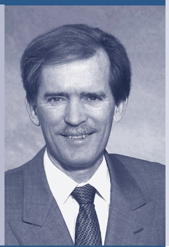

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Investment Outlook

PIMCO

December 2001

The Bond Bull Market Is Dead! Long Live The Bond Bull Market!

My wife Sue claims that I exaggerate and I suppose that she's right, but if so, my tallest tales and biggest whoppers are reserved for our 13-year-old son Nick. Teenage boys need their dads to be heroes, and somehow managing bonds and being on T.V. occasionally doesn't automatically translate into having a Supermanish-like "S" tattooed on my chest as far as Nick is concerned. I think he wishes I were a professional surfer, but I haven't hung 10 or even 5 for nearly 40 years now, so in order to compensate for my ill chosen career I stretch a few yarns about my past in order to come close to the hero he requires.

Take the one about how I almost played on the Duke basketball team. Nick's currently into roundball, and so on a recent summer's visit to my old alma mater we sneaked onto the floor where the Cameron Crazies do their thing. Never mind that the rest of the Duke campus was in its resplendent glory, Nick only wanted to touch the floor where Duke has played its games for nearly 60 years, and to take a free throw or two before the campus guards kicked us out. As we bounced and shot, he said "Dad – did you ever play basketball for Duke?" Well, now – I ask you – would a simple "No, I wasn't good enough" be an appropriate response in that setting, at that time? No way. So, I fired back in my best Walter Middy impression, that I had tried out for the team (true), but had been the last guy cut (false). Actually, I thought to myself, maybe I was the last guy cut – no one ever really knew. So no harm, no foul as they say in B-ball and we left the court with my arm around his shoulder and a large "S" temporarily tattooed on my chest. Score a three pointer for the power of exaggeration.

Then there's the "what I did in the war" routine that comes up whenever Nick seems to have an overdose of teenage testosterone and wants to talk about killing Afghans or terrorists, etc., etc. Should I be content with telling him that the only real action my Navy Seal team ever saw was the morning I overslept and literally missed the boat? No Superman S for that my friends. So when he asks if I ever killed anyone in Vietnam, my answer of "I'm not sure – the jungles were always so thick it was hard to see," is only a slight exaggeration. No matter that I never fired a gun, those jungles were pretty thick and that's a fact. What joy to be a hero in your son's eyes, and all for the price of just a teensy-weensy, flimsy-flamsy, stretch of reality.

I bring up this infinitesimally minor flaw in my character as a lead-in to a discussion on the prospects for the bond market in 2002, because like Sue said, and you've just found out, I tend to overdo it sometimes when it comes to verbal or even written hyperbole. Take the headline title on the first page for instance. It's a takeoff, of course, on succession to the royal throne, the first line of which was meant to state most emphatically (without exaggeration by the way) that the 20 year bull market in bonds is over and done with – flat out dead and buried in a casket six-feet under. "Now you tell me," you scream, five weeks and 100 basis points higher. Well actually as you probably know, I have been telling you but maybe not just as emphatically as I should have.I even have three or four recent videotapes of myself on CNBC claiming that the bond bull market was almost over, or that I wouldn't buy the Treasury market at the ridiculously low level of yields just one month past. I exaggerate not. So Nick, your Dad did call the end of the 20-year bond bull market, to the very day no less, and made billions of dollars for his clients. Superman! Yeah, well sort of. Don't ask me to name the day, or come up with the billions though.

The second line of the title, however, is perhaps the most intriguing and my biggest stretch short of Duke basketball or how I got shot in the war. It is an exaggeration that I will admit to in advance. I wrote it to grab your attention in hopes that you would think you were going to make as much money from bonds in the next 20 years as you have in the past 20. Not true. Exaggeration big time. We are not about to begin a new bull market only five weeks after the old one died. What the title should have said was:

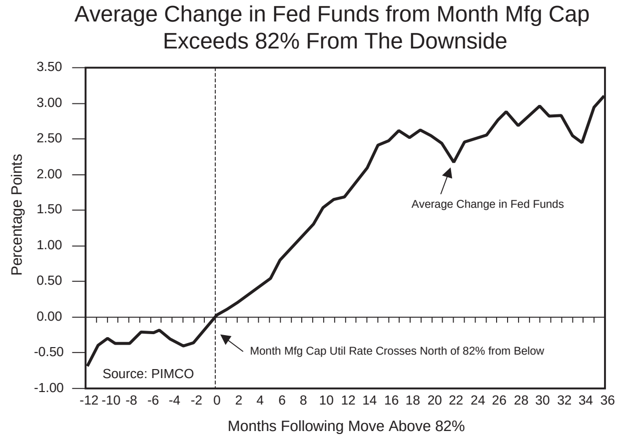
The Bond Bull Market is Dead!
Long Live the Bond Market Spread!

In that subtle change lies a strategic shift of significant proportions, one of which in some ways mimics PIMCO strategies of the mid-90s that we called "Butler Creek" and in other ways initiates an entirely new direction that we hope will make money for you in 2002. Let me explain.

Although the bond bull market may be dead, that forecast in no way implies that a new bear market has begun. Long Treasuries sinking to 4.65% last month does not have to lead to the same fate as NASDAQ 5000. That is because recessions, such as the one we've had for the past eight months or so, create a considerable amount of excess capacity, which over time produces lower inflation. Subdued inflation in turn helps to keep bond yields relatively low. It's a high probability that, with industrial operating capacity at 75% and unemployment accelerating up to and through 5.7%, inflation will not only come down, but will stay down for all of 2002 and beyond. 1.5% is a reasonable target for the next 12 months, especially given the recent behavior of oil prices. Even a V-shaped recovery, which we don't expect, would take several years to threaten a resurgence of inflation. In turn, gloomy global economies, especially that of Japan, promise no excessive demand pressures any time soon.

If inflation comes down and stays down, there seems to be no basis to presume a bear market in bonds absent a crash in the dollar and withdrawal of foreign investment. The past 4 weeks' mini-bear market then, can only be described as a take back of excessive exuberance (seems bond investors can overdo things too) and not a debacle in the making. What bond investors have really been trying to do is to forecast the end of the Fed's easing cycle and the beginning of Fed's tightening. As of Friday, December 7th, that forecast called for a Fed Funds ebb tide in early 2002 at $1^3/_4$%, then a significant increase of nearly 200 basis points by year end. That forecast, however, is an exaggeration almost as bad as my claiming to nearly having played Duke basketball. The Fed has raised short-term interest rates with long lag times following an economic recovery.

After the last recession it took a year and a half before they began to tighten and previous recessions in 1969-71, 1974, and 1979-81 produced no significant central bank hikes until an average of 12 months later. One of the best signals I have found to indicate a beginning of Fed tightening is when the U.S. manufacturing operating rate or capacity utilization rate hits 82% as the economy is recovering. The following chart shows that on average for post WWII recessions, the first tightening comes on the very month that capacity utilization hits 82%.



That is because at that level, the Fed begins to anticipate a buildup in future inflation. Up to that point, the all clear sign is flashing. According to PIMCO calculations, even a sharp V-style recovery would take 16 months to get us back to 82%. Another warning signal of higher short-term interest rates is a visible decline in the unemployment rate. That rate, in PIMCO's view, has much further to go on the upside and should only begin to level off or decline in early 2003. Even if the Fed does raise rates sooner than the PIMCO forecast, the 200 basis point increase which the market has discounted seems like a Paul Bunyan whopper.

So fears of a bear market in bonds over the next 12 months are exaggerated, to say the least. But that still begs the question of how to make money if the bull market is over and Treasury yields are so low. The answer lies in the SPREAD. PIMCO intends to buy the spread. What that implies could take several more pages of discussion which you probably don't have time or patience for and yours truly shouldn't necessarily divulge – especially since competitors hit the PIMCO website these days quicker than I could streak down court for a layup during my Duke basketball days. But buying the spread as I suggested previously, in part resembles our old Butler Creek strategies: buy higher yielding bonds that trade at significant spreads to Treasuries – corporate bonds, mortgages, and emerging market debt with yields averaging 200-300 basis points more than intermediate Treasury yields. They could be the 30-year bonds of AT&T, for instance, at 8% or 10-year debt of Mexico at $8^1/_2$%. They could be GNMA pass-throughs yielding $6^1/_2$ % or even a few long-term Treasuries in the mid-5s. Together the portfolio should produce a $6^1/_2$- 7% yield in a world of $1^1/_2$% inflation. Not too shabby I'd say. In addition, there are strategies that implicitly seek to take advantage of the market's current fears of excessive future Fed tightening. These strategies are different than those of Butler Creek days past because they produce significant capital gains, even if the Fed raises interest rates by 150 basis points over the next 12 months. In combination with corporate, mortgage and emerging market bonds that yield $6^1/_2$%+, they constitute the "spread" to which I refer on the first page of this *Outlook*.

So fear not dear readers and valued clients. The bull bond market may be over, but the reign of the "spread" has just begun. As long as the Fed doesn't raise interest rates by 2% or more over the next 12 months, 2002 should be a great year for PIMCO portfolios. Total returns approaching 8% are likely, which in a $1^1/_2$ % inflationary environment and a 5% stock market world over the longer term (see November's *Investment Outlook*) are attractive returns indeed. It's time to forget the cares and woes of the past few weeks and to have a Merry Christmas, a Happy Hanukkah, and a prosperous New Year. I myself, plan to spend a few of the season's holidays scrimmaging with Shaq, Kobe and a few of my Laker friends down here in Laguna Beach. I thought about inviting Nick to play, which would be the thrill of his young life I suppose, but it may be a little early. I think I'll just tell him the story about it in a few years or so. That should keep the Superman S on my chest at least until he graduates from high school.

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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 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 their obligations. An investment in high yield securities, lower rated securities, lower rated securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in foreign securities may entail risk due to foreign economic and political developments and may be enhanced when investing in emerging markets.

***PIMCO Total Return Fund Top Holdings representing 44.35% of the portfolio** 1. GNMA I TBA 6.50% OCT, 2. FIN FUT EURO-BOBL 5Y EUX GSC 12/06, 3. GNMA I TBA 8.00% OCT, 4. FIN FUT EURBUND 10YR EUX DEU12/6, 5. FNMA TBA 6.00% OCT, 6. US TREASURY INFLAT PROTECT, 7. FIN FUT US 30YR CBT DEU 12/19/01, 8. US TREASURY INFLAT PROTECT, 9. GNMA I TBA 7.50% OCT, 10. GNMA I TBA 7.00% OCT.*

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