

I've Got to Admit It's Getting Better Getting Better All the Time

I have been since early childhood, and remained, through most of my maturing adulthood, a boy who “could do better than that.” My mother, whose soul now rests, dreamed things for me that all mothers dream except she was not so much a dreamer as a dream weaver and as events eventually unfolded, a “Bond-King” maker, whose demands for excellence pointed me in the direction of my ultimate career. The Gross goslings were expected to perform at the peak of their capabilities, and when they did not, we would hear some very loud honks from Mother Goose. I can remember enduring her criticism even into my late 20s when politely asking her to dance at a local dinner club. After only a few steps on the floor she counselled, “Bill, you can do better than that.” She was right but I had no intention of mimicking Arthur Murray so we quickly sat down to our salads in order to control my frustration. I was her son who was going to do very, very well, but not so well it seemed that I couldn’t “do better than that.”

Looking back on those years it is true that I wish there had been a little more

sugar in my childhood Kool-Aid but then, how could I possibly complain about the final brew. As a matter of fact, today’s parents (including myself) could learn a lesson or two from her generation’s style of both psychic and material deprivation. I view her demanding demeanour now as but a small expense that returned a much larger reward. If the price be that emotionally I sometimes continue to view my own behaviour critically, the blessing comes most certainly from my family and the opportunities I can afford them and others outside my family circle, as well as a now intellectual acceptance that I have done what I set out to do. I recall an early visit by my parents to Southern California after just having started a job at the fledgling Pacific Investment Management Company in 1972. “Mom,” I told her, “someday I’m going to become the best bond manager in the world.” Eyebrows were raised without a return comment of encouragement, but then while she didn’t know a thing about bonds, she knew a lot about me, and I now suspect she thought I had a chance – whatever it was that bond managers

did. A few years ago when I returned to the Mausoleum where both of my parents are interred I had a one-way ghostly conversation with them, and at some point during my silent soliloquy I finally broke the decades-old emotional umbilical cord by saying, “you know Mom, I can’t do any better than this.” I think instead of raised eyebrows she must have been nodding in mutual agreement. While not at the end of the line, I had reached a destination from which I could go no further or “do better than that.”

Who would have thought the bond market could have done “better than that” – better, that is, than what it typically does during periods of rising short-term rates? Not yours truly, nor Alan Greenspan who calls it a “conundrum” – a word with less impact than “irrational exuberance” but fraught with significance nonetheless if only because it acknowledges mystification by a man who is supposed to have a lot of the answers. The fact is that since the Fed has raised the overnight rate from 1% to 2½% (with market expectations for more), the 5-year Treasury (a proxy for the market as a whole) has declined by 15 basis points. Long bonds and 10-years have done even better, dropping

75 and 50 basis points, respectively. Greenspan and Gross as well as the entire A-Z list of bond managers know that while typically the yield curve flattens as the Fed marches upward, it does so by intermediate and long yields going up less than short rates. What they call bull flatteners (long rates going down) are as rare as Ahi tuna that never hits the grill. How then to explain it, and is there an irrationality to this market that speaks to overvaluation or perhaps even a bubble?

I must tell you that we at PIMCO have been talking about this topic for months. We, too, have been befuddled and have been forced to readjust expectations and examine new evidence in light of a transformed global economy. Our conclusions, reached some days before Greenspan’s testimony, are outlined in a summary memo I addressed to our Investment Committee on 17th February. I submit it to you in its entirety with only minor modifications and additions (primarily in the graphs that follow).

To: Investment Committee
From: Bill Gross
Sent: Thursday, February 17, 2005 12:29 PM
Subject: macro/portfolio management thoughts

Specific to recent discussions which have been spiced by Greenspan's testimony I believe our Committee believes that the "conundrum" is due in part to a recycling of the U.S. trade deficit back into the U.S. bond market whether it be Treasuries, Agencies, mortgages, or corporates. In effect, U.S. overconsumption is being recycled nearly one for one back into the bond market as opposed to direct investment or investments in stocks, producing artificially low yields of indeterminate magnitude – perhaps 50-100 basis points but unclear. Chart 1 graphically demonstrates the growing shortage of Treasuries available to domestic investors despite the burgeoning budget deficit. It is this shortage, as well as similarly reduced supplies of other mortgage and corporate bonds that have lowered yields when they normally move the other way. Due to global arbitrage and currency/portfolio diversification requirements by Asian central banks, other markets in Euroland, and selective EMG markets are in a similar "conundrum." In effect, a lack of global investment opportunities due to a shortfall of global aggregate demand has resulted in a surfeit of savings, which is flooding the global bond markets. The attempt by Asian Central Banks to suppress their own currencies is but a part of this larger secular phenomenon. A FRENZY TO CAPTURE CARRY HAS BEEN THE INEVITABLE RESULT, PRODUCING ARTIFICIALLY LOW YIELDS OUT THE CURVE, ARTIFICIALLY LOW SPREADS, AND ARTIFICIALLY LOW VOLATILITY AS PARTICIPANTS ANTICIPATE A CONTINUATION OF CURRENT TRENDS. In addition, the assumption of a "measured" Fed, together with an assumed low level for real short rates in future years has further dampened volatility which in turn has helped to flatten the curve, as have changes involving GSEs and the mortgage market. Recently enacted and proposed accounting changes as well as cash flow specific contributions from the PBGC and others have focused interest at the long end of the curve as well as both here and in Europe.

How to structure portfolios in such an environment which belies the common business and interest rate cycle?

My proposal, consistent with many others in the IC (although certainly not unanimous) is as follows:

1) In general, do not own nominal notes in 2-10 year paper in countries with average or vibrant demographic conditions which are able to inflate their way out of the global aggregate demand predicament, and which currently price in

a continuation of today's high savings, low interest rate "conundrum." The U.S. is the primary culprit in terms of what we can/do own and its market yields currently qualify as a "mispricing." It is also most vulnerable to foreign central bank diversification or "buyer's strike" even if probabilities of the latter are low.

2) Focus on bond market economies that are decaying demographically and that are deflation prone—thus maximizing real returns over time and providing relative price protection as well as comparable carry if possible. Euroland is the primary candidate, qualifying demographically, structurally, and exhibiting comparable carry to the U.S. which soon may move to the plus side as short rate differentials widen. Japan's carry is still deficient although it is becoming more attractive.

3) Invest in the U.S. in TIPS since inflation in demographically stable economies is a natural result of low real interest rates and the asset inflation which it produces. A continuing declining dollar reinforces this view as a strong EURO and YEN add to the positives in #2 above.

4) Seek cash/low duration as a haven in all markets but in the U.S. specifically if and when yields begin to approach the level of the bond market itself. Eurodollar reds are beginning to qualify even under our low real rate assumptions for the FED.

5) Be mindful of Asset Liability Management (ALM) trends which may force money into markets with limited supply. While Euroland has more flexible supply conditions, its ALM trends are more advanced and some of the supply may be priced into the current curve. Although U.S. supply is severely constrained (20-year TIPS being the only new issue) it is also subject to a Treasury Department policy reversal. I'm not clear on which long end is more attractive but would be open to either.

6) Be alert to developments which may reverse this "perfect Goldilocks" environment and anything that would affect the trade deficit or induce volatility back into the market—geopolitical, LTCM look-alikes, trade legislation, dollar crisis, oil. Analyze too, if the current trend continues, whether existing yield levels could go even lower. I do not believe they will however due to the climbing level of short rates and their forward curve counterparts which are becoming increasingly attractive.

The above considerations produce the following portfolio structures:

A) We should lower overall durations to the point of flat carry to our bogies. Where that is I'm not sure but the idea reflects the view that while we are not sure when the "conundrum" will reverse, we want to protect ourselves against it as long as our portfolios can wait it out without sacrificing yield. I wouldn't be concerned about a duration as much as 1 year lower than indices if carry equaled the index.

B) Foreign orientation—0.5 to 1.0 years duration, perhaps as much as 30% of typical portfolio holdings.

C) Front-end duration focus if forward yields are attractive compared to 5s and 10s.

D) TIPS—overweight.

E) Slightly lower than index weighting of long duration assets to protect against ALM trends.

F) Vol sales at wings even at existing low levels.

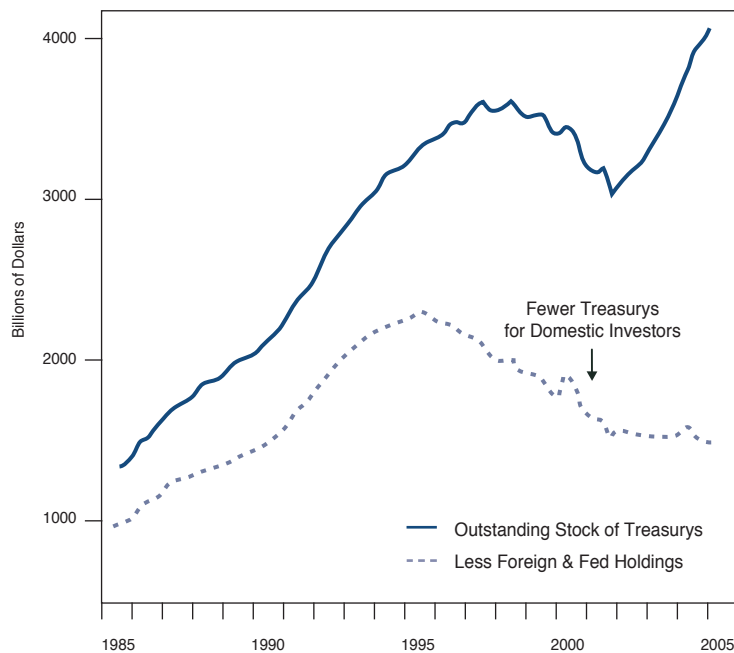
G) Long-term Munis at 97%+ of Treasury counterpart yields.

H) Low mortgage and corporate concentrations.

This portfolio is a different one for us so I will need to solicit comments.

WHG

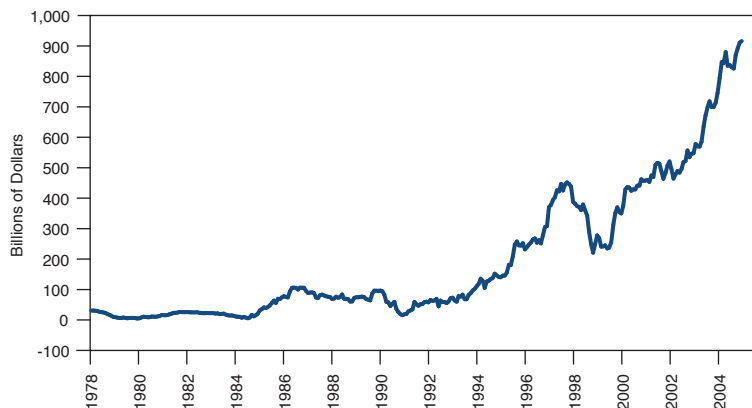
Bond Market Tsunami



Source: BCA Research 2005 ©

Chart 2

Net Purchases of All U.S. Securities by All Foreign Countries
12 Month Rolling Sum



Source: Department of the Treasury International Capital (TIC) Reporting System
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In light of our rationale, which attempts to explain the great “conundrum,” an interested reader might wonder why our durations and overall strategy appear so defensive. After all, if foreign central banks and others continue to absorb 70%+ of the bond market’s new supply (900 billion out of an estimated 1.3 trillion in 2004), why wouldn’t this “squeezing” out of domestic investors continue unabated, with yields continuing to move lower? The insensitivity to price/yield exhibited by Asian central banks in an effort to cap their own currencies might seem just as illogical 50 basis points lower as it does right now. And if the lack of global aggregate demand reflected in a surfeit of savings is really the primary cause, the malady is not likely to improve for years. Point granted. We might be at the mercy of a bond market

tsunami here, whose first wave has struck and is now receding, only to be followed by more of the same in a few short months. This possibility is part of any interest rate guessing game except it is complicated in this new instance by buyers who have non-interest rate concerns. Still, there are limits. Why would a central bank buy 10-year Treasury paper below 4% if it expected 3-month Treasury Bills to be yielding 3½% by the end of the year? It could cap its currency just as easily by going the short maturity route without risking future price losses. And for those institutional foreign bond holders, and the “hedgies” domiciled in the Caymans, there’s no doubt too that a higher and higher short rate reduces and in some cases eliminates “carry,” leading to collapsed positions and ultimately higher yields further out on the curve.

So the road, as most roads do, ultimately winds back to the central banker controlling the world's reserve currency – Alan Greenspan. While he may have legitimate questions about why yields are so low in the face of rising Fed Funds, he indeed sits on a throne higher than his global counterparts. If he wants the 10-year Treasury at 4½%, he should just wave that Fed Funds sceptre at a few more meetings, and there'll be no bull bond market tsunami. Four percent is the floor for 10-year Treasury notes in my view. It's time to get defensive as long as your portfolio "carries" enough yield to outlast the wave of global

savings and price-insensitive central bankers who have dominated the cycle to this point. Because of them, a bear market may not be in the offing for some time, but Greenspan's Fed Funds sceptre should be enough to stop the current bull market charge. If it doesn't, you can write and say I should have known "better than that," but it won't bother me as much as it used to.

William H. Gross
Managing Director

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