level of expectations. While corporate bonds, mortgages, and long-term Treasuries have hardly moved over the past week, if the bull market in bonds were to be judged by the

short to intermediate portion of the Treasury yield curve, I would have to say it's "full" – stick a fork in it, it's done.

We at PIMCO will be selling the bulk of our short dated maturities over the next few days and pulling back to a more neutral durational and yield curve position. Our portfolios have benefited substantially from the existing recession and yes – the past few days' rally even though an external attack was not one of the "weakest link" possibilities discussed at May's Secular Forum. It is time to pull back to the center. The famous early twentieth century investor Bernard Baruch once said, "No general keeps his troops fighting all the time." We intend to give your portfolios a rest, ironically as our own military troops are about to be called into action. The next few weeks and months should afford ample opportunities to take risk in corporate, emerging, and even high yield bonds if the markets trade down to bargain levels. Importantly as suggested in prior paragraphs, we'll monitor the willingness of American, and indeed global citizens and businesses to take risk for future indications of a snapback in the economy or conversely an inability to get out of the sickbed. Durations in either case will shift off of center at some future date.

Whatever the outcome, all of us at PIMCO share in the world's revulsion

to last week's attacks. We, as you might imagine, have many friends still at the bottom of the rubble. May God bless America and all peace loving people in the world including those in the Middle East and Central Asia. And may God help us to seek justice instead of revenge, if only because lasting peace in the world depends upon it.

As a final personal note, let me say that it was serendipitous good fortune to be watching the attacks from the sanctity of my California home instead of the 110th floor of the World Trade Center. I recognize my invulnerability, at least until now, in this entire disaster. Still, I know, as I think you all know – and as the church bells toll in mourning – that we should ask not for whom they are tolling: they toll for me, they toll for thee, in addition to the dead and their families. Our best response, I believe, once the dead have been buried, and the guilty identified and dealt with, is to go on living well, to ring not just the bells of mourning or of war, but the bells – as my poem suggests – that still can ring. There is, I'm sure, "a crack in everything," but the eventual ringing of life's joyous bells, is how the light will ultimately shine though.

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