

Curveball

Bill Gross

02/01/2006

With Greenspan having chaired his last Open Market Committee meeting it would seem fitting to use this *Outlook* intro as a paean or requiem for this heavyweight of nearly 30 some years who steered the U.S. economy from/into the shoals of financial disaster depending upon either one's sense of history or conversely, one's foreboding for the future. I'd like to write about Mr. Greenspan, but I have another memorable, if less renowned, personage to say goodbye to who happens to be departing at the very same time. That he is leaving PIMCO as opposed to the global arena will cause milder shockwaves perhaps, and certainly fewer headlines, but Mohamed El-Erian's goodbye, followed by his Harvard Endowment hello will be no less significant for any of us cloistered here in Newport Beach or in associated PIMCO offices around the globe. He will be missed. That he will be leaving at the top of his emerging market/fixed income game is unmistakably apparent to associates and clients alike. Nearly seven years ago, when he crossed threshold from the IMF to PIMCO, he brought with him the skills of a classically trained Oxford economist but was admittedly lacking in the back street trading know-how of Wall Street. He remembers Bill Thompson and me telling him during a final interview that he "could learn it"—a remarkable challenge for anyone approaching 40 years of age, I suppose. Learn it he did. Perhaps most memorable and undoubtedly a key to his success was his work ethic. Mohamed would often sign off the evening to me with a 9:00-10:00 pm Bloomberg message only to follow it with a 4:00 am update on the opening levels of a Brazilian new issue. During these past few months, one would logically have expected a drop off in commitment and intensity at PIMCO as his allegiance gradually shifted to Harvard. Nothing of the sort. He proved himself the Jerry Rice of the investment world, working harder at the end than the beginning. Such a man will undoubtedly succeed wherever he goes. PIMCO's loss...Harvard's gain—well, perhaps that's the only platitude about Mohamed that will be hard to stomach. Every other accolade you can think of is more than applicable. Bon voyage, break a leg, God speed, Mohamed. You will be missed.

Mohamed's contribution in PIMCO's Investment Committee will be missed as well, having importantly defined and refined in recent years our concept of globalization and associated financial flows. Greenspan's "conundrum" to PIMCO is more of a future uncertainty than an *ex post* mystery, although no firm or economist totally understands this financial interplay of the early 21st century. What we would say, however, is that the conundrum is best currently viewed as a non-cyclical lowering of U.S. and global yields at the intermediate and long end of fixed income markets, resulting at present in an almost perfectly flat U.S. yield curve at levels that some consider to be still remarkably stimulative which others (PIMCO included) consider to be increasingly restrictive. What I would like to ponder in this *Investment Outlook* are not necessarily the merits of either side of that argument but the **shape of the future yield curve if current globalization/monetary recycling trends continue**. One of Mohamed's last admonitions to us came last week in an Investment Committee meeting where he suggested we view the world without the economic/financial fat tails represented by a U.S. trade deficit imploding to 2% or 3% GDP or exploding to new peaks approaching double digits. "How would you want to position a portfolio's duration, curve and credit exposure assuming residence in the **middle** of a "Bretton Woods II" bell shaped curve?" he asked. We responded, that while the duration of our portfolios at the moment is rather agnostic and the credit orientation rather pessimistic, the future shape of the yield curve itself is a source of increasing certainty, being a reflection of the Fed's soon to come final resting point and the assumption of a continuation of foreign central bank financial flows into the intermediate and longer ends of the yield curve that have helped flatten it in the vicinity of 4½%. **This recognition of the importance of global flows in shaping the curve is critical in assessing its future behavior**. Prior academic literature almost invariably assigned liquidity and short rate/inflationary expectations as the keys to the yield curve's behavior. If Fed Funds were expected to rise in the future, the curve would be positive with intermediate and long bonds requiring higher yields as a cushion against accelerating short rates. If the Fed were

expected to lower rates, a flatter, even inverted curve might result. It's not that this academic theory has been dislodged in recent years but it may have been asked to take a seat next to the increasingly important variable of global financial flows. These flows, no doubt, rely critically on the willingness of foreign investors to hold U.S. assets in the face of potential currency and asset price depreciation. Still, as El-Erian has pointed out, many of these flows coming back into U.S. financial markets come from **non-economic agents**, his hush-hush euphemism for central banks. What he means is that these "agents" are less performance driven and more economically driven, less concerned with the price changes of bonds and more concerned with generating stable (and hopefully high) levels of income on their burgeoning domestic reserve balances, as well as high levels of employment in their domestic economies. Now that economic growth, inflation, and interest rate movements have seemingly come under control because of what has been described as the "great moderation," it's only natural that central banks would be willing to extend their bond investments further out on the curve in an effort to capture higher yields. That they have done so is graphically demonstrated in the following two charts/tables that point to an increasing presence, nay domination, of foreign buying—especially central bank buying—on the intermediate and long ends of the U.S. yield curve. Both charts point out that "Foreigners" and indeed "Official Foreign" central banks own greater percentages of notes and bonds up to 10-years in maturity, than they do bills.

CHART 1

**% of Outstanding Trsy's Held by Foreigners
(by maturity bucket)**

Maturity	Official	Private	Total
Bills	35.1%	9.6%	44.7%
<1*	43.5%	13.9%	57.4%
1-2	49.7%	17.8%	67.5%
2-3	41.3%	21.3%	62.6%
3-4	48.9%	30.1%	79.0%
4-5	52.5%	29.9%	82.4%
5-6	39.4%	21.4%	60.8%
6-7	44.2%	22.3%	66.5%
7-8	31.5%	26.6%	58.1%
8-9	37.0%	29.0%	66.0%
9-10	40.3%	27.4%	67.7%
10-15	6.4%	21.8%	28.2%
15-20	7.0%	17.5%	24.5%
20-25	5.2%	16.8%	22.0%
25-30	7.6%	30.9%	38.5%

* < 1-year coupon securities.

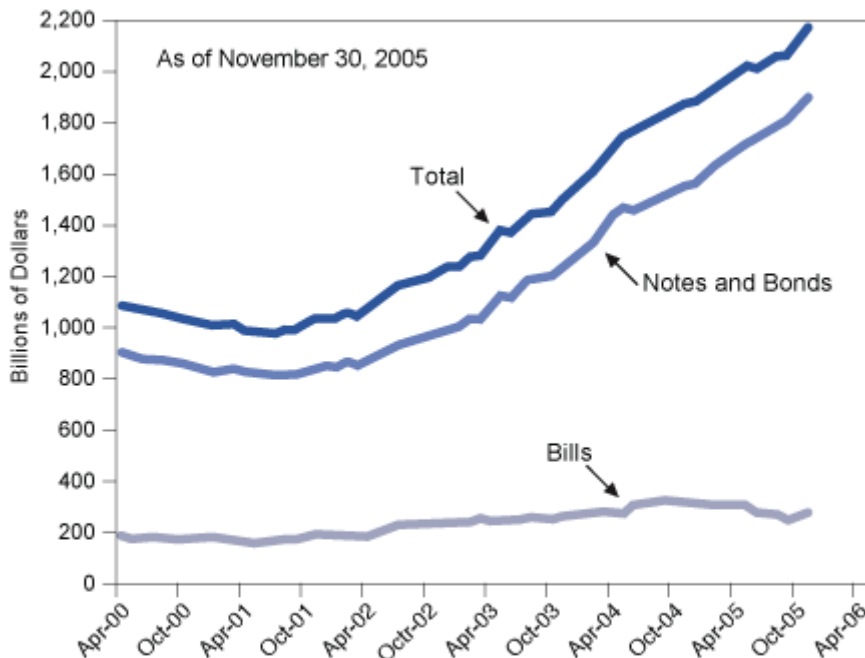
Data as of 6/30/04 and not including SOMA

Source: Merrill Lynch, Fixed Income Strategy, August 11, 2005

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

CHART 2

Holdings of Treasury Securities (Foreign Officials AND Private Foreigners)







Source: Bianco Research, L.L.C. All Rights Reserved. Copyright © 1990 - 2006

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

If the reader is willing to accept this increasing influence of foreign “non-economic” agents in shaping U.S. (and global) yield curves, and *if* these flows continue relatively undisturbed in future years, one must come to an important near-conclusion: **curves will be flatter in future years and during future business cycles than they have been in previous ones.** That doesn’t mean that if economies weaken and central banks respond with looser monetary policy, that short rates won’t be lower than long rates. It is my contention, in fact, that 21st century capitalism **depends** upon a positive yield curve which provides the “vig” of short rate/intermediate rate arbitrage that banks, unregulated banks (hedge funds), and a host of financial institutions utilize to make structural profits. We will get that required positive yield curve sooner or later (probably sooner) in order to ensure the ongoing success of the U.S./global economy. But the balance of the curve with its historic “hump” may instead be relatively flat as reserves are recirculated into bond markets in search of higher yields.

It’s important as well to view this phenomenon, as PIMCO’s Paul McCulley viewed the phenomenon of disinflation, from the standpoint of both a past journey and a destination. If in fact, reserve recirculation policies remain relatively constant, an observer must recognize that the “journey”—that is the exploitation of higher yields on the longer end of curves is basically over. (ALM/pension fund behavior may represent a new and separate journey but will be held neutral for this *Investment Outlook’s* discussion purposes.) **If this be the final destination, then future interest rate movements will be dominated not by non-economic agents, but by the Fed and associated policy makers. Once the curve is flat, “agents” have no incentive to disproportionately favor any maturity on the curve, thus the short overnight rate, set by the Fed, ECB, and others will dominate all levels, and the entire curve may move in more unison than previously experienced.** In addition, relative yield curve volatilities may change compared to historic parameters, creating price movements in option related financial instruments including mortgages and a host of previously issued financed derivatives.

I am forced to conclude with the following two quick observations in terms of future yield curve shape. The U.S. curve shape as we approach the end of 2006 will more than likely transition from this , to this . At some point later on, once ALM legislation in the U.S. takes shape and begins to dominate pension fixed-income investing, the curve will likely resemble this  as opposed to a more historic this .

Capitalism's need for carry will necessitate a front-end steepness. Our demographic requirement to fund retirement benefits will one day bend the back-end down as well. And the entire curve will ride up and down more or less synchronically and in unison, dependent on the stability of economic growth and inflation for its level, its volatility, and its front-end steepness. For those suggesting that the conundrum has been solved, there's more than enough question marks inherent in the last sentence to provide for alpha generating opportunities in future months and years. Harvard is fortunate to have their new wizard to guide them through the maze. We will rely on a developing bench of strategic thinkers to steer us as well. Let the games begin/continue, and let us find out who can hit a curveball in addition to the heater.

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. [Click here](#) for a complete list of the PIMCO Funds and Allianz Funds prospectuses. Please read the prospectus carefully before you invest or send money.

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. 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. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

Investing in foreign securities entails additional risks, including political and economic risk and the risk of currency fluctuations; these risks may be enhanced in emerging markets. Alpha measures a portfolio's risk-adjusted performance, which is the difference between a portfolio's actual and expected returns, given the level of market risk as measured by beta. Duration is a measure of a portfolio's price sensitivity expressed in years. 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. A derivative instrument is a contract whose value is based on the performance of an underlying financial asset, index or other investment. Use of these instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Mortgage-backed securities are subject to prepayment risk and may be sensitive to changes in prevailing interest rates. When interest rates rise, the value of fixed income securities generally declines. Managed accounts are available through Allianz Global Investors Managed Accounts LLC, 1345 Avenue of the Americas, New York, NY 10105-4800. The funds are distributed by Allianz Global Investors Distributors LLC, 2187 Atlantic Street, Stamford, CT 06902. For information about either product, contact your financial advisor.

NOT FDIC INSURED / MAY LOSE VALUE / NO BANK GUARANTEE