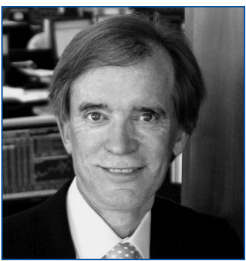


Investment Outlook

by PIMCO's Bill Gross

The Shadow Knows



Bill Gross
Founder and CIO,
PIMCO

The woven tangled web of subprimes has claimed more than its share of victims in recent months. Homeowners by the hundreds of thousands, to be sure, but also those that created, packaged, insured, distributed, and ultimately bought what should have been labeled “junk mortgages,” but which by a masterstroke of marketing genius were given a more respectable imprimatur. “Skim milk masquerades as cream,” warned Gilbert & Sullivan a century ago and sure enough, modern day subprimes packaged into financial conduits with noms de plume such as “SIVs” and “CDOs” pretended to be AAA-rated cubes of butter. Financial institutions fell for the charade hook, line, and sinker and now we all suffer the consequences. Defaults are rising, the dollar’s sinking, and good Lord—even Google’s stock price is going down. Something must really be wrong here.

It is. What we are witnessing is essentially the breakdown of our modern day banking system, a complex of levered lending so hard to understand that Fed Chairman Ben Bernanke required a face-to-face refresher course from hedge fund managers in mid-August. My PIMCO colleague, Paul McCulley, has labeled it the “Shadow Banking System” because it has lain hidden for years—untouched by regulation—yet free to magically and mystically create and then package subprime mortgages into a host of three-letter conduits that only Wall Street wizards could explain.

As I’ve noted before, it is certainly true that this shadow system with its derivatives circling the globe has democratized credit. And as the benefits of cheaper financing became available to the many, as opposed to the few, placating and calming waves of higher

productivity and widespread diversification led to accelerating economic growth, incomes, and corporate profits. Yet, as is humanity’s wont, we overdid a good thing and the subprime skim milk has soured.

Still, to equate rancid milk with a breakdown in the modern-day banking system is a bit much, don’t you think? Aren’t our central bankers coming to the rescue with lower interest rates and doesn’t Treasury Secretary Paulson finally have a plan to steady Citibank and friends with a “Super” SIV as well as a bailout plan to fix subprime yields and keep homeowners in their homes as opposed to on the streets? They do, but what may be needed more than cheap financing or SIV bailouts is a return of confidence to a shadow system built on fragile foundations. Financial conduits supported by a trillion dollars of asset-backed commercial paper were constructed on the basis of AAA ratings that whispered—nay shouted—that these investments could never fail: no skim, just crème de la crème. Now, as the subprimes undermine these structures and the confidence in them, it is a stretch of the imagination to suggest that 75 basis points of interest rate cuts by the Fed will bring back the love. As the commercial paper market shrinks by hundreds of billions a month, central banks worldwide are facing a giant stress test of the modern-day shadow banking system. The publicized and photographed overnight “runs” on Countrywide and the U.K.’s Northern Rock

in mid-August were nothing compared to what's taking place in the shadows of the real banking system. Credit contraction, with its inevitable companion of asset destruction, is spreading with the speed of an infectious bacterial disease.

How does one protect "deposits" during a run that no one can see? To be blunt, what does this mean for your pocketbook? Commonsensical analysis has only to ask what investments did especially well during the shadow's formation in order to understand where future losses may lie. Home prices have been the obvious first hit—down 5% nationwide already, with perhaps another 10% to go over the next several years. Following in lock-step have been financial stocks with subprime exposure to be joined in short order by consumer-based equities as jobs and disposable income falter. These investments thrived as the shadow worked its voodoo and now its curse will sap money from the pockets of any and all who believed in its black magic. Importantly, add to the list of investment victims the strength and viability of our national currency. The SIVs and CDOs of years past supported the dollar at unrealistic levels as foreign investment in the hundreds of billions powered into our markets. Now with confidence waning, the visible but unphotographable run away from George Washington into the Euro, the Yen—anything but the dollar—is underway. Protecting an American-made pocketbook should begin by understanding that purchasing power is more likely to be enhanced via investments in strong, not weak, currencies.

And too, as the shadow unravels, bond investors have been barraged with a host of changing relationships that present a tantalizing menu of attractive arbitrage possibilities against U.S. Treasuries—the star "flight to quality" performer in an environment where almost all bonds are viewed with suspicion. Even Agencies, the step-sisters to Cinderella Treasuries, have been avoided due to billion dollar write-offs at Freddie

and FNMA. Swaps—in third place on the quality ladder, yet still reflective of LIBOR yield levels offered by the world's best banks—provide 70+ basis point premiums or more to Treasuries across almost the entire yield curve. Agency-guaranteed mortgages, reflecting higher levels of assumed volatility, present 150 to 175 basis point pick-ups. What appear then, to be strikingly low yield levels for U.S. Treasuries, are not being reflected by the rest of the U.S. high-quality bond market. Fed ease has lowered Treasury yields, but for the rest of the market—the segment that influences the bottom line of U.S. corporations, homeowners, and consumers—not much has changed. Those that claim that the current cycle of Fed ease will inevitably—and shortly—lead to vigorous economic growth do not really have their ears to the ground or their eyes on their Bloomberg screens. The Fed needs to bring Fed Funds levels down steadily and significantly more in order to counteract the contraction of the shadow banking system which has imposed, and will continue to require, higher risk premiums for non-Treasury securities in an increasingly risky financial environment.

The ultimate destination of Fed Funds is dependent on the state of the domestic economy which, in turn, will be influenced by the direction and level of U.S. housing prices. Chairman Bernanke and his divided band of governors will have to feel their way along this treacherous path with canes in hand—not totally blind, but significantly hampered by a lack of historical context which might point the way to the ideal rate via precedent as opposed to feel. Nonetheless, there are theoretical guidelines which may help to validate or invalidate current assumptions reflected in Fed Funds futures contracts which currently forecast an ultimate floor of 3¼% sometime late in 2008. Traditionalists would point to the "Taylor Rule" which formulaically computes a neutral Fed Funds yield based on divergences of real GDP and inflation from "potential"

and “target” levels. Since these levels are somewhat variable and subjective, there is no one number that a computer can spit out, but nonetheless, using reasonable assumptions, neutral Fed Funds levels somewhere in the 4% “+ or -” range are produced. Assuming the Fed would have to drop below neutral to stimulate a faltering economy, the 3¼% Fed Funds futures forecast does not seem unreasonable.

My own methodology incorporates historical cyclical evidence as well as a rather commonsensical conclusion based upon the evolution of the leverage-wrapped shadow system described in opening paragraphs. First of all, history would point out that Fed easing cycles during prior recessionary or near recessionary economies have invariably dropped to 1% Fed Funds rates when calculated on a “real” or inflation-adjusted basis. With PCE core levels at 2%, a destination of 3% would therefore be a reasonable current target. Secondly, one can easily compute a “neutral” real Fed Funds level by simply averaging the spread between funds and core inflation over a period of time long enough to incorporate the ups and downs of cyclical influences on inflation and GDP. Such a history should produce the real Fed Funds level required to keep the economy growing at a reasonable non-inflationary rate typical of the last decade—a logic quite similar to that incorporated in the Taylor Rule.

The average real short-term rate using this methodology over the past eight years has been 1½%. Commonsensically, this 1½% real rate is the neutral

rate that has pumped life into our new finance-based economy with its complicated shadow banking system. It is logical to me therefore, to assume that 1½% is the neutral rate required to keep the future Shadow oiled and properly functioning. If so, then 2% core inflation and 1½% real Fed Funds require a drop to at least 3¼% just to maintain current momentum. To restart a near recessionary economy we may need to eventually go down to 3% or lower.

Forward-looking bond investors should understand that the shadow banking system has been built on leverage and cheap financing and that to keep it from imploding, a return to Fed Funds levels closer to those of 2003 may be required. While the Fed is not likely to repeat its 1% “deflation insurance” levels of that year, current Fed Funds futures which predict a 3¼% bottom are not likely to be correct either. Standby for a tumultuous 2008 as the market struggles to move from the shadows back into the sunlight of sounder banking and financial management, accompanied by Fed Funds levels at 3% or lower.



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 of the markets 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. References to specific securities and issuers are for illustrative purposes only and are not intended as recommendations to purchase or sell securities. Allianz Global Investors Distributors LLC, 1345 Avenue of the Americas, New York, NY 10105-4800, www.allianzinvestors.com, 1-888-877-4626.

A structured investment vehicle or "SIV" is a limited-purpose operating company that undertakes arbitrage activities by purchasing mostly highly rated medium- and long-term, fixed-income assets and funding itself with cheaper, mostly short-term, highly rated commercial paper and MTNs. Collateralized debt obligations (CDOs) include types of asset-backed securities and structured credit products which gain exposure to the credit of a portfolio of fixed income securities and apportion the credit risk among different tranches.

Swaps are a type of derivative in which a privately negotiated agreement between two parties takes place to exchange investment cash flows or assets at specified intervals in the future. There is no central exchange or market for swap transactions, and they are therefore less liquid than exchange-traded instruments. A portfolio using swaps bears the risk that the counterparty could default under the swap agreement.

London Inter-Bank Offer Rate (**LIBOR**) is the interest rate that the banks charge each other for loans (usually in Eurodollars). This rate is applicable to the short-term international interbank market, and applies to very large loans borrowed for anywhere from one day to five years. This market allows banks with liquidity requirements to borrow quickly from other banks with surpluses, enabling banks to avoid holding excessively large amounts of their asset base as liquid assets. The LIBOR is officially fixed once a day by a small group of large London banks, but the rate changes throughout the day.

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. **Gross Domestic Product (GDP)** is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance. **Core Personal Consumption Expenditures (PCE) Deflator** is computed by the Bureau of Economic Analysis and provides a measure of the prices paid by people for domestic purchases of goods and services excluding food and energy. It is a somewhat broader measure of consumer prices than the CPI.

AA884_20063

Investment products

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