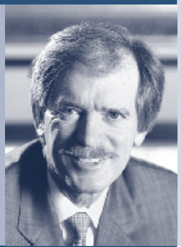
Bill
Gross



Investment
Outlook

PIMCO

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Haute Con Job

Fashion models are gorgeous. Fashion models are thin and desirable. Fashion models wear the clothes that every woman will wear next year. Fashion models…agh, enough already. How about haute fashion is one big con and the models are the carnival barkers, swishing down that runway, body language shouting, "be a winnah, be like me!" Except no one can. The ladies with figures that can fit into a Jeffrey Chow creation are all 18-23 years old and can't afford to buy them. And the women with some bucks have had a baby or two or better yet a meal or two in their 30+ years and can't fit into 'em. Still the charade goes on, fall season after spring season after fall season as if something very important was happening here. Writers for the *NY Times* speak of the new '05 fashion season "entering Phase 3 of its post 9/11 life (displaying) the contrived simplicity of ethnic orientation." Say what? I thought we were talking about a dress here, not some editorial on the cultural ramifications of 21st century geopolitics.

But I jest of course ladies. You can have your haute couture if it makes you feel good just like we guys have our cars with phony wings and "Goodyear" printed in big bold letters on the side of our tires. After all, don't those NASCAR/Indy/Formula 1 cars have 'em? Doesn't matter that we can't buy a Dodge like Jeremy Mayfield who just took the checkered flag at Richmond. Those Dodges have gotta be damn good cars if they can whip team Toyota year after year! Con, Con, Con. The American way of advertising. You can fool some of the people most of the time and that apparently is good enough to ring enough cash registers to perpetuate the cycle whether it be fashion, cars, or politics. After all, if $10 million in ads are enough to convince the American public that something about John Kerry and swift boats didn't quite float during the Vietnam War, then I figure you can sell anything to just about anybody these days. My solution to all of this is for the next Administration (whoever they are) to work with Congress (whoever they are) to purchase a TIVO for each and every TV set in these United States. To hell with Hoover's "A chicken in every pot." I'm going for "A TIVO in every family room." That way whenever a commercial comes on you just blast right through it – except for Super Bowl Sunday – and you can't get conned. No more haute couture, no more "haute cars," no more "haute con jobs." Not sure who would pay for the TV programs, but I'll figure that out later. Forget about Bush <u>and</u> Kerry. Gross for President!

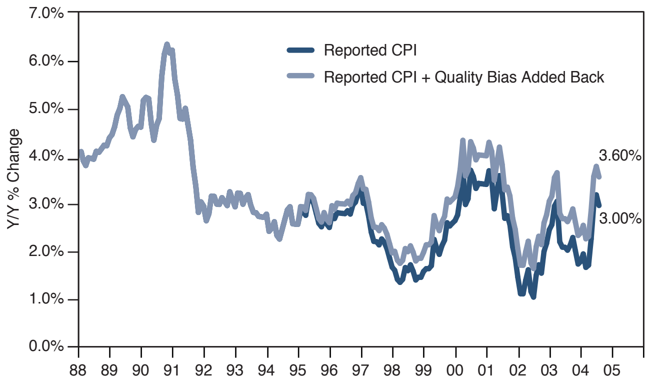
TIVO probably wouldn't help much when it comes to the con job perpetually foisted on the American public about the low level of inflation. "Inflation under control" – (ex food and energy of course) shout the carnival barkers. "The CORE is running at just under 2%," the barkers shout with glee because a low CORE number tells us that we can continue to run monetary policy with negative real interest rates and fiscal policy with $400 billion dollar deficits. A low CORE number allows us to pretend that American productivity is the best in the world, that the dollar should be strong, and that the markets, by golly are going up. No matter that a gallon of gasoline is over 2 bucks or that a half gallon of milk will set you back $3.69; the CORE is under 2%. Still as Todd Heft, a 44-year-old salesman recently quoted in *The Wall Street Journal* said, "People have to buy groceries and drive to work. It's not realistic to strip out food and gas prices." Ah the core, the core, the core. Semper Fi to low inflation, I guess.

My quarrel though is not just with those who are fixated on the core CPI or the core PCE, but with those who support what we know as hedonic adjustments. Talk about a con job! The government says that if the quality of a product got better over the last 12 months that it didn't really go up in price and in fact it may have actually gone down! Why, we could be back to Bernanke deflation real soon if the government would quality adjust enough products. For instance, prices of desktop and notebook computers declined by 8% a year during the past decade, The *WSJ* reports but because the machines' computer power and memory have improved, their hedonically adjusted prices have dropped by 25% <u>a year</u> since 1997. No wonder the core is less than 2% with computers dropping by that much every year. But did <u>your</u> new model computer come with a 25% discount from last year's price? Probably not. What is likely is that you paid about the same price for hedonically adjusted memory improvements you'll never use. Similarly, government statisticians manipulate the price increases for cars and just about any durable good that comes off an assembly line but find it difficult to extend that theory to underwear or a pair of shoes. Perhaps that's next. Talk about Uncle Sam getting into your shorts!

Actually, to make the case for a government con job, it's important to point out that the bulk of these hedonic adjustments have come only in the past few years, when it became necessary to buttress Greenspan's concept of our New Age Economy. Back in the 1990s the Clinton Administration blessed a start to quality adjust inflation statistics. But then in 1998, the methodology was adopted for computers – surely the biggest step backward in realistic inflation calculations. Since then, the BLS has expanded the concept to include audio equipment, video equipment, washers/dryers, DVDs, refrigerators, and of all things, college textbooks! Today no less than 46% of the weight of the U.S. CPI comes from products subject to hedonic adjustments. PIMCO calculates that without them, and similarly disinflating substitution biases, Greenspan's favorite inflation measure, the PCE, would be between 0.5% and 1.1% higher each year since 1987. This implies as well that since inflation was higher than actually reported, that conversely, real growth must have been lower by the same amount.

The first chart shows the hedonically adjusted numbers vs. what would be reported if this hedonic stretch didn't exist.

Hedonic Magic



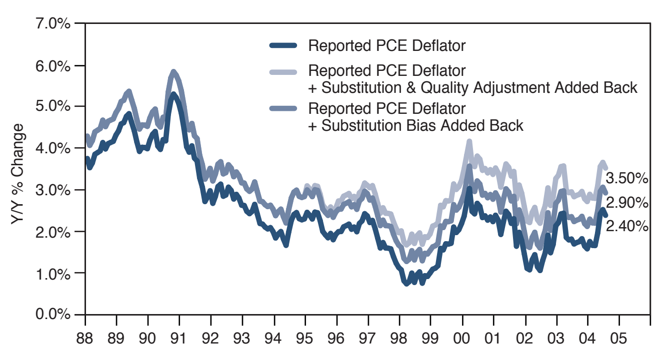
Source: Bureau of Labor Statistics, PIMCO, Saumil Parikh

Peter Bernstein in a recent *Economics and Portfolio Strategy* piece makes the hedonic point, as have Jim Grant, Stephen Roach, Marshall Auerback, Caroline Baum, and a host of other voices in the inflationary wilderness. Bernstein points out that since 1990, total CPI inflation was 2.7% a year, yet hedonically adjusted durable goods suspiciously managed to increase by only .1% annually. Over the past 12 months the BLS reports that non-durable were up at a 4.61% rate while those quality adjusted computers, cars, and refrigerators by golly managed to actually go down by 1.25%. "Holy Greenspan, Batman!" If we just could focus on those durable goods we could lower interest rates to 0% like the Japanese and drive up the markets one more time!

In addition, when "substitution bias" (a BLS maneuver that follows your preference for Chicken McNuggets vs. a Quarter Pounder) is eliminated, the gap gets even worse. For those of you sophisticated economists who feel the substitution bias is more than justified, chew on this for a second. If you substitute a pound of chicken for a pound of beef because it's cheaper, then switch back to beef later on because it came back down in price, the overall round trip which resulted in no ultimate substitution and no relative price change winds up reducing the stated PCE. Oh man, what a con.

Which brings me to a question that no rational money manager or economist wants to answer for fear of becoming a fool, or a conspiratorial kook. Why does the U.S. government and the Fed continue to foist this hedonic/substitution mantra on a gullible public when they should know better and when, by the way, <u>no other government does it in the same magnitude and with the same conviction</u>? Let me just answer it this way – and hopefully not seem foolish (or worse) in the process. Alan Greenspan has a dual prerogative at the Federal Reserve. He is charged with keeping inflation low and economic output high. The magic of hedonic/substitution adjustments keeps both of these birds flyin' at the same time, one <u>under</u> the magical 2% radar, which marks the dividing line between benign and worrisome inflation, and the other (real GDP), <u>over</u> the hurdle of 3% which suggests the continuation of high productivity, along with its concomitant implications that the stock

Substitution Bias Means Lower Short Rates



Source: Bureau of Labor Statistics, PIMCO, Saumil Parikh market should be healthy, the dollar strong, and all's well with the Greenspan legacy. Granted Greenspan doesn't run the BLS, but he pounds the table hard for hedonically adjusted statistics. They might serve him well, but they do a disservice to those grounded in the reality of stretching a paycheck for new cars, laptop computers, and cell phones that somehow haven't gone down as much in price as the government says they have.

Deceptive hedonic/substitution adjustments also serve a government burdened not only with hundreds of billions of annual deficits as far as the eye can see, but ladened with a demographically aging U.S. workforce rapidly approaching Social Security time. By fudging on inflation, they pay less and the amount could cumulatively run into the hundreds of billions over the next few decades. They disserve, of course, all of those who receive social security, as well as other private pensioners dependent on an accurate accounting of prices paid. They disserve buyers and holders of TIPS – inflation protected securities – which adjust inadequately to a faulty and near fraudulently calculated CPI that one day could total billions of dollars per year for TIPS holders. And they disserve all owners of U.S. Treasury obligations – including foreign central banks and institutions – who mistakenly assume that they are earning a real return over and above inflation, and that the dollar upon which they are denominated is justifiably strong because of GDP growth and productivity numbers that are pumped by hedonic magic to resemble the Arnold Schwarzenegger of 1980 instead of his verbal "girlie man" analogy of today.

No I cannot sit quietly on this one, nor as I've mentioned, have other notables in the past few years. The CPI as calculated may not be a conspiracy but it's definitely a con job foisted on an unwitting public by government officials who choose to look the other way or who convince themselves that they are fostering some logical adjustment in a New Age Economy dependent on the markets and not the marketplace for its survival. If the CPI is so low and therefore real wages in the black, tell me why U.S. consumers are resorting to hundreds of billions in home equity takeouts to keep consumption above the line. If real GDP growth is so high, tell me why this economy hasn't created any jobs over the past four years. High productivity? Nonsense, in part – statistical, hedonically created nonsense. My sense is that the CPI is really 1% higher than official figures and that real GDP is 1% less. You are witnessing a "haute con job" and one day those gorgeous statistics just like those gorgeous models, will lose their makeup, add a few pounds and wind up resembling a middle-aged Mom in a cotton skirt with better things to do than to chase the latest fad or ephemeral fashion. If those Moms are holders of government bonds based upon a benign outlook for inflation, they had better cash some of them in, especially at today's 4.0% yield for 10-year Treasuries.

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