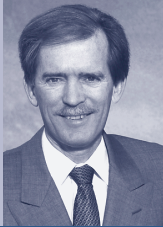


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Investment Outlook

P I M C O

October 2002

Knock, Knock, Knockin' on Heaven's Door

Soothsayers must always sooth with discretion or at least a modicum of humility. Although Dylan warned us that “everybody must get stoned,” it was the Oracle of Delphi that felt the rocks first and foremost. “A guru not busy being born is busy dying” is one of my half original self admonitions and it suggests that there is risk in being a gnome of Zurich or any other metropolis for that matter. Yet forecasting something is a necessary part of portfolio management. Peter Lynch may have felt that you couldn't forecast the economy but he wasn't bashful about predicting the fortunes of individual companies. Warren Buffett by suggesting that few stocks met his criteria for purchase, almost explicitly was saying that markets were overvalued and wouldn't produce acceptable returns in the foreseeable future. Holding a financial asset of any sort, it turns out, is a forecast in and of itself, in addition to being a statement of risk preference.

Still, the astute market psychic must know that there is a certain art or proper methodology to all of this. Soothing perpetually in one extreme direction or another, for instance, will ultimately be suicidal. Perpetual bears or perennial bulls will have their day, or

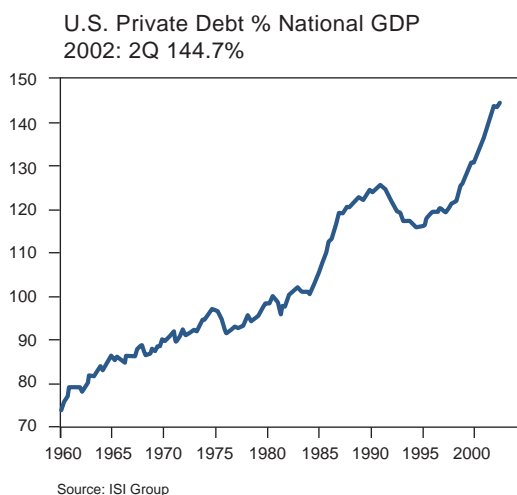
decade as it may be, but when the tide turns, their careers will have foundered on the rocks of stubborn-headedness, single-mindedness, or perhaps sheer ignorance that there are roads less traveled by. On the other hand, weather vane-type seers who change direction with every shift of the wind become untrustworthy. A public demands some consistency of thought if only to prove there is substance and mental discipline to the forecast. Only minor zigging and zagging is allowed. And finally, a market oracle should make meaningful forecasts but ones not so extreme that they alienate even the most receptive of audiences. My Dow 5000 “valuation” comes immediately to mind. It was what I believed, but a little “fringy” if you get my point. I might have gotten by with Dow 6000 and been able to create the same message, but that wasn't what my research showed. If, in this case, you “value” too low or too high, most of the caring world will place you in the category of a quack or a biased businessman with an axe to grind. Nonetheless, I'll stand by the number even though it may have broken one of my cardinal rules of “forecasting.” At least it shows I've got some guts, if not a brain.

But this is not a Dow 5000 apologia. It's really meant to reintroduce PIMCO's most recent secular forecast from May of this year which spoke to reflation at some early point in the next 3-5 years and to suggest that such forecast may have been a bit premature. This will be an *Outlook* with just a touch of zig and a pinch of zag, but no outright disclaimer. Ron Insana, one of CNBC's and indeed financial journalism's most astute commentators, was one of the first to recognize My/PIMCO's nuanced shift in a question and answer session a few weeks ago. Sometimes a journalist's questions serve to focus your own thinking even in the space of the required 15 seconds or less allotted for a response. Weren't we making a change, he asked and yes maybe just a little bit I responded, suggesting that deflation might rule the early years while reflation might command years four and five plus. Such fine-tuning might seem a bit of a mind game to some of you, but the timing of the shift, if in fact it reverses at all is likely critical to near-term bond market performance. So let's explore the nuances of deflationary/reflationary timing for a page or two.

Deflationary fears are all the rage these days. Almost all of Asia is deflating and the prices of goods at retail are down across Europe and in the U.S. as well. Services and – in America – housing prices expressed via “equivalent rents” are all that's really keeping us above the line. Oil prices, sure, but that's a war-time, not a longtime bias. Deflation, of course is not necessarily an evil thing as George Bush might phrase it. We had

deflation during much of the nineteenth century and did just fine economically, thank you. But deflation combined with too much fixed rate debt can be an economy killer. It means that companies and individuals (not most governments with domestically owned bonds) who lack pricing power may be unable to make interest payments that were contracted on the assumption of an ever increasing stream of revenue, income, or wages. Even a narrowing “margin of safety” as lenders would phrase it, as opposed to an outright inability to service interest payments can be an assassin, because it forces lenders to restrict debt refinancing which leads to cost cutting, layoffs, and an accentuation of the original deflationary impulse. Debt and lack of pricing power is a dangerous combination. Gasoline and a match fall into the same category.

We know we have lots of debt as evidenced by the chart below. Total private corporate and consumer debt as a percentage of GDP is at levels more than double what it was 40 years ago.



The real question is why the lack of pricing power? Why can't General Motors raise the price of its cars, why does Ford have to offer 0% financing to move the goods out of the showroom, why are things so different now from the inflationary problems during the 70s and early 80s? Globalization is one answer. We're all competitors now, whereas national markets 20 years ago could be viewed more in isolation. And because of this heretofore, inexorable process of globalization, China (and to a lesser extent India) have become a huge factor at the margin, establishing downward pricing power in almost every market. Sure they don't make cars, but Japan does and Japanese carmakers operate in a deflationary environment brought about not only by their own policies and demographics, but the inexorable downward push of Chinese exports. Speaking of which, did you know that we now import more from China than we do Japan? Times have indeed changed and because China has so many people, so much

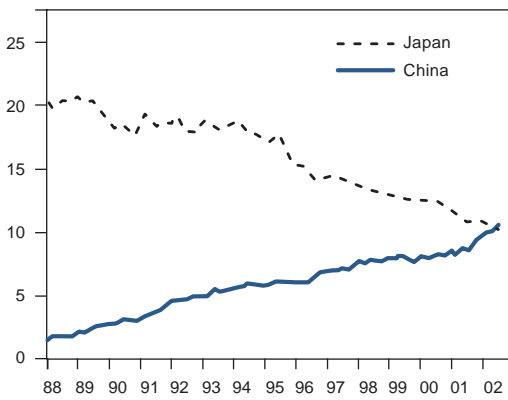
cheap labor, and the necessity to grow at 6-7% annually just to stay even with current high levels of unemployment, the prices of their goods are not the critical factor to them. It's the production and sale of them that counts.

Into this explosive mixture of fire (debt) and gasoline (pricing power) comes a flame retardant or a fire marshal of sorts – at least in the U.S. Our economic version of Smokey The Bear goes by the name of the refinancable mortgage. No other country really has it and it has saved our fannies up to this point by lowering interest costs and “creating” wealth where no other wealth was to be found. Remember the point about fixed rate debt being a deflationary villain? That applies primarily to companies and in some cases, strangely enough, to consumers via floating, yet somehow, permanently high interest rates in the credit card arena. American style mortgages are another story and because of them, most American homeowners (70% of U.S. households) have been able to keep on consuming via reduced monthly payments, increased equity takeouts, or both. The Queen of England mistakenly knighted Alan Greenspan as the saviour of the global economy. She should have instead tapped the originator of the refinancable mortgage.

But there are limits dear reader, there are limits. And every sophisticated money manager and financial observer is keenly aware of these limits. They half whisper them over the phone or in their nightmares as if to recognize that

U.S. Imports From China % U.S. Imports
3 Month Average July 10.6%

U.S. Imports From Japan % U.S. Imports
3 Month Average July 10.3%



Source: ISI Group

the margin of error is now very, very slim. Because we are certainly within $1\frac{3}{4}\%$ of zero as Ed Yardeni might express it and we are therefore within perhaps 50 basis points of the lowest possible 15 and 30-year mortgage rate that Americans are going to be able to refinance into. Mortgage rates will not follow the Fed Funds rate basis point for basis point lower because the extension risk and the negative “convexity” risk to the buyer (PIMCO) becomes outrageous if it does. There will never be much less than a 5% 30-year GNMA, Freddie Mac, or FNMA mortgage issued in size no matter what Greenspan does – and that’s a forecast you can take to the bank, with a high probability outcome. No investor in their right mind would be on the buy side of a 30-year mortgage with a 4% coupon and a potential extension from a 5-year, to a 12, to an 18-year average life staring them in the face.

And so? Well, here’s what those same astute observers whisper, but are afraid to believe will happen. If the American refinancing boom ends before a new investment boom begins, we are in a world of hurt. Consumption withers, investment rejuvenation will not have begun, and the U.S. global economic locomotive, such as it is, will grind to a halt. How long do we have? Twelve months at the most, even if Greenspan drives rates toward zero.

To refer back to my opening comments about minor zigzagging revisions to the timing of our secular reflationary scenario:

Such a scenario was predicated upon the successful restimulation of monetary and fiscal policies anticipated by PIMCO to be put into effect over the next several years. Central banks, primarily our Fed, are moving in the anticipated direction but there appears to be little conventional ammunition left in their holster. Sure we can count on higher deficits, sure we can count on Europe amending its Stability Pact, and maybe we can count on the Japanese to finally do something. But for sure we can count on China to deflate, deflate and deflate some more. We are enmeshed in a deflationary/reflationary tug of war as described in the May Secular *Outlook*, but the winner and the timing is not as obvious as it appeared to be back then. In turn, the current level of U.S. Treasury interest rates – while at low historical extremes – will not appear to be so ridiculous or reminiscent of recent equity bubbles if deflation prevails in the face of the soon to be “non-refinancable” refinancable fixed rate mortgage. Standby. This George Bushian battle between good and evil, with the deflationary Devil cast as the economic world’s primary villain, and renewed pricing power as it’s hoped for Angel of Mercy, is now seemingly up for grabs. The markets hear the knockin’, and many say that this particular Devil won’t come in, but they, like PIMCO, are a lot less sure of that than they were six months ago.

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Each sector of the bond market entails some risk. Municipals may realize gains & may incur a tax liability from time to time. Treasuries & Government Bonds guarantee is to the 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. An investment in high yield securities, lower rated securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk due to non-U.S. economic and political developments and may be enhanced when investing in emerging markets. Government National Mortgage Association - A wholly owned government corporation within the Department of Housing and Urban Development. It helps to raise funds for the mortgage market by guaranteeing securities backed by pools of mortgages. GNMA's government guarantee is to the timely repayment of principal and interest of a mutual fund's portfolio securities and not to the shares of the mutual fund, which will fluctuate in value. Even though government bond funds may invest their assets in U.S. government securities, the government does not guarantee the fund's shares and they will fluctuate in value as market conditions change. The guarantee is to timely repayment of interest and does not eliminate market risk. GNMA's are a type of mortgage-backed security and may be sensitive to changes in prevailing interest rates and therefore may entail risk. Federal Home Loan Mortgage Corporation (Freddie Mac) - Provides a secondary Market for conventional residential mortgages. It issues a number of mortgage-backed securities. Federal National Mortgage Association - A privately owned corporation, which provides a secondary market for federally guaranteed or insured mortgages as well as conventional mortgages. Its stock's trades on the NYSE. It issues a number of different mortgage-backed securities, which its value may be sensitive to changes in prevailing interest rates.