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Investment Outlook

P I M C O

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What Do They Know?

If you're struggling to find something that symbolizes the transition from the old-fashioned markets of yesteryear to the seemingly inexplicable wildness of today's derivative-driven, conduit-imploding financial complex, you need look no further than the contrast between old television's Louis Rukeyser and thoroughly modern Jim Cramer. Calm, stately, with deep-throated baritone certainty, Rukeyser was the spokesman for aging boomers who wanted assurance that a nostril-snorting bull market would reign supreme. No less a cheerleader, but with soprano-inflected importuning decibels louder than any rival on the flat screen, Cramer, in recent weeks at least, has been willing to recognize that the momentum could turn in favor of the visiting bears. At a moment of courageous yet seemingly reckless abandon during a week when Treasury, Fed, and White House officials were trying to calm investors with an "all clear" story line, Cramer screamed at the CNBC camera, "They know nothing, they know nothing!" Just who "they" were was left to the imagination, but it was clear that in Cramer's world

Rukeyserian bullishness was not the order of the day.

Indeed, it was not. As Cramer was railing, I and other PIMCO professionals were attempting to describe to high-ranking Treasury and Fed officials the near-frozen commercial-paper markets and the draining confidence of bond and stock investors worldwide. It was Thursday, August 16. Stocks had closed down 210 points and were expected to open hundreds of points lower on Friday. The country's largest mortgage originator, Countrywide Financial, was rumored to be in liquidation mode (it survived that crisis). This was to be Ben Bernanke's first test, an opportunity to prove that he and his board of governors knew "something" as opposed to "nothing." Pass the test he did, cutting the discount rate the next morning and calming markets in ensuing weeks. When Bernanke's Fed met officially on September 18, it acted again and joined a convoy of global central bankers maneuvering to restore a semblance of normalcy to credit and equity markets. So far, so good.

Yet the validity of Cramer's rant remains to be disproved. The modern financial complex has morphed into something unrecognizable to many astute market veterans and academics. Bernanke's fellow governors and Hank Paulson's staff at the Treasury spread their roots during an era in which traditional banking activity – lending out deposits backed by a certain level of reserves – was the accepted vehicle for liquidity creation. Remember those old economics textbooks that told you how a \$1 deposit at your neighborhood bank could be multiplied by five or six times in a magical act of reserve banking? It still can, but financial innovation has done an end run around the banks. Derivatives and structures with three- and four-letter abbreviations – CDOs, CLOs, ABCP, CPDOs, SIVs (the world awaits investment banking's next creation; perhaps IOU?) – can now take a "depositor's" dollar and multiply it ten or 20 times. Reserve banking, and the Federal Reserve that regulates the system, appear anemic in comparison.

I'm sure that Bernanke, Paulson, and their cohorts understand this, but it isn't yet clear how much they appreciate it. Alan Greenspan admits in his newly published book that he didn't appreciate until recently the impact adjustable-rate mortgages and their subprime character, accompanied in some cases by outright fraud, would have on the housing market.

If the Fed was so slow to grasp the role that subprime mortgages played in the housing boom and bust, do the Fed and the Treasury of today totally comprehend what happens when the nonbanking private system suddenly stops flooding the market with credit? Do they recognize that such a shutdown puts spending for housing and business investment at risk, and job growth as well? The Fed will have to adapt its monetary policy, and the Bush Treasury will have to adjust its fiscal policy to this brazen new world dominated more and more by private rather than public policies and proclivities. To overcome private-market caution, the Fed may need to put on a bold face marked by even more decisive cuts in short-term rates. To prevent a housing-market slump from metastasizing into a cancerous self-feeding tumor, Treasury Secretary Paulson will have to coordinate policies that lend a helping hand to homeowners in distress.

But Paulson's attempt to assist ailing homeowners will be complicated by the free-market *laissez-faire* policies of Republican orthodoxy. In addition, the rescue effort will be hampered by an uncomprehending press and public who appear to be more focused on revenge and "just desserts" as opposed to the ultimate negatives ahead for housing prices, employment, and economic growth. To use the old saw in updated form, a recession is when home prices

in a neighboring state go down – a depression will be when the price of your home does. Well, if that be the definition of modern depression, then 70 million American homeowners will soon be residing in Bush, not Hoovervilles.

But if Paulson cannot prevent expected declines of 10-15% in national home prices over the next several years, it is problematic as to whether Bernanke can substantially cushion them either. First of all, the aforementioned lack of “appreciation” of a modern-day shadow banking system has put the Fed far behind the 8-ball in its reflexive duty to lower interest rates in an anticipatory fashion. Mortgage credit has been contracting on the ground level for all of 2007 with individual, small, and then national mortgage brokers and originators closing their doors. Legal threats and regulatory pressures have compounded the credit implosion. As a result, home prices, as shown in Chart 1, have been declining for nearly 12 months and only now is the Fed responding to an unfolding crisis.

Bernanke’s Fed may be as opposed to targeting asset prices as was Greenspan’s, but housing and stock market bubbles are birds of entirely different feather. 1987’s equity crash and its negligible effect on economic growth as well as Nasdaq’s fall from 5000 to 1500 in recent years, which led to a very mild investment led-recession, cannot be the textbook examples for Fed asset price policy today. Wall Street, despite its increasing influence in America’s finance-based economy, is not Main Street; and stock prices do not dominate the spending habits and confidence of its consumers in the same degree as do home prices. So Fed policy must, as governor Don Kohn mentioned recently, be as asymmetric as asset prices – emulating an escalator on the way up (25 basis point increases) and an elevator on the way down (50 basis point reductions).

Bernanke, however, may face a problem with this elevator-based ease in monetary policy. As I have pointed out in prior pages and *Outlooks*, globalization and financial innovation have enormously complicated the job of central bankers. Whereas in prior decades a “one size fits all” policy rate move has coincidentally and democratically affected households and corporations alike, the 21st century has ushered in an innovation revolution favoring corporations with global investment

Taking the Down Elevator

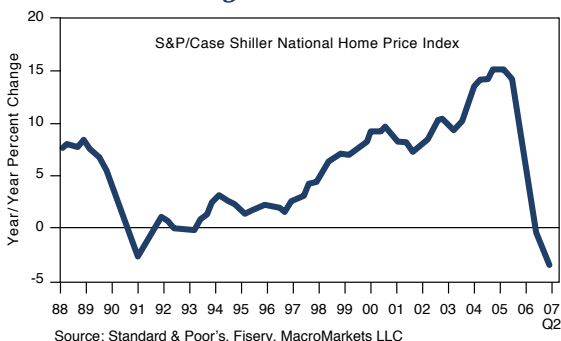


Chart 1

opportunities as opposed to individuals with daily bills to pay. The same 4¾% rate is not and cannot be “neutral” for both sides in today’s U.S. economy.

Whereas current yields are not restrictive for investment grade corporations with global opportunities, they are far too high for homeowner Jane Doe and two million of her neighbors facing higher and higher monthly payments on adjustable rate mortgages. Should Bernanke put on a brave face and freeze the elevator and rates in mid-descent, he risks exacerbating a housing crisis in the making. Yet, should he favor the homeowner over the corporation, he risks reigniting speculative equity market behavior, and – in addition – a run on the dollar.

PIMCO’s view is that a U.S. Fed easing cycle historically has required a destination of 1% real short rates or lower. Under a conservative assumption of 2½% inflation, that implies Fed Funds at 3¾% or so over the next 6-12 months. Actually that’s only two, 50 basis point reductions, something that could, but probably won’t, be accomplished by year-end. Don Kohn’s asymmetric elevator will

likely be interrupted by false hopes of a housing bottom, fears of a dollar crisis, or misinterpreted one month’s signs of employment gains and faux economic strength. The downward path of home prices, however, will dominate Fed policy over the next several years as will the lingering unwind of related financial structures and derivatives that have yet to be discovered by the public, and marked to market by their conduit holders.

Know nothing? Perhaps they now know more than I or Jim Cramer gave them credit for on that raucous day in August. If they do, however, their options are limited by Republican political orthodoxy, the receding willingness of the private sector to extend credit, and a still exuberant global economy. What do they know? I suspect at the very least they know they’re in a pickle, and a sour one at that.

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