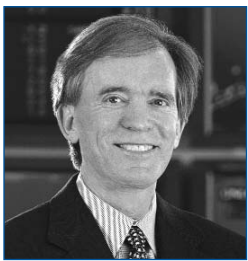


Investment Outlook

by PIMCO's Bill Gross

Dear President Obama:



Bill Gross
Founder and CIO,
PIMCO

Thought I would jot down this little note to President Obama. It's a little presumptive of course; first that he'll even be President (he will) and second that he'd read it (he won't). But presumptiveness is an inherent requirement of an investment manager, and so I shall proceed.

Dear President Obama:

You have inherited a mess. Your predecessor, fixated on emulating a former Republican icon from a far different economic era, chose to emphasize tax cuts for the rich and excessive consumption for all Americans. He promoted deregulation and free markets when, in fact, the markets and their institutions needed tough love. Over eight years, he failed to put forth a coherent energy policy. He needlessly invaded Iraq and lowered worldwide esteem for this nation as a symbol of freedom and benevolence.

But enough about W's spilt milk. I've already ticked off so many readers that they're questioning my Republican Party voter registration. What do I think you should do as the new President to rectify this mess? All I know is that any solution will come with a high price tag. Although your campaign slogan says "Yes we can," I have my doubts. Granted, you're going to raise tax rates on the rich, give a break to the lower/middle class and rebalance the scales of economic justice somewhat. I myself won't enjoy paying that near 50 percent marginal tax rate after you remove the current cap on the payroll tax, but my wealthy neighbors and I in Newport Beach should just look at it this way: we've had an eight-year lease extension on the "high life." Now it's time to give something back and I suspect we won't be working any less hard. That ol' Laffer Curve has a certain logic to it, but it only makes sense at the upper margin. People did work less at confiscatory tax rates imposed pre-Thatcher/Reagan but once they got down to 50 percent or lower, it was all

gravy—promoting conspicuous consumption as opposed to higher productivity and overtime at the office. Gosh, now we don't even **want** those oversized trophy houses! The *New York Times* reports that the high-profile crowd now favors small ecologically certified "LEED" houses—"Leadership in Energy and Environmental Design." My, what **green** eyes we have, Grandma!

Anyway, so you're gonna do the tax thing, Mr. President, and throw in some form of universal healthcare to boot that your buddy Hillary will help spearhead. You hope you can get a lot of this passed despite a potentially long string of filibusters from a Senate that won't quite have sixty Democrats. In addition, you'll need to provide some immediate relief to homeowners in the form of FHA (Federal Housing Administration) subsidies and low mortgage rate loans that somehow have been studied and studied in Congress for the past six months yet still haven't been passed into law. By January, home prices will be down another 10 percent or so and our Japanese-style property deflation will be in full stride. Congress will have had its summer recess though and spent September and October on the campaign trail. They had to get re-elected you know, so those homeowners just had to wait.

But you'll have your tax bill and your healthcare bill and your housing fix, and somehow it'll all be paid for by wealthy hedge fund managers, oil companies or, pray tell, a robust economy that's creating good jobs at home instead of exporting them abroad. Uh, I don't think so, Mr. President. That's where the "yes we can" morphs into "no we can't." Not that you won't accomplish most of that—the robust economy and the good jobs notwithstanding. It's just that you won't be able to **pay** for it and it's better to admit it now as opposed to later. No David Stockman confessions in **your** administration. You're smarter than Ronald Reagan and too nice of a guy to distort reality like King George. So let's start out by dropping all of that "budget neutral" rhetoric and admit where we're headed. **Your administration will produce this nation's first trillion dollar deficit!**

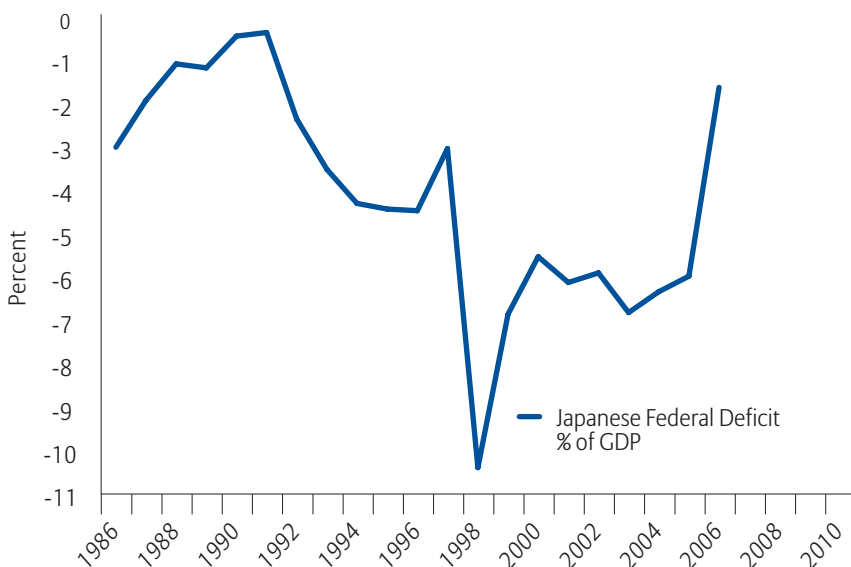
While the Republicans will blame you for years and label you "Trillion Dollar Obama" in future campaigns, there is in fact not much that you or any other President can do. You've inherited an asset-based economy whose well has been pumped nearly dry with lower and lower interest rates and lender of last resort liquidity provisions that have managed to support Ponzi-style prosperity in recent years. Foreign lenders have cooperated by purchasing Treasuries at yields which when combined with dollar depreciation have

resulted in negative returns on their money. Even if these charades continue (and they may not), their stimulative effects—their magical powers to transform a 110-pound weakling into a Charles Atlas/Arnold Schwarzenegger mensch of an economy—are gone. What you need now is fiscal spending and lots of it. No ordinary Starbucks will do, Mr. President, you need to step up for a six-pack of Red Bull.

Now I know, Mr. President, that you're already addicted to those nicotine smokes and I'm not trying to promote a caffeine habit here, but this economy will need an additional jolt of \$500 billion or so of government spending real quick. It must replace both reduced residential investment **and** consumption whose decline has placed the U.S. economy near, if not in a recession. Some quick math for you Sir: gross private domestic investment (machines, houses, inventories) has declined by \$200 billion since its peak in late 2006. Due to higher unemployment and energy costs, domestic consumption will soon be \$300 billion less than it should be if we are to return to historical economic growth rates. According to that old C + I + G formula (scratch the trade deficit for now) when C + I is reduced by \$500 billion, then G should **increase** by that amount in order to fill the gap. The G, Sir, is **you**—the government deficit, the fiscal stabilizer popularized by Keynes following the Depression. And since the fiscal deficit for 2008 is likely to press \$500 billion even before you take the oath of office, well there you have it: \$500 billion + \$500 billion = \$1 trillion big ones, probably by sometime in 2011 or so. It takes time to spend those types of bucks.

It took the Japanese a lot of time too, Sir. Take a look at the chart to the left, which graphically displays Japan's increasing deficits as a percentage of GDP following their property bubble of the late 1980s. Over a seven-year span, expansionary fiscal spending widened from a relatively benign two percent deficit to a level that exceeded 10 percent at its peak in 1998. Our one trillion dollar level in 2011 would equate to something like six percent of GDP, a mere pittance by Japanese standards.

Chart 1
Look in the Mirror My Friend!



Source: Japan Cabinet Office

And what will this mean for investors? Well, it's not totally clear. That same Japanese example was accompanied by declining inflation and near zero percent interest rates in Japan by the time it was all over. They experienced a liquidity trap that stifled investment and failed to revive their economy for nearly a decade. Some fear the same thing here in the U.S. PIMCO has for many years now debated the tightrope walking of the U.S. economy on the knife's edge between deflation and inflation. A serious case can be argued for either side. Still, as our recent Secular Forum concluded, strong global growth spearheaded by developing countries and accompanied by significant commodity inflation should provide a firm background for stimulative U.S. monetary and fiscal policies during your first administration. Importantly as well, current negative real interest rates along with the innovative liquidity provisions by Bernanke's Fed should promote "re" as opposed to "de"-flation. A trillion dollars of government deficit spending is potent medicine. **Its potency regarding inflation will not be felt fully during the peak deficit period. Rather, inflation will accelerate during the subsequent recovery as the government bonds acquired during the recession are transformed once again into risk bearing assets and high levels of investment. That suggests that intermediate and long-term yields on government bonds have already bottomed and will gradually rise throughout your first, and perhaps second Administration. Your term will not go down in history as investor friendly.**

In the final analysis I wonder why you or anyone else would **want** to be President in 2009. But there's the ego thing and a hope for a better tomorrow and all that. Come to think of it, "President Obama" does have a certain ring to it. When I listen to your speeches, you even have me half convinced!

All the best, and a fist bump to ya!

A handwritten signature in black ink that reads "Bill Gross". The signature is written in a cursive, flowing style with a long horizontal line extending from the end of the name.

William H. Gross
Ordinary Citizen

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.

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