



## Clueless



Election season sometimes brings out the worst in us or perhaps the worst of us, depending upon your point of view. Whichever perspective you take, the current California recall has reminded me that politics and Bill Gross just don't seem to mix. It is, of course, flattering to walk down the street or be exercising in the gym and be asked by total strangers why I didn't run for governor. But give-ups in compensation and prestige aside, I excuse their exuberance if only because they couldn't possibly be aware of my abysmal failings in the political arena. The phrase "he couldn't be elected dogcatcher" was meant for me, and my life history gives testimony to it. I, for instance, made the perfunctory run for vice president of my high school junior year class in order to stuff my resume with the requisite amount of goodies to get into a good college. My opponent was a savvy kid named Mike Erickson who plastered "Elect ME for Vice President" all over the school's walls, the ME being an abbreviation of his name and a clever way to condense a campaign slogan. Unfortunately I didn't get it, I was Clueless, but I thought it

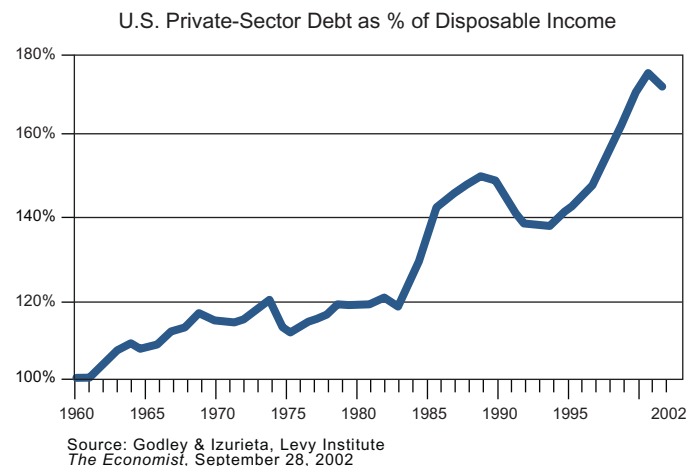
would be a good counter to print posters importuning the juniors to "Elect ME for Vice President – Bill Gross." Somehow that semi-plagiarized catch phrase failed to excite the electorate and I went down to a crushing defeat. Then there was the time in my college fraternity when I threw my hat into the ring for election to what was as low a position as that proverbial dogcatcher. Half the fraternity (or more) hated my guts so I decided to woo them by placing my name in nomination for the Sheraton Hotel representative – being responsible for reservations for parents during homecoming and such. Even though no one else was running, I was somehow rejected on the basis of too closely resembling "Animal House's" John Belushi. So it is on this brief yet more than conclusive historical resume that I chose to decline my supporters' urgent plea to run for governor of California. As you can see, I pose no threat to the Terminator, or anyone else in the state for that matter. All of them could beat me, every single one, even illegal immigrants I suppose, once they get their drivers' licenses.

Actually I was elected to something – Chief Investment Officer of PIMCO – although I squeaked by in the early years because no one else wanted the job, and by acclamation in the later years. Sometimes, though, I sense that my partners’ silence if given vent would scream, “Elect ME for CIO!” Thank goodness there’s nobody here by the name of Mike Erickson. But being the duly elected CIO, at least for now, I feel it incumbent as the incumbent to speak out on issues of the day, sometimes a tad afield from the bond market, but mostly confined to that arena. I wouldn’t want to jeopardize my possibilities for political office by opining too often on delicate topics such as GE, IRAQ, or life itself. Some people might not like me, turn their thumbs from up to down, and not bend their chads in my direction. Every vote counts as the Florida election dramatically pointed out.

But sarcasm aside, I will continue to opine. Last month and in other *Outlooks*, I wrote about hegemonic decay – “What We Worry?” – and tried to make the case that our domestic economy was vulnerable on several fronts. If and when domestic interest rates – short-term, intermediate, and/or long began to go up, then the housing market as well as almost all of our financed-based service and industrial corporations would be affected. In addition, I elaborated on the potential Chinese water torture in which Asian holders of U.S. Treasuries might trigger such an interest rate increase and therefore economic stagnation, as their holdings became larger and larger and therefore riskier and riskier. Let me elaborate on why our domestic and therefore the global economy is particularly vulnerable to a rise in interest rates at this juncture – no matter what the trigger.

During business cycles past, economic recoveries continued for quarters and in some cases many years beyond the initial jump in yields whether it was Fed or market induced – or both. Higher interest expenses were absorbed as companies regained pricing power. Demand increased as unemployment came down and hundreds of thousands of workers found jobs every month. Today the recovery is structurally different. Global competitors – China, India, Brazil, and a host of others – limit pricing-power by ferocious trade policies whether they be currency based or cheap labor oriented. At the same time, their competitive exports are responsible for a structural roadblock in employment policies. U.S. companies hire more people, they just don’t happen to live in the United States. And so a new and stultifyingly different business structure means that profit margins – after the benefit of layoffs and higher productivity are dissipated – will be negatively affected by interest rate increases. If so, the recovery will ultimately flounder.

Another difference this time is that individuals and companies are much more in debt than they ever have been as seen in the Chart below. Up to now with yields declining and home mortgages, car loans, and all sorts of debt being discounted to



near 0% yields, the debt levels have not mattered. Who cares, as the Chart shows, that private sector debt as a percentage of disposable income is now 25% higher than it was at the beginning of the last recovery? If you don't pay any interest on it, there's no limit to the amount businesses and consumers can borrow and therefore spend. My point exactly: if and when rates do go up, we will all care – the leverage will work in reverse, the economy will flounder.

Finally, it's important to point out that most U.S. corporations these days are finance dominated companies whether they make widgets or cars, whether they sell insurance or overalls. Many if not most American companies are profitable primarily because of their finance activities. Sears until just a few months ago was really a credit card lender, not a retailer. General Motors in this year's second quarter earned almost all of its money from its mortgage subsidiary. Deere sells tractors, but has a finance arm that contributes a significant portion of annual profits to the bottom line. Dare I mention GE? It's really more of a financial conglomerate/leasing company. If it brings good things to life, it's because interest rates are low and their profits are favorably affected. Almost all of these companies as well benefit by swapping their long-term debt back into Libor-based/short-rate sensitive hedges. If the Fed jacks yields, they will pay through the nose and then some, as will our economy.

One investment conclusion is this: do not expect the Fed to be the hangman by raising rates. If this were a game of Clue and we were wondering whether the killer was 1) Prof. Plum, 2) with a lead pipe, 3) in the library, you can be very confident that it won't be 1) Chairman Greenspan, 2) with an interest rate hike, 3) at the

Federal Reserve. He knows better and will only raise short-term yields if and when the U.S. economy appears to have the legs to withstand such a shock. For all of the above reasons, that day is far advanced – way out there – back, back, back, back as Vin Sculley might describe a Barry Bonds' home run.

But there are other players in the financial arena, including PIMCO, and they make decisions too. Last month's *Outlook* suggested that Clue's economic and bond market murderer might ultimately be 1) Zhou Xiaochuan, 2) with a currency reval, 3) in Beijing OR 1) Toshihiko Fukui, 2) with a Treasury bond sales ticket, 3) in Tokyo. I described the near trillion dollars of U.S. Treasury securities held by Asian countries and posited that at some point the risk might outweigh the reward and that the ensuing sales might trigger a run on the bank, a hike in yields, and a beginning of the end for our Hummer and Hummvee prosperity. Asia, and principally China, might very well be the prospective culprit – they have a pretty big lead pipe that's for sure and now it's just a question of motive, not opportunity. But the fact is that for now, the status quo sort of suits them. They are sucking up a lot of Treasuries, yes, but they're also putting a lot of their people to work and in the case of China, that means tens of millions. Why revalue their currency, why sell their surfeit of Treasuries if they can instead employ the outflow of young workers from exterior provinces into Shanghai by fixing the Yuan to the dollar? In the case of Japan, why risk renewed deflation via a stronger Yen? Some say they should buy dollars, buy Treasuries, do everything possible to keep their exports competitive and their economies above the line.

Last month's *Outlook* suggested, however, that sooner, perhaps later, they would act,

if only because the risk would become unbearable, but the timing was unclear. Just a week ago, though, the Yen cracked the important 115 to the dollar barrier, a sign that their appetite for dollars and U.S. Treasuries might be sated, and that the long enamored and widely held “Yen carry trade” might be on its last legs. U.S. Treasury yields have since risen.

Still, Asian countries’ apparent willingness to trade-off jobs for a bad investment begs a better question. If Asia is subsidizing its growth by purchasing dollars and Treasuries at a premium price, what about all the rest of us? What ancillary benefits do we get by purchasing a rich dollar denominated bond? Surely PIMCO and others get the same interest rate and (absent money management alchemy) we get the same return as do Asian investors. We therefore are getting the short straw, the hind teat, in short, a bad deal. We have nothing to show for our investment prowess other than an under-yielding Treasury note denominated in an overvalued currency. So when I wrote last month that China holds the keys to the Hummers, I was getting close to identifying the culprit in our ongoing game of Clue. What I didn’t suggest is that the waiting game is a dangerous one for other investors – they in fact could be the victims. There are rewards for playing of course. Instead of ¾% money market returns there’s 5%+ for holding long Treasuries and even more if you shift sectors to corporates and mortgages. Rollers of the Clue dice rightly claim that Prof. Plum or Japan central bank boss Fukui might not be the one, or perhaps

that the dirty deed of reval or Treasury sales might never happen. They have a point. Waiting for Fukui or China’s Zhou Xiaochuan could be an expensive proposition. But what oh what if it turns out to be true, or what if the PIMCOs of the world wise up to their subsidizing Chinese employment by holding an overvalued Treasury portfolio? And, lest I sound too apoplectic, the name of the next game doesn’t have to be Armageddon. A more likely course would posit reduced Asian and U.S. purchases of Treasuries, a diversification into Eurobonds, a stronger Yen and Yuan over the next few years, more expensive U.S. imports after a lag, a sapping of consumer spending power, gradually rising intermediate and long-term rates, a declining housing market and yes a near body blow to America’s financed-based economy for all the reasons outlined in previous pages. I reiterate: the stocks, bonds, and currency of a debtor nation in the process of reflating are not attractive investments. At the moment the markets are without one – but sooner or later they are bound to get – a CLUE. My vote, PIMCO’s vote, will be to play the game with eyes wide open and our wallets and purses close to the hip. Inflation and currency protection will be paramount in the initial stages of this game of Clue, and credit protection in the latter phase as the U.S. economy is mugged by a host of Prof. Plum “act-alikes” with their lead pipes.

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