

Questions For The Genie

So much information – so little time to digest it. The more and more we sink into the age of technology with its bits, bytes, and megabytes the more we realize that a good answer needs an even better question. The modern world has a surfeit of facts but far fewer intelligent queries. Ever since I was a child, I have played a mind game involving a Genie offering up answers to my three most important questions. Early adolescent ponderings begged for clues concerning Christmas presents or prospective girlfriends. My mid-life Genie was occupied with answering the meaning of life and the possibility of an eternal soul. Now, as if in near futility, I ask only one initial question of this mental Genie of mine: “What are the two remaining most important questions to ask?” Why should I know more than the Genie, I figure, when it comes to asking the critical questions – so I’ll use some bait to catch a bigger fish.

Bond market Genies are harder to summon. Thirty years of lamp rubbing have only infrequently yielded surefire answers to the direction of interest rates and the highest prospective total returns. Uncertainty abounds. Still I’ve found that chances for right answers are immeasurably improved by asking the right questions, and that my current life pattern of wondering which are the most important questions to ask is

critical when it comes to bonds as well. So let’s give it a try right now, OK? “Oh bond market Genie, what are the two most important questions to ask as we head into this new year of 2003?” “You have asked wisely, oh Bond Man,” the turbaned soothsayer replied, “and you shall have your answers in due time, but first stop that incessant rubbing and sit back and relax while I explain a thing or two.” This then is what the Genie said:

Your previous debate over the prospects for inflation or deflation is a critical one. After all, bond yields reflect not only a mercurial real rate of return but a premium for inflation and the erosion of the purchasing power of paper money. If inflation were to disappear, so too would that premium and interest rates would begin to mimic the near 0% world of modern day Japan. There would be continuing capital gains for high quality Treasury paper and accelerating problems for debt laden corporations as issuer’s inability to regain pricing power placed solvency into question. You have previously suggested that high corporate and individual debt levels, combined with the acceleration of globalization – featuring low cost powerhouse China – have fostered this near deflationary environment. You have, however, cautioned that central banks and governments would not sit idly by.

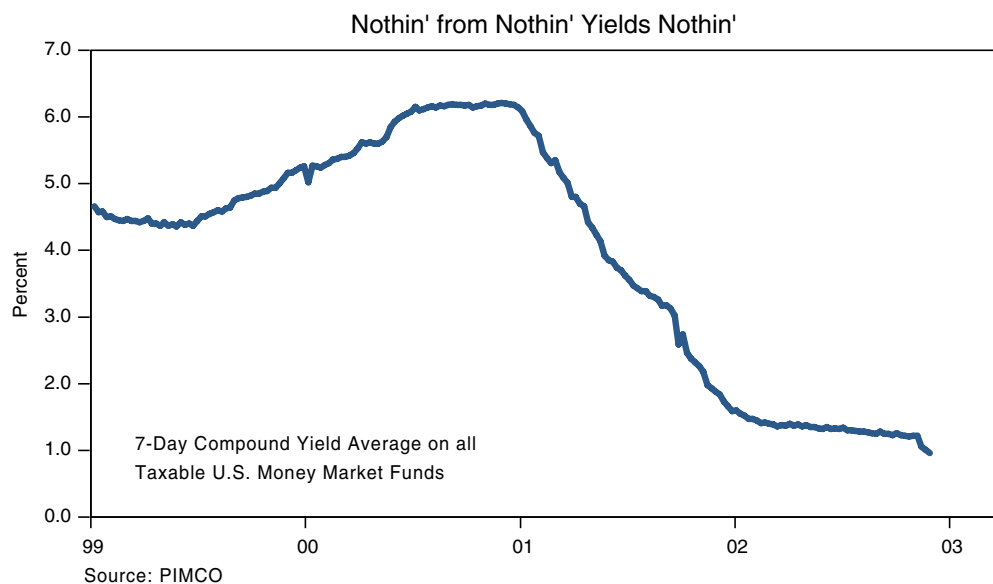
Investment Outlook

A 200 billion dollar fiscal deficit and 1¼% short rates in the U.S. are ample proof of that. Still the government's pixie dust seems to have lost a bit of its magic. The economy is recovering, yes, and the stock market has caught a bid of late but it's not the same as before, somehow. Perhaps deflation is inevitable.

But things change – even over a few months time. Since you last wrote about this struggle in October, Greenspan dropped short yields by 50 basis points to protect against a continuing “soft patch” in the economy (read: “potential deflationary downdraft”), and changed the Fed’s future bias to neutral. In addition, Fed Governor Bernanke came forward with a Greenspan authorized, coolly calculated speech before the National Economists Club entitled “Deflation: Making Sure ‘IT’ Doesn’t Happen Here.” These two events are near seminal. First of all, even if Mr. Greenspan’s bias wasn’t officially “neutral,” there isn’t any more room to ease short interest rates.

At current levels the two trillion dollar money market fund industry is in jeopardy of breaking the buck simply by yielding negative after expense returns. 75 basis points of yield minus 75 basis points of average expenses yields nothing. Mom and Pop in Des Moines and Coral Gables will not be well pleased if the Fed cuts again. And too, most consumer durables are being bought and financed at 0% already. Not only cars, but TVs, appliances, and DVDs are sold at no cost 0% financing. All of this must tell you that short rates are going no lower. Remember that forecast when it comes to my first suggested “question,” Mr. Bond Man.

Secondly, the forcefulness of Bernanke’s speech tells observers plenty about the ultimate winner in the battle between inflation and deflation. Avoiding deflation it seems depends not only on appropriate policies, but on the resolve of government authorities and their agencies to implement them. Both Euroland and Japan seem to cower in front of an imaginary inflationary



bogeyman, but this speech by Bernanke – my, oh my – the title says it all – “Making Sure (Deflation) Doesn’t Happen Here.” Bernanke listed several heretofore rarely used policies that would be emphatically employed by the Fed to avoid deflation: (1) should conventional open market purchases of Treasuries not do the trick, the Fed would extend out on the yield curve to include even long-term bonds, (2) the Fed could influence the yields on privately issued securities – corporates and mortgages – in order to lower the cost of private credit, (3) the Fed would buy foreign government debt in a thinly disguised attempt to lower the dollar and increase U.S. competitiveness and inflation at the same time.

I must tell you, Bond Man, I believe them. These people may be misguided, their policies might eventually do more harm than good, but I believe them. They will not allow the U.S. economy to deflate as long as the current regime (read: “Greenspan’s Fed”) is in power. Remember this as well when it comes to your second most important question.

And – speak of the Genie – here is what he proposed. Quite simple really and only a tad presumptuous on his part in lieu of the near impossibility of lower short rates and the near inevitability of the Fed’s ultimate victory against deflation considering their most recent pronouncement. These were his two questions to ask:

(1) If the cost of money in the U.S. can’t go down, then it must eventually go up, he said. The question to ask is WHEN?

(2) If we won’t have deflation then we must eventually have reflation. The question to ask is HOW MUCH?

Three simple words, two question marks, and the fate of the bond market resting on the answers. Well, dear reader, I must tell you I was now licking my chops. Having “wasted” one of my three questions in an attempt to find out the two most important ones to ask, I was now ready for his 2nd and 3rd most important answers. But as I had experienced at least several times before during my previous lamp rubbing sessions, this Genie seemed to either lose energy or be called away by a more demanding client. His visage slithered back into the bottle leaving me alone to guess at the outcome. Well OK, I said – I can do that. Maybe not with Genie-like precision, but I can do that, and so here are my humble responses:

WHEN?

At first this might seem like a frivolous question. If the cost of money (interest rates) is going to go up, why not just sell bonds now and avoid the pain, whenever it comes? The answer of course is that the waiting itself can be very painful, especially at 1% money market rates. If it takes two years for the Fed to risk higher yields, then the 4% annual premium for owning a long Treasury bond will protect against nearly 100 basis points of long end yield curve tightening. Two years? I suspect not, especially in light of the “soft patch” 50 basis point insurance cut several weeks ago. A more normal, Taylor Rule level for Fed Funds

is probably closer to 2% than 1¼% so Greenspan may have the courage to go back up there at some point in late 2003. If so, the onerous penalty of holding cash and shorter than index durations will not seem so significant.

HOW MUCH?

This question if you'll recall, refers to the level of future inflation not interest rates, but the two go hand in hand. Answer one and you'll pretty well answer the other. Despite the Fed's "guarantee" to prevent deflation there is no assurance that they can create substantial inflation. Just ask Japan how that works. But a determined Fed and a spendthrift Congress that may at some point in the next 24 months produce a \$500 billion fiscal deficit are a powerful combination – the deflationary China card notwithstanding. Jim Grant said it rather succinctly in a recent Interest Rate Observer: "There is nothing so inflationary as a whiff of deflation." High levels of personal and corporate debt need to be reflatd away. Pricing power needs to be restored to rejuvenate corporate profits. Pension liabilities need to be diluted by increases in interest rates. State and local budgets need to be bolstered by higher levels of taxes which are most easily obtained by inflation as opposed to tax hikes. Our levered American economy requires at least a modicum of inflation in order for it to continue to function as we have experienced it. How much? 2-3% is desirable. An overshoot, which has been the historical precedent, might at some point give us more.

Are the answers to both of these two most important questions bearish for bonds? Of course, but not for all of them. Like the stock manager who clings to the belief that even in a bear market there are "bargains" to be found, I believe that not all bonds will provide miserly total returns in future years. Euroland bonds, for instance, are in a delayed cycle of their own, with their central bank still easing and with plenty of room on the downside. Emerging market and some investment grade corporate bonds, which offer lofty enough coupons to offset the future onslaught of increasing Fed Funds and higher inflation, should perform reasonably well. And government guaranteed TIPS, which offer protection against inflation (if not slightly higher real yields) should be the best performing Treasury issues. Still, there's little doubt from this Bond Man or perhaps even his AWOL Genie that the bond market's salad days are over. 4-5% annual total returns at best over the next several years should be expected. The Fed and the Congress will make sure of that by conquering deflation, promoting inflation, and perhaps in the process creating even more financial and economic instability than we have seen in recent years.

William H. Gross
Managing Director

P I M C O

840 Newport Center Drive
Suite 300
Newport Beach, CA 92660
949.720.6000

Past performance is no guarantee of future results. All data is as of 9/30/02 unless otherwise indicated and is subject to change. Investment return will fluctuate and the value of an investor's shares will fluctuate and may be worth more or less than original cost when redeemed. This article contains the current opinions of the manager and does not represent a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission. This is not a recommendation or offer of any particular security, strategy or investment product. This article is distributed for educational purposes and should not be considered investment advice.

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 foreign securities may entail risk due to foreign economic and political developments and may be enhanced when investing in emerging markets. Money market funds are neither insured nor guaranteed by FDIC or any other government agency and there can be no assurance that any money market fund will be able to maintain a net asset value of \$1.00 per share. The credit quality of the investment in the portfolio does not apply to the stability or safety of the fund. Treasury Inflation Protected Securities (TIPS) are guaranteed by the US government (for timely payment of principal and interest), however the shares of the Fund are not. The credit quality of the investment in the portfolio does not apply to the stability or safety of the fund. Duration is a measure of the Fund's price sensitivity expressed in years.