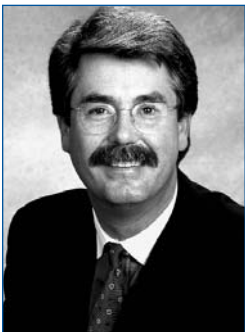


Global Central Bank Focus

by PIMCO's Paul McCulley

If Fed Funds Rate "Fails" to Fall



Paul McCulley

As a single parent of a 17-year-old son, my night job has come to resemble my day job as a central bank watcher: listening to the words of my protagonist in the context of deeds, forming expectations of future words and deeds, adjusting my risk positions accordingly. Neither is easy though increasingly, I believe it is easier to anticipate a 17-year-old than a central bank, even though 17-year-olds specialize in obfuscation, while central banks are ostensibly ever more transparent.

Why? Seventeen-year-olds, while normally opaque and obscure, are quick to correct misalignments between their expectations and a parent's expectations—as in, *"If you think I will resist turning the computer back on after you hit the sack, Dad, you are nuts."* In contrast, central bankers frequently exploit misalignments between their policy intentions and market expectations for those intentions, letting market misperceptions "do their work," until such market "work" threatens to be counterproductive to the central bank's objectives, requiring the central bank to overtly realign market expectations.

Seventeen-year-olds don't play word games with their parents, even though they most certainly play their parents with defiant deeds. Central bankers, in contrast, play word games with markets, hoping to minimize the magnitude and abruptness of their policy deeds. The former is, at least for me, much easier to handicap than the latter.

Not that I'm existentially critical of either: both are cut from monopolistic cloth, just sewn up differently, with 17-year-olds wearing their power on their shirtsleeves and central bankers wearing their power up their shirtsleeves. Which, when you think about it, is rational—kids know you will always love them, but central bankers constantly worry about losing the markets' love, technically known as credibility.

Of Noise and Asset Prices

Most important in real time, I think, central bankers abhor (1) the risk of getting whipsawed, prematurely changing policy on noise in the data flow and then having to quickly reverse in the opposite direction, and (2) being accused of targeting asset prices. Thus, it is eminently rational for central bankers to use constructive ambiguity as one of their tools, letting market players chase noise in the unfolding data flow until such noise proves to be not noise, but cumulatively a policy signal, at which time policy is adjusted.

Such a reaction function benefits the central bankers in two ways: (1) it minimizes whipsaw risk, with market players suffering the whipsaw, not the central bank and its credibility, if noise hinting at fundamental change turns out to be nothing but mere noise; and (2) the asset price changes associated with noise will tend to have a smoothing effect on fundamentals, as these changes in so-called financial conditions in response to noise have automatic stabilizer qualities.

Indeed, such has been the case since the Fed's August 8 decision to stop hiking short rates, after doing so for 17 meetings in a row, starting in June 2004. This self-labeled "pause" was triggered primarily by clear fundamental evidence—not noise!—that the housing market had gone into recession.

There was, actually, nothing extraordinary about the Fed stopping, despite its own assessment that inflation risks remained on the upside. Any central banker not wearing inflation-nutter clothes knows that housing is a leading fundamental variable in aggregate demand growth relative to aggregate supply growth,

called the output gap, while inflation is a lagging fundamental variable to the output gap. Smart central bankers don't chase lagging variables.

What has been extraordinary since the Fed stopped has been the markets' willingness to quickly discount a reversal to easing, as shown in Chart 1, despite the Fed's continued preaching of upside inflation risks and a bias towards further tightening, in the context of the ex-housing economy holding up well and a falling unemployment rate.

To be sure, markets, notably the bond market, always front run the Fed in discounting a reversal to easing after a prolonged tightening cycle. But, as Chart 2 on the next page displays, this cycle is unique in the willingness of the markets to ease financial conditions in anticipation of a reversal to Fed policy easing, without:

- In-the-face fundamental evidence pointing in that direction, notably a rising unemployment rate, and/or
- A gathering storm of financial instability and widening risk premiums.

Bottom line: Given that there are clearly no present signs of widening risk premiums, but just the opposite, the ineluctable conclusion must be that the bond market's growth hurdle for **discounting** easing has fallen relative to the Fed's traditional growth hurdle for **actually** easing.

Nothing wrong with this per se. Indeed, turbocharged front running of prospective Fed policy actually increases the efficiency of changes in Fed policy, speeding the transmission of monetary policy's impulse to aggregate demand growth. Such front running is not, however, symmetrical.

Markets can sustainably tighten financial conditions quite easily, lifting market rates ever further above the prevailing Fed funds rate; this was the role of the so-called bond market vigilantes of yesteryear, who would punish the Fed for "failing" to tighten in the face of incipient inflationary pressures. It is quite another thing, however, for markets to sustainably ease financial conditions from a starting point of the yield curve below the prevailing Fed funds rate, as the case at present.

In this circumstance, it is not the market punishing the Fed for deficient anti-inflation action or credibility, but rather the Fed punishing the market with negative yield pick up for doing its "work," easing financial conditions, tempering downside risks to growth. At some point, rational market participants will refuse to pay to play (give yield to be long of duration), lifting market rates back up toward the higher Fed funds rate, tightening financial conditions, un-tempering downside risks to growth.

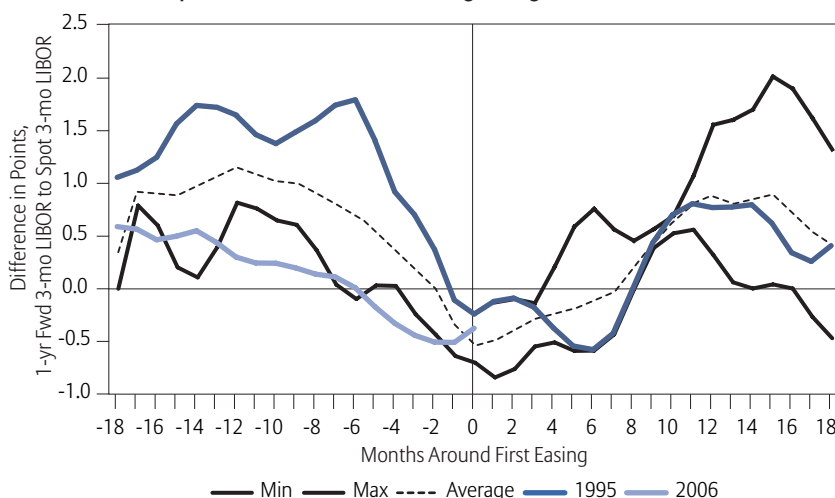
Paradoxically Yours

Just such a scenario has been nascently unfolding since early December, with market-determined yields up some 40 basis points, but still 25-50 basis points below the prevailing 5¼% Fed funds rate, on the back of stronger-than-expected growth data and resolutely anti-ease Fed rhetoric. Ironically, some of the stronger-than-expected data has actually been from real estate markets, with a seeming stabilization after a year-long precipitous decline in permits, starts and sales.

In my view, however, such stabilization will be but a mirage if the market continues un-discounting Fed ease, taking market rates all the way back up to or through the prevailing 5¼% Fed funds rate. Indeed, none other than Fed Vice Chairman Kohn acknowledged the risk of this scenario two weeks ago, when he said (my emphasis):

"In my own judgment, housing starts may be not very far from their trough, but the risks around this

CHART 1
Relative To Prior Cycles, Forward Market is Pricing Easing as if it is Imminent

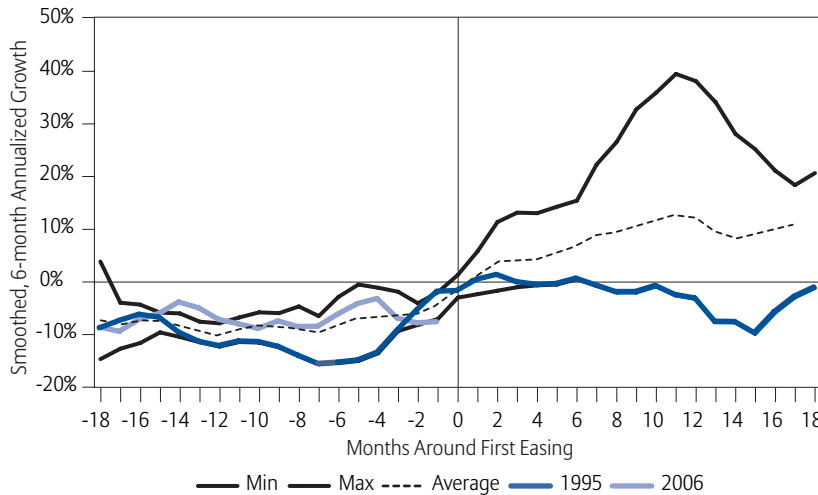


*Average = 1989, 1995, 2001

Source: Bloomberg Data

This chart is not indicative of the past or future performance of any Allianz Global Investors product.

CHART 2
The Unemployment Rate, However, Hasn't Shown the Increase Typically Associated With the Eve of Easing



*Average = 1989, 1995, 2001

Source: Bureau of Labor

This chart is not indicative of the past or future performance of any Allianz Global Investors product.

outlook still are largely to the downside. Although house prices nationally have decelerated noticeably and appear to have fallen in some markets, they are still high relative to rents and interest rates. Building permits decreased substantially again in November, and inventories of unsold homes have only started to edge lower. We also do not know whether the possible stabilization that seems to be taking hold would be immune to a rise in longer-term interest rates should term premiums increase or the federal funds rate fail to follow the downward path currently built into market expectations.”

It was wonderful to hear Mr. Kohn talk so candidly, explicitly acknowledging downside risk to growth associated with a “failure” of the Fed funds rate to fall, explicitly acknowledging that longer-term interest rates are where they are, putting a possible floor under property prices, precisely because longer term interest rates embody expectations of Fed easing.

Note, he did not talk about relatively low longer-term interest rates in the context of former Chairman Greenspan’s conundrum, which was all about why the positive spread of longer-term yields over Fed-controlled shorter-term yields was so skinny.

That’s still an open question, but an inverted yield curve, notably when the inversion begins at nine months out on the curve is not a conundrum! Rather, such a curve is an explicit market statement, backed by real money, that investors are betting on Fed easing. And those bets are, as Mr. Kohn observed, part of the reason for soothing news about downside risks to growth, notably from housing.

Thus, we have a paradox: the Fed doesn’t want to signal ease, because the data are looking better, but the data are looking better because the market is explicitly betting on Fed easing. In fact, I believe that it is not just the yield curve that is making that bet, but “risk assets” more generally, notably ebullient stocks with low volatility and tight corporate credit spreads (which are linked, of course, by the Merton thesis¹).

Bottom Line

This paradox will not long endure, in my view: either the Fed will “validate” the markets’ pricing of easing, or the markets will un-price that easing, tightening financial conditions. In the former scenario we will all live happily ever after, or something like that, sometimes labeled a Goldilocks soft landing.

In the latter scenario, we will all live happily ever after, too, but only after an unnecessary interlude of melancholy, where the markets undo the easing “work” they have done for the Fed, reopening downside risks to economic growth that provide justification for the Fed to do its own easing work.

And what are the odds on these two scenarios? I wish I knew! I really, really do. But I don’t. What I do know is that a soft landing—which is the odds-on fundamental scenario—will require the economy’s runway to be lubricated with Fed easing. So sayeth the markets.

Or, as my 17-year-old would say, “*You will ultimately see it my way, Dad, it’s just a matter of whether I have to drive you crazy first.*”

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Investors should consider the investment objectives, risks, charges and expenses of any mutual fund carefully before investing. This and other information is contained in the fund's prospectus, which may be obtained by contacting your financial advisor. Please read the prospectus carefully before you invest or send money.



¹The Merton model links the equity and bond part of a company through an option-based framework in the following way: equity holders can be thought of as being long call options on the firm's value, while bond holders can be thought of as being short puts on the firm's value. In the case of default, the firm's equity price drops to zero, and the bond holders lose part of their principal. Since higher risk to the firm's value (via higher uncertainty, volatility, leverage etc.) is detrimental to the equity due to increased likelihood of default, and lower risk is beneficial to the equity due to decreased likelihood of default, the credit spread on the bonds adjusts to movements that impact the price of the equity. Market participants in credit markets look to the equity markets for the perceived risk of default, and participants in the equity markets look at credit markets for the same, leading to a possible self-fulfilling feedback loop.

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