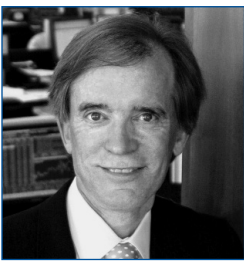


Investment Outlook

by PIMCO's Bill Gross

Pyramids Crumbling



Bill Gross
Founder and CIO,
PIMCO

My college experience dates so far back that it can only be labeled “ancient history.” Still, there are a few seminal lessons I learned at Duke University—unfortunately none of them having much to do with the classroom. “Ticket Scalping 101” and “Beginning Blackjack” probably head the list, but not far behind would be “Introduction to Pyramid Schemes.” While the first two courses may be rather unique to my own experience, the latter I assume is standard fare, and has been since the first diploma was awarded at Harvard, Yale or whichever college claims to have been the “firstest” with the “mostest.” A second semester senior who never signed up for a dorm-born chain letter cannot really claim to have received a college education at all. The chain’s lesson was that you should be the **originator** of the letter, not the 500th recipient. You wanted your name at the apex of this upside down pyramid not at the broadened top, which signaled the exhaustion of additional fish, tuna or whatever derogatory noun one could employ to signify the university’s last few suckers.

Wall Street and its global lookalikes, of course, are life’s largest colleges where lessons can be mighty expensive and downright bankrupting. The last two decades alone have witnessed pyramid schemes involving savings and loans/junk bonds, the small investor/dot.coms, and now global bonds/subprimes. I could go on and you have your own candidates to be sure, but in each and every case the originator of a surefire “can’t miss” concept collected huge premiums from a willing investment public, only to see the pyramid collapse either of its own merits or from the lack

of additional gullible investors. There will be more to come, much like a regular university that welcomes a never-ending stream of new “students” who pay annual “tuition” to be “educated.”

In addition to the pyramid shape of its securitized assets and the endless chain of its letters, finance and especially modern finance is centered around banking and now, unfortunately, around shadow banking. Both, *The Economist* magazine points out in its September 22nd issue, are built on a fundamental (and ever present) mismatch: they borrow short and lend longer and riskier. Recognizing this flaw, governments have for over a century mandated that banks have an ample percentage of reserves in order to bridge the liquidity and investment risks that periodically ensue. Like Jimmy Stewart in *It’s a Wonderful Life*, the critical job of a traditional banker was to have enough reserves or cash on hand to prevent a run. Stewart’s modern day counterpart must follow similar guidelines, although a 21st century banker now can always look skyward for a guardian angel in the form of the Fed, the ECB, or the Bank of England. Recent infusions of over a half a trillion dollars by this triumvirate point to the perennial need for reserve banking in either an earthly or a more heavenly sense.

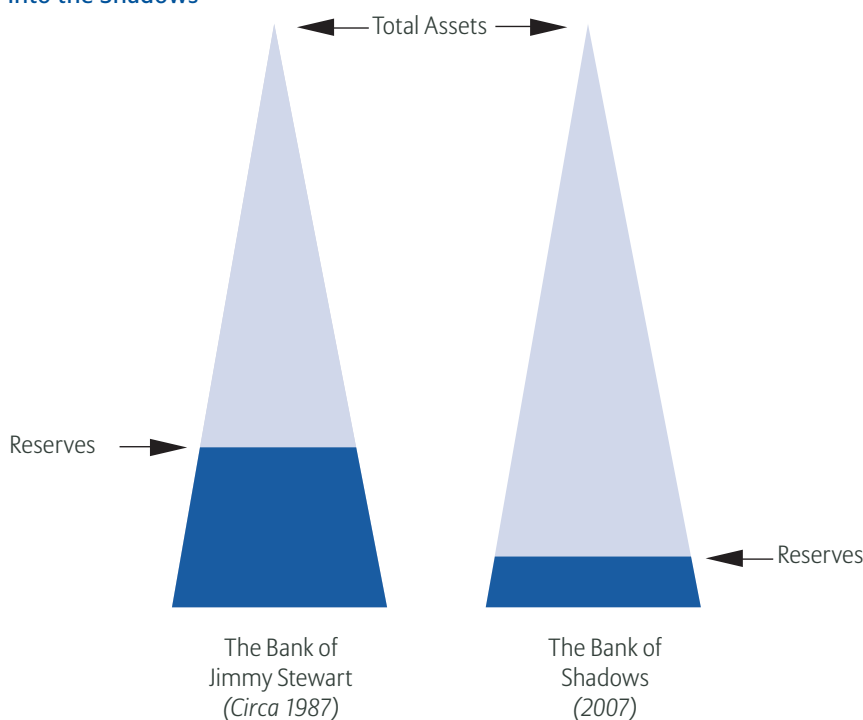
But today's banking system as pointed out in recent *Investment Outlooks*, has morphed into something entirely different and inherently more risky. Our modern shadow banking system craftily dodges the reserve requirements of traditional institutions and promotes a chain letter, pyramid scheme of leverage, based in many cases on no reserve cushion whatsoever. Financial derivatives of all descriptions are involved but credit default swaps (CDS) are perhaps the most egregious offenders. While margin does flow periodically to balance both party's accounts, the conduits that hold CDS contracts are in effect non-regulated banks, much like their hedge fund brethren, with no requirements to hold reserves against a significant "black swan" run that might break them. Jimmy Stewart—they hardly knew ye! According to the Bank for International Settlements (BIS), CDS totaling \$43 trillion were outstanding at year end 2007, more than

half the size of the entire asset base of the global banking system. Total derivatives amount to over \$500 trillion, many of them finding their way onto the balance sheets of SIVs, CDOs and other conduits of their ilk comprising the Frankensteinian levered body of shadow banks.

Defenders might claim no harm, no foul. Theoretically, many of these trillions represent side bets between risk seeking or risk avoiding parties—both adults at a table where the calming benefits of diversification work for the systemic good of all. Originators and existing supporters of these securitized WMDs might also point out that their reserves come in the form of equity and subordinated tranches comprising 10 or 20% of the repackaged loans. They do. But as this equity/subordination shrinks due to underlying defaults, the pyramid begins to unravel. Rating servicer downgrades can and do lead to the immediate liquidation of certain CDOs. The inability to rollover asset-backed commercial paper does and has led to the liquidation of SIVs or, pray tell, a misguided attempt to restructure them as super SIVs. CDOs and even levered municipal bond conduits known as "Tender Option Bonds" have been and will be similarly vulnerable to "Jimmy Stewart-like" runs as the mono-line insurers that theoretically stand behind them are themselves downgraded to less than Aaa status.

The withdrawal of deposits from our new age shadow banking system has frightening potential consequences because a thinly capitalized banking system is always at risk relative to its more conservative counterpart. Visualize, as does Chart 1, in crude yet understandable form, today's shadow system versus that of two decades ago.

CHART 1
Into the Shadows



Source: PIMCO
This chart is not indicative of the past or future performance of any Allianz Global Investors product. For illustrative purposes only.

While the exact amount of reserves supporting the Bank of Shadows is undeterminable, let's go back to the \$45 trillion BIS estimate of outstanding CDS for more insight. If total investment grade and junk bond defaults approach historical norms of 1% in 2008 (Moody's and S&P forecast something close) then \$500 billion of these default contracts will be triggered resulting in losses of \$250 billion or more to the "protection selling" party once recoveries are inserted into the equation. To put that number in perspective, many street estimates ascribe similar losses to subprime mortgages, a derivative category substantially distinct from CDS insurance. Of course, "buyers of protection" will be on the other "winning" side, but the point is that as capital gains and capital losses slosh from one side of the shadow system's boat to the other, casualties and shipwrecks are the inevitable consequence. Goldman Sachs wins? Fine, but the losers in many cases will not be back for a return match. Much like casinos depend upon a constant stream of willing gamblers believing that this is their day, so too does Wall Street. But a trillion dollars of SIVs with their asset-backed commercial paper may be a dinosaur relic of yesterday's shadow system. They will likely not be back. And the New Century mortgage originators? The Bear Stearns hedge funds? The chastened Freddie Macs and Fannie Maes, and all of the banks and investment banks requiring fresh capital through the sale of stock? They'll be back but not in risk taking, fighting form. Throw in an embarrassed regulatory network consisting of the Fed and Congressional watchdogs asleep at their post, but are now more than willing to display their prowess, and you have a recipe for credit contraction, a run on the shadow banking system that would give Mr. Stewart shivers aplenty. The unfairly "Ben Stein pilloried" Jan Hatzius of Goldman Sachs estimates that mortgage related losses of \$200-400 billion alone might lead to a pullback of \$2 trillion of aggregate lending. Even if this occurs gradually, he writes, "The drag on economic activity could be substantial."

Add to that my \$250 billion loss estimate from CDS, as well as prospective losses in commercial real estate and credit cards in 2008 and you have a recipe for a contraction in credit leading to a recession.

Pyramid schemes and chain letters collapse because there is no more credit to feed them. As the system of modern day levered shadow finance slows to a crawl, or even contracts at the edges, its ability to systematically fertilize economic growth must be called into question. **And as the private shadow banks of the 21st century are found wanting, so then must public finance in the form of lower interest rates and increasing fiscal deficits fill the breach. The Fed will likely reduce Fed funds to 3% by midyear 2008. Congress and the Administration should, but likely won't, join hands in a tax relief program that benefits low income homeowners.** Market based, regulation-lite American style capitalism, seemingly so ascendant after the dot.com madness nearly a decade ago, has met its match with the subprimes and the poorly structured and supervised derivative conduits of today's markets. Financial innovation will inevitably march forward, if not in distinctly new forms, then into new asset markets and even unexplored continents. For now, however, its current surge is spent. Investment survivors will have to learn to live in a different world, filled with new risks, lower leverage, and at some point, hopefully greater rewards.

William H. Gross



Managing Director

About the Author

Bill Gross is Co-Founder and Managing Director of PIMCO, one of the country's foremost fixed income managers with a client list that includes many of the largest U.S. corporations. Regarded by many as America's most influential authority on the bond market, Mr. Gross makes frequent appearances on TV and in the business press.

As a reminder, an audio file of this *Investment Outlook* will be available on www.allianzinvestors.com.

Past performance is no guarantee of future results. This is not an offer or solicitation for the purchase or sale of any financial instrument. It is presented only to provide information on investment strategies and opportunities. The material contains the current opinions of the author, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Forecasts are inherently limited and should not be relied upon as an indicator of future results. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

Investing in the bond market, including derivatives (i.e. Credit Default Swaps "CDS") and Collateralized Debt Obligations "CDO", is subject to certain risks such as market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Use of these instruments may involve investing in derivative instruments that could lose more than the principal amount invested in those instruments. With CDS there is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments. Structured investment products (SIV) such as CDOs are complex instruments, typically involving a high degree of risk and are intended for sale only to sophisticated and qualified investors who are capable of understanding the high degree of risks involved. The market value of any structured security may also be affected by changes in economic, financial, and political environment (including, but not limited to spot and forward interest and exchange rates), maturity, market condition and volatility, and the credit quality of any issuer. Asset-backed commercial paper (ABCP) is composed of a special purpose vehicle or conduit which issues commercial paper (defined as a money market security issued by large banks and corporations to finance short-term needs) and uses the proceeds of that issuance to obtain interests in assets through purchase or secured lending.

The target federal funds rate is the interest rate published by the Federal Open-Market Committee (FOMC) of the Federal Reserve Board as a target for overnight, inter-bank loans. The rate is a leading economic indicator of interest rate movements and Federal Reserve monetary policies.

Allianz Global Investors Distributors LLC, 1345 Avenue of the Americas, New York, NY 10105-4800, www.allianzinvestors.com, 1-888-877-4626.

AA885_20396

Investment products

Are Not FDIC-Insured | May Lose Value | Are Not Bank-Guaranteed