Erich Maria Remarque’s 1929 masterpiece quoted above stands tall in its eloquent soliloquising of the horrors of war. “The wisest were just the poor and simple people,” he wrote. “They knew the war to be a misfortune, whereas those who were better off…were beside themselves with joy.” His description of WWI’s life in the trenches could not envision the multipartheid fronts of modern-day Iraq with its randomly spaced IEDs and computer-directed flying drones, yet the carnage is the same and probably just as futile. Remarque’s Western Front has migrated to the Middle East, but the human condition with its conflicted politics remains unchanged: there are combatants – each with God on their side and a cause to die for. Yet for the soldiers, only survival and camaraderie seem to prevail once in the trenches. “We have lost all sense of other considerations,” wrote Remarque in describing the horrors of his day’s impenetrable line. “Only the facts are real and important to us. And good boots are hard to come by.”

They remain so, I suppose, although in recent years the scarcity has morphed to bulletproof vests and steel-plated Humvees. Still, they die, and we are the poorer because of their loss. May the living fly home in their boots and plant them once again on American soil.

There have been multiple fronts in the investment markets in recent years with varying strategies – much like we are witnessing in Iraq. For PIMCO though, at least from the standpoint of my biased and vulnerable memory bank, there has been a consistent and easily definable plan ever since late 2006:

1. Avoid the subprime mortgage meltdown and prepare portfolios for the consequences of a housing downturn. (Mission accomplished!)
2. Anticipate the monetary policy changes of the Fed by purchasing high quality front-end investments that would benefit from Fed Funds cuts to as low as 2%. (Mission nearly accomplished!)
(3) Reinvest in high-quality financial institutions which suffer capital impairment during the anticipated recession. (Mission uncertain!)

(4) Ultimately invest in lower quality bonds as corporate defaults rise to peak levels. (Mission for the future.)

(5) Be mindful at all times of the effects of a globalised economy/financial marketplace and its consequences for real interest rates, inflation, and currency levels. (Mission ongoing.)

While this plan has obviously been quite successful to date, it hasn’t come without risk nor sleepless nights. The first half of 2007 was fraught with self doubt and hundreds of “expletives deleted” amongst the PIMCO platoon pinned down in the trenches of a bulled-up credit market where seemingly nothing could go wrong to shake the confidence of levered investors. In order to avoid getting our heads shot off, we had to go without the plentiful L+ 25 basis point rations that were feeding an entire universe of soldiers strung out along the same impenetrable trench of risk taking. Ah, but then the pivotal turning point – the collapse of the Bear Stearns hedge funds in June of 2007, the horrific days of mid-August, and now the aftermath of another Bear Stearns debacle one year later. We have not only survived, but gained territory and are eager for further advances.

It is here, however, where battlefield generals have to pause and consider whether to mount an all-out attack or wisely assess the enemy’s flank in addition to its hollowed centre. PIMCO has two CIO generals now, and for several months, Mohamed El-Erian has been counselling to at least consider a fat-tail possibility that could stop us in our tracks at #3 on the list of our strategic battle plan.

Mohamed suggests the possibility, not the probability, that recent euphoric moves in equity prices and credit market spreads might be premature. The market’s justification may rest on the two-barrelled conclusion that, 1) the deleveraging of the financial system is reaching a natural culmination as prices stop going down and banks and investment banks recapitalise their balance sheets, and 2) that numerous and previously unthinkable policy responses have restored enough liquidity to re-lubricate our finance-based economy. That may well be the case he counsels, but these are changes centred on Wall Street and “The City.” Life on Main Street, U.S.A. and its English counterpart may be another matter. Recession, and its vicious-cycle effect on employment and consumer spending, remains a threat and this recession, although currently mild and as of yet not even officially validated, may not be your garden-variety, father’s Oldsmobile-type of downturn.
To that possibility, PIMCO’s Investment Committee (IC) turns to member Paul McCulley whose Keynesian roots are fertilised even more so by the less famous Hyman Minsky, himself a Keynesian but with a financial system orientation. In retrospect, it was McCulley who introduced PIMCO’s IC to Minsky’s *Stabilising an Unstable Economy* back in 2002, and thus laid the groundwork for step #1 in our strategic plan – avoiding the subprime mortgage meltdown. That book, Paul’s endorsement, and a lot of collective commonsense and internal research have been worth billions. But to the point: Main Street instability in the form of consumer spending – itself a function of a destabilising downward spiral in home prices – must be contained, or else the current giddiness of the markets’ premature armistice may remorph into the guns of August (2007). Home prices and their real economic fallout are the financial markets – and PIMCO’s – vulnerable flank. And it is Minsky with his analysis of prior 20th century financial crises who serves as a key observer from his outpost of decades past.

To be brief and blunt, the reason that home prices are so critical, he would claim, is that they are at the forefront of potential asset deflation. Because the U.S. and selected other economies are now substantially asset-based and dependent on stable and upward tilting prices, a deflation of an economy’s primary financial asset can be ruinous. Its deflationary thrust must be countered, wrote Minsky, or else the battle might be lost. If so, the real economy as Mohamed El-Erian suggests, might become so shell-shocked that financial markets once again turn down instead of up.

Minsky, McCulley, El-Erian, Gross, Feldstein, Summers, and a host of others would likely argue that additional policy measures are required to support home prices which have fallen by 10% over the past 12 months and are set for a repeat by this time in 2009. Lower Fed Funds? They would, in PIMCO’s opinion, likely do more damage than good from this point forward. Foreign and domestic investors are being fleeced with negative real interest rates, and the weak dollar, stratospheric commodity prices and steadily rising import inflation are the result. The better alternative is to initiate a limited mark-to-market write-down of private mortgage debt as envisioned in the Dodd-Frank Congressional proposal combined with government-subsidised loans at below market rates. Look at it this way: you can allow a home to fall in price from $400,000 to $300,000 and force an upside-down “short sale” foreclosure, or you can reduce the homeowners’ $400,000 mortgage to $350,000, refinance the loan through the FHA at 4% and stabilise the neighbourhood and its home prices. Surely Republicans, Democrats, AND
Wall Street mortgage holders (PIMCO included) can recognise that stability as opposed to freefall market clearing is the better alternative, especially if the pain is shared by all parties. It is our best chance to cushion Minsky’s asset-based deflation.

Other policy initiatives such as the Bank of England’s 100 billion dollar term funding of their own mortgage market as well as the continued potential for U.S. agencies or the Fed to participate in similar manoeuvres are promising alternatives with a unified objective in mind: support home prices. A continued housing deflation of several trillion more dollars now threatens to impact the real economy which in turn might produce a reversal of financial market fortunes. For now, all is quiet on our investment front and the war appears to be winding down. We remain on the alert however as we seek to implement step #3 and eventually step #4 of our investment battle plan. Remarque wrote of his WWI soldiers: “We live in the trenches...we fight. We try not to be killed. Sometimes we are. That’s all.” At PIMCO, with a much less dangerous but perhaps equally probabilistic occupational outcome, we will keep our heads low in hopes of fighting for another day.

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