

Just a Singer in a Rock & Roll Band

I spent all day writing this *Outlook* and all I got for it was this lousy T-Shirt! Actually I'm referring to the *IO* that just hit my library trashcan. That one just didn't cut it, and this one may not either! Writing *Outlooks* is getting a little bit harder these days. "Don't do this, don't do that, can't you reeeead the signs," scream the in-house lawyers. Go easy on Iraq, careful about women and minorities, eliminate references to politics, religion, and sex, and for God's sake don't mention any of our clients or their products, which by the way knocks out about 250 of the *Fortune* 500 and every major industry in the U.S. Actually, as you might have noticed, that hasn't stopped me from stirring up the politically and legally correct waters in recent years. But I suppose I tiptoe a little more carefully these days, if only in recognition that PIMCO's a franchise and not a start-up and there are now many more livelihoods at stake than my own. Renting a soapbox right across the street in Newport's Fashion Island could be a much less expensive way to vent my iconoclastic views I suppose.

And too, as many of you already believe, I am – in Moody Blues' parlance – just a singer in a rock and roll band. There's nothing about being a bond market wiz that necessarily qualifies me to opine on world events, or anything else for that matter. The purpose of these introductory paragraphs, however, has always been to liven-up a somewhat unfathomable and inherently boring topic and in that I undoubtedly have succeeded beyond someone's wildest dreams. The interesting problem I find these days – besides the untouchable topics – is that I'm trying to write less about me, and more about you and human

interaction, but finding it very difficult to do. I tried to write a few paragraphs once without ever using an "I," "me" or "mine" and found it almost impossible to do and still sound interesting. Mark Twain undoubtedly could have done it but then, as Senator Bentsen might have suggested, I'm no Mark Twain. As such, I guess I'll have to stick to the approach used by my wife Sue on many of our frequent weekend walks around the neighbourhood. After discussing an hour's worth of her problems she'll turn to me and say "But enough about me, let's talk about you. What do you think about me?" Ah, humour at its best. It's Sue that should be writing these *Outlooks* if only she had the time.

Actually, Sue might stumble a little bit when it comes to the meat and bones of bond market strategy. While she has mastered the interest rates up/bond prices down maxim, she couldn't distinguish a Bund from a Bond if she met one on the street, but then that's the only thing I can do that she can't. And it was Bunds, not bonds that made the performance difference for us in 2004. That along with TIPS and some strategically timed forays into emerging markets. In a year that confounded most bond managers, because of falling, instead of rising intermediate and long-term rates, we managed to avoid extreme duration statements and instead profited by shifting money into reflationary beneficiaries in the U.S. (TIPS) and near deflationary economies outside our borders (Bunds).

2005 will witness a changing environment in some ways – slower global growth, somewhat higher short-term rates – but

the dominant moneymaking themes in the bond market should be the following: 1) The Fed stays relatively low, 2) China revalues its currency, 3) Spread product underperforms, 4) Europe remains sick, and 5) Cash is Prince.

Let me elaborate:

(1) The Fed stays relatively low

Our belief that the Fed stays relatively low ($\frac{1}{2}\%$ real short rates or less) is a long-standing one and based on several secular and cyclical observations. Since the primary global economic problem is a lack of what is known as aggregate demand, central banks everywhere will continue to remedy the affliction by keeping real short rates low. Low short yields help stimulate demand by creating gradually rising inflation, and nurturing capital gains in equity, real estate, (and yes) bond markets. In addition, the highly levered U.S. consumer and their main conduit – mortgage debt – require low short rates just to keep their heads above water. Thirdly, with the Fed now implicitly on board in support of adjusting our balance of payments deficit via a depreciating currency (and a reduced deficit), low real short rates are the mon-

etary policy tool of necessity. Whether the Fed stops at $2\frac{1}{2}\%$, $2\frac{3}{4}\%$, or $3\frac{1}{2}\%$ is really more of a debate as to the future of U.S. inflation, not the fact that real short rates must stay down for a long, long time.

(2) China Revalues

Admittedly our most problematic money making theme, if only because of its timing, is our belief that 2005 is the year when China/Asia revalue their currencies upward. Actually, the decision is entirely in China's hands, but evolving events should force at least a semblance of a resolution. China will be more inclined to revalue if internal inflation accelerates (currently not the case), their banking system stabilizes, and/or tariff pressures from the U.S. threaten to kill the golden goose of free trade. Perhaps just as important, China's gradual evolution from WTO inductee to potential kingmaker at future G8 economic policy discussions argues for some type of symbolic move that speaks to cooperation in a global context.

Should a meaningful (more than 5%) revaluation occur against the dollar or even a basket of diversified currencies, the event

would signify a further extension of U.S. reflation via an upward repricing of U.S. labour and wage rates that accompany a falling dollar. Bond bearish? Yes, in several ways. First of all from the obvious effect on U.S. inflation – perhaps as much as $\frac{1}{2}\%$ over the next several years depending on the extent of the Chinese reval. Secondly, from the prospective sale (or reduced buying) of U.S. Treasury and corporate bonds in anticipation of the revaluation. Such gingerliness may

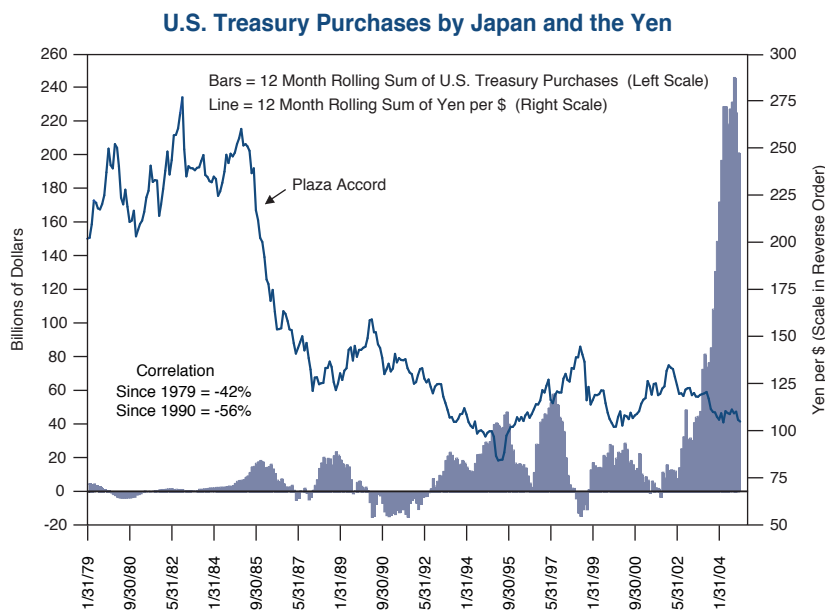


Chart I

simply reflect the cautionary sales by the PIMCOs of the world in anticipation of the knock-on effects of future inflation. But additionally, the astronomically high levels of bond purchases by surplus generating economies (Japan primarily, China secondarily) may begin to come down as shown in Chart I.

Although purchases are currently near peak levels, 2005 could witness a buyer's strike of sorts that reflects an unwillingness to hold fixed income assets denominated in a deteriorating currency. As observers such as Jim Bianco point out, dollar depreciation hasn't stopped them yet, but there are limits and even a marginal cessation of blind and near mindless Treasury purchases to support the Yen and other Asian currencies may soon begin. It is PIMCO's opinion that central bank purchases in 2004 were the primary force in lowering 10-year Treasury rates from 4.90% to nearly 4.0% in October, while the Fed was in the process of raising short rates by 125 basis points. We could see a run back up towards those levels if foreign buying tapers off, even while the Fed stays low as pointed out in #1 above.

(3) Spread product underperforms

In fond memory of my six-year-old sandbox playmate Robin Rosen-trater who, with tongue extended in a direction toward yours truly, gurgled the most overused mantra of my/our youth, let me gurgle my own impression of risk/spread product for the next 12 months (sans tongue):

Spread and its clones may bruise my bones, but further capital gains, they just can't hurt me.

There, I've regressed and now I'll grow up and explain my thesis like an adult (you be the judge). Spread product which

basically includes anything riskier than Treasuries, had a fine year in 2004. It's a wonder that PIMCO did so well because we didn't own much of it. Not many corporates, slim on mortgages, reduced high yield, no flings with CDOs and CLOs except with clients willing to step up to the plate and own them as an asset class. No matter – TIPS and Bunds made up for our unwillingness and ineptitude in not climbing on board the risk-taking train during a year in which corporate profits soared, the economy stayed out of trouble, and investors chased yield like those buccaneers used to chase skirts at Disneyland's Pirates of the Caribbean ride (discontinued in lieu of political correctness). Still as forward-looking investors in search of predictability, it is fair to ask whether near historically low spreads for corporate bonds as shown on Chart II can be maintained or extended for long. Our answer is "probably not," but even if they do, spreads are so slim that the capital gains inherent in spread narrowing are no longer likely and the yield spreads offer little compensation for future risks of an economic or geopolitical nature.

(4) Europe remains in its sickbed

With the Euro soaring and Euroland inflation moving down not up, German Bunds

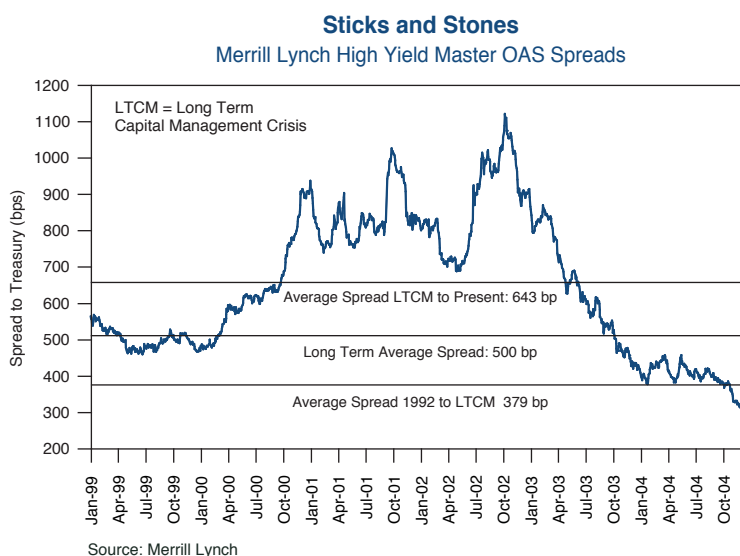


Chart II

remain a better alternative than U.S. Treasuries despite their 50 basis points lower yields. One should recognize that this 50 basis point negative hook come February's Fed hike will be completely eliminated on a currency hedged basis. Additionally, accounting changes for insurance companies and other European financial institutions will soon mandate the purchase of long dated fixed income assets that could mimic the behaviour (and inversion of its yield curve) of U.K. markets in recent years. Finally, Asian currency/asset diversification points toward further accumulation of Bunds as opposed to Treasuries over the next 12 months. They may not make our year in '05 like they did in '04, but there's more life left in that old German mare.

(5) Cash is Prince

Finally, it seems difficult to imagine how many if any fixed income maturities/sectors can outperform good old cash in 2005. Take the example of a 5-year Treasury for instance whose duration and yield pretty well reflects that of the bond market itself. At 3.60% and with a duration of 4.25 years an increase of only 15 basis points over the next 12 months will lower its total return to 3% for 2005 – a return that most investors believe will be available from short-term commercial paper. The skirts that today's bond market buccaneers are

chasing therefore, are not only politically incorrect but needlessly risky relative to cash alternatives. Cash may not exactly be King in the current 2-3% range, but let's call it a Prince. Better than being a 1% frog I suppose, like it was for much of 2004.

The successful 2005 bond strategy therefore, will likely be to avoid duration, avoid spread product and to flock to the stability of cash, TIPS, and foreign bonds issued by strong currency countries in an openly reflationary world. If so, bond market returns of 3-4% for the year may be all an investor can rationally expect, and if those Asian investors flee for the exits then longer duration portfolios might even wind up in the red. As always, I/we thank you for your confidence in PIMCO these many years and I in particular promise to be nicer and more sensitive when writing my *Investment Outlooks* (and if you believe that, you likely believe that Bush will actually cut the deficit in half, that we'll be out of IRAQ in a few years time, and that privatisation of social security will fix a suddenly bankrupt system! As to my opinion on gay marriage, [REDACTED] [REDACTED] censored by PIMCO lawyers.)

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