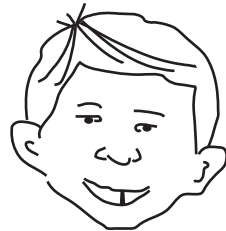




Investment Outlook



"What, WE Worry?"



Let me describe a world for you: an economic world for the most part and therefore more of a scenario than a play with live action figures, but definitely not a fictionalized world. If this were a book, its Dewey Decimal would place it in the non-fiction row, not children's fairytales, though as you're about to find out, part of it resembles a compendium of those old MAD magazines. Still there's a rather frightening aspect to it – a "bad dream, this can't be happening" tone – that moves it closer to the Stephen King corner. But why don't I just let you the readers decide what kind of book it is. After all, it's your future, your country, your money.

My book's thesis rests on the growing reality that the U.S. is overextended, not just militarily but economically. We are trying to do too much, borrow too much, spend too much and sooner, perhaps later, we will have to suffer the consequences. We are a country in the beginning stages of what can be aptly described as hegemonic decay. But decay from a hegemon's perspective is something that more appropriately belongs in a Gibbon's Decline and Fall of the Roman Empire context. Empires take decades if not centuries to wither and the perspective is more easily viewed from a rear view mirror as opposed to a windshield.

Politicians, investors, and citizens alike no doubt would choose Alfred E. Newman rather than Edward Gibbon as their spokesman. "What, we worry?" is pretty much our national motto when it comes to our finance-based economy and its future prospects.

So for those of you that prefer *Mad* magazine to a history tome let me approach this predicament from a more personal angle. I'm gonna compare a typical American family to a country, so that the hegemon has a face and an actual personality. Pretend that you're a head or co-head of a household. You earn a good salary but it never seems to be enough. There are bills to pay, the Joneses to keep up with, you've had your eye on that goofy Hummer for at least a few months now. You'd like to save money but you can't or you won't, so you don't. As a matter of fact, each year for the past decade or so you've had to borrow 4, 5, 6% of your annual income to pay for what you want. You're running a personal deficit not a surplus. But that's still ok you figure. You're strong, vibrant, prospects are good, there's no way you shouldn't be able to handle it. You can grow your way out of current liabilities and have more than enough to pay for future obligations such as college for the kids, that far away retirement for

you and the spouse, and healthcare if that should ever come up. And your creditors undoubtedly will see it the same way too. They know a good risk when they see one. Come to think of it, should your Hummer be that macho black or maybe, just maybe that outlandish canary yellow?

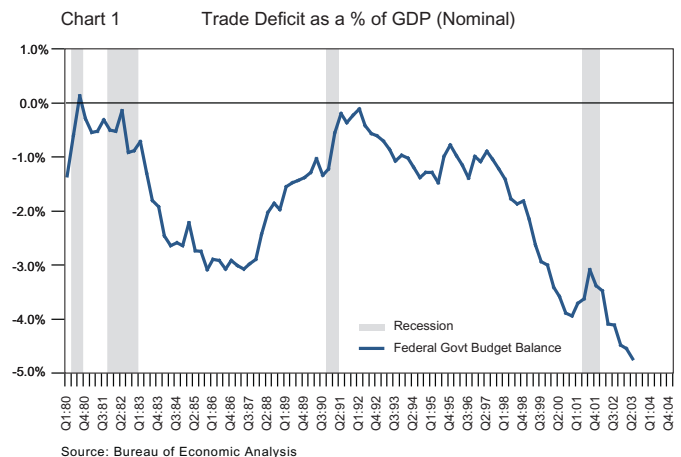
Well, let's shorten this personal fairytale a bit and introduce the catch, the chink in the armor, the unexpected, the heel of family Achilles, or in this case family Newman. Something happens. For some reason you can't grow your way out of this. Your company's prospects sour, your raises virtually vanish, your health deteriorates, your family life sours, who knows. The big S happens. With no savings and a boatload of debt the wheels all of a sudden go into reverse. Creditors are not so friendly. Not only will they not lend you that 6% of your salary every year, but they want a higher interest rate on what you've already borrowed. Forget the Hummer pal – black, yellow or polka dot purple. You're thinking about survival, not staying up with the Joneses. This hegemon with a face has started to decay.

Countries are no different than people except they fight with rockets, bombs, and currencies, instead of lawyers. The United States as a matter of fact is strikingly similar to the Hummer wannabes - the Alfred E. Newman's - just described. It's strong and vibrant, with a future seemingly about as bright as any other country on the planet. Productivity is soaring, its markets are recovering, its salary (or GDP) shows decent increases almost every year. It goes wherever it wants to go, its

Hummvees are symbolic of global military domination. What's not to like here? Where's the decay in this hegemon?

Well, maybe I'm just pessimistic because I'm a Californian and the not so Golden State currently resembles the pulp not the juice of its once famous oranges. But California is 15% of the nation and it is the trendsetter in more ways than fashion, Hollywood, and tongue rings. We have a huge deficit based on overspending which was in turn based on the anticipation that financial markets and their capital gains would continue indefinitely. Our schools are a mess. Businesses are departing daily to points unknown. But this Outlook will not be a California diatribe. I use it only to suggest that as California goes so goes the nation and at the moment its prospects are not good, Terminator or no Terminator.

The U.S. is in a similar predicament – as a matter of fact its story parallels not only California but our imaginary family, the Newmans. For years, Americans have wanted to save money but the savings rate has hovered close to 0. They have depended upon those 1990's capital gains



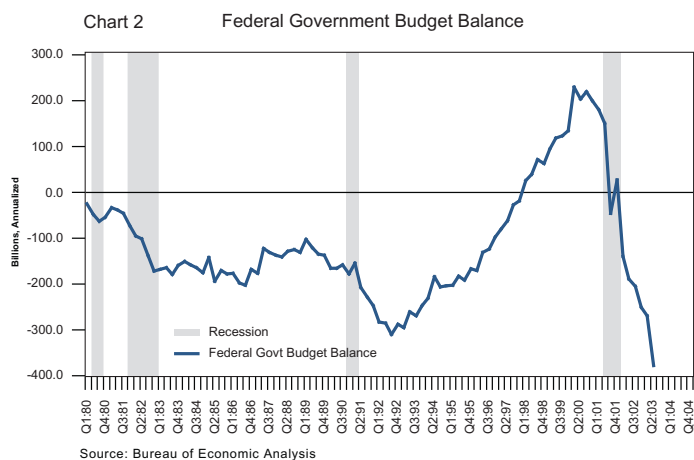
to give the impression that their liquid assets were on the rise. In turn, U.S. citizens have had to borrow 4, 5, 6% of their annual income (GDP) in order to pay for what they want. Economists call that the trade deficit, and Chart I amply points out the decay – hegemonic to be sure.

Add to that, new evidence that our government’s deficit, the budget deficit shown in Chart II, is running at \$450 billion+, with few prospects for improvement (a new prescription drug bill and Alternative Minimum tax adjustment will add nearly 100 billion annually to the total and Iraq perhaps \$50 billion more). President Bush and his economic team claim that the \$450 billion is well spent, that it is an investment in America, and after all, “we owe it to ourselves.” Such nonsense belongs in *Mad* magazine. The \$450 billion is paying for overconsumption, for Hummers in L.A. and Hummvees in IRAQ and we increasingly owe it to foreign creditors. It is plain for all to see that we are living beyond our ability to pay if for some reason the Big S happens on a national scale.

Could it? Better yet, how could it? Well, I suppose S could happen in a number

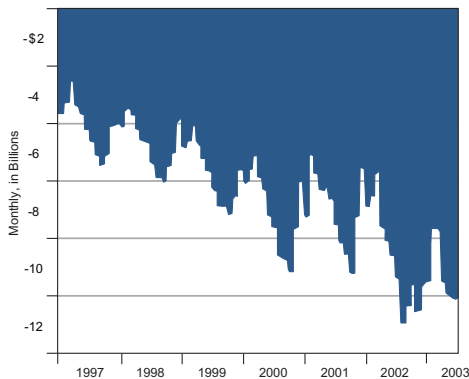
of ways with alternative time horizons. Typically though, with families such as the Newmans and countries such as the United States, the spending/savings discipline necessary to right their fiscal ship has to come from the outside. They won’t stop on their own. Hummers and Hummvees are way too cool to say no to. So it’s the creditors that say no. And their discipline has already started. Bond market vigilantes, (not so vigilant it seems prior to June of ‘03) have suddenly recoiled in horror at the U.S. budget deficit and the failure of the Fed to guarantee its funding at exorbitantly low interest rates. In turn, foreign creditors for more than a year have been liquidating dollars in favor of other country’s currencies with current account/trade balances closer to neutral, and budget disciplines resembling that of an adult as opposed to a neurotic teenager with a credit card. But despite the resultant higher interest rates and cheaper dollar that these actions imply, our country’s economy appears to be chuggin’ right along – thank you very much. If this is my idea of the big S happening, then “bring it on” as Commander Bush might hypothetically intone. Where’s the big, bad wolf in this story?

Well in addition to future domestically induced bond market sell offs destroying the housing market, and a finance-based economy inexorably slowing down as restrictively higher yields work their historical magic, the fulcrum of a future creditor based revolt likely rests in Beijing as opposed to NYC or Washington DC.

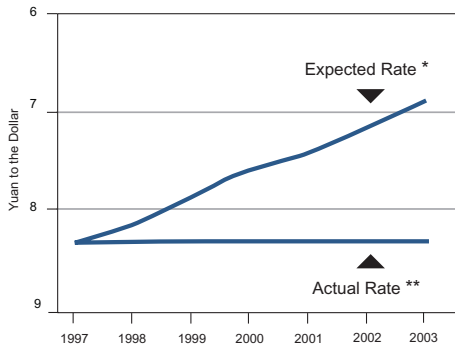


Chinese Water Torture

Chart 3 U.S. Trade Deficit With China



The Value of the Yuan



* Estimate based on relative purchasing power.

** Managed by Chinese authorities.
Source: NY Times, Economy.com

Chart III shows the potential for Chinese water torture in two different forms. First since its monthly trade surplus of \$10 billion+ with the United States implies a \$120 billion annual addition to its dollar reserves, there will come a time when their hundreds of billions if not a half trillion or so in holdings of U.S. notes and bonds look a tad too risky. In turn the hundreds of billions that the Japanese and other Asian countries have been buying in order to keep their currencies competitive with the Chinese Yuan (Renminbi) and the U.S. dollar will be subject to a sanity check

as well. The currency/bonds/stocks of a reflating economy engaged in guns and butter, Hummer and Hummvee spending of near historical proportions are bad investments. Sooner, perhaps later, our Asian creditors will wake up and smell the coffee. Perhaps their java will take the form of dollar or Treasury Note sales. Perhaps the aroma will resemble a revaluation of the Yuan and then the Yen. Either way we pay the price: higher import costs, a cutback in spending on cheap foreign goods, rising inflation, perhaps chaotic financial markets, a lower standard of living. Mark these words well for what they're worth (not much some will say): China holds the keys to our kingdom, and our Hummers. Their willingness to buy our bonds, their philosophy of fixing their currency to the U.S. dollar will one day be tested. And should their patience be found wanting, all of their neighboring Asian China wannabes will move in near unison. Reflation's second round will have begun, U.S. interest rates will rise, our goods in the malls and the showrooms will be less affordable, and the process of national belt tightening and increased savings will have begun. Are the Newman's worrying yet? Not if they bought stocks six months ago. Not if they refinanced their home in early June or bought that Hummer with 0% financing. But they will. The Newman's represent your future, your country, and your money and to think otherwise would clearly be MAD.

William H. Gross
Managing Director

P I M C O

840 Newport Center Drive

Newport Beach, CA 92660

949.720.6000

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