

Bill
Gross



Investment Outlook

P I M C O

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Anything but .01%

I'm not so much concerned
about the return on my money
as the return of my money.

– Will Rogers, 1933

Toothpicked, straw-hatted Will Rogers was a journalists' dream, combining common sense with a sense of humour that could trump any newsman of his day, an era that was characterised more by its hopeless and helpless ennui, than its promise for a better tomorrow. During the Great Depression, just breaking even by stuffing your money in a mattress was considered to be a triumph of conservative investment. Likewise, during the past 18 months there have been similar "Will Rogers" moments. Perhaps remarkably, during the week surrounding the Lehman crisis in September of 2008, yours truly frantically called my wife Sue to empty our two local bank accounts into apparently safer Treasury bills. I was not the only PIMCO professional to do so. Preserving principal as opposed to making it grow was the priority of the day – digging a foxhole instead of charging enemy lines seemed paramount.

My how things have changed! With the global financial system apparently stabi-

in vogue, and conservative investors who perhaps appropriately donned a Will Rogers mask nary a fortnight ago are suddenly waking up to the opportunity cost of 0% cash versus appreciated assets at renewed double-digit annual rates. That 0% yield is not a joke. Almost all money market accounts – totalling over \$4 trillion dollars, shown in Chart 1 – yield close to nothing, so close to nothing that I mistakenly did a double take when reviewing my monthly portfolio statement. "Yield on cash," read the buried line on page 15 of the report, ".01%."

Well now, I say to myself, this is very interesting from a number of different angles. If I was hoping to double my money, it would take approximately 6,932 years to get there at that rate! Somehow, that wouldn't satisfy even Will Rogers, who might be choking on his toothpick or at least eating his straw hat in amazement. Secondly, being a savvy professional investor and all, I knew that money market funds actually earned 20

case were allocating a paltry one basis point to me. The words of the Beatles' "Taxman" immediately popped into mind: "That's one for you, nineteen for me – TAXMAN!"

Ah yes, but in this case it was the Fed and Wall Street that were passing the collection plate. Whether it was really "God's work," as Goldman's Lloyd Blankfein asserted, I wasn't quite sure. If there was a "temple" in the vicinity I was thinking that God should be driving the moneychangers out as opposed to inviting them in for a pep talk.

Ah, but this is not a vindictive diatribe, although to me, money changers resemble Mammon more than archangels, and they all make too much money, including PIMCO. My point is to recognise, and to hope that you recognise, that an effective zero percent interest rate, as a price for hiding in a foxhole, is prohibitive. Like the American doughboys near France's future Maginot Line in WWI – slumping day after day in a muddy, rat-infested pit – when the battalion commander finally blew his whistle to charge the enemy lines, it probably was

accompanied by some sense of relief; anything, anything but this! Anything but .01%!

Recently, approximately \$20 billion a week has been exiting those payless, seemingly godless funds in search of a higher-yielding Nirvana. Yet, as Will Rogers knew, and Lehman Brothers demonstrated to another generation, the pain of the foxhole can immediately transition to the dodging of real bullets on the investment battlefield. Moving out on the risk asset spectrum has worked wonders since March of this year, but it comes with the risk of principal loss – failing to receive the return of your money. When viewed from 30,000 feet, there is even a systemic risk that new asset bubbles are in the formative stages – perhaps because of the .01%. Gold at \$1,130 an ounce, global equity markets up 60-70% from their 2009 lows, a cascading dollar now 15% lower against a basket of global currencies just 12 months ago, oil at 80 bucks, mortgage rates at 4% thanks to a \$1 trillion dollar credit card from the Fed; the list goes on. The legitimate question of the day is, "Is a 0% funds rate creating the next financial bubble, and if so, will the Fed and other central banks raise rates proactively – even in the face of double-digit unemployment?" As Chicago Fed President Charles Evans said in a recent speech, "This notion is often described as an imperative to 'lean against a bubble,' meaning that a central bank should act to lower asset prices that by historical standards seem unusually high."

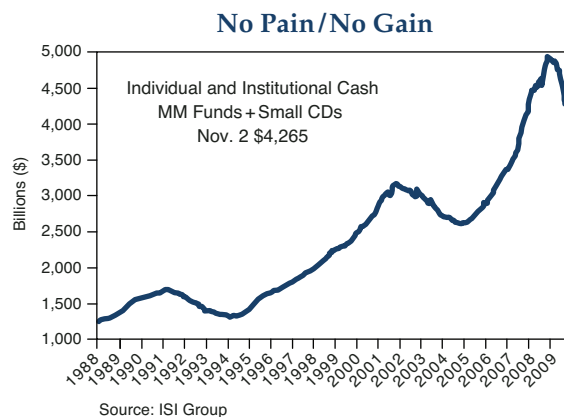


Chart 1

Yet even if the Fed and others are becoming sensitised to the dangers of up as opposed to exclusively down asset prices, it would seem that now is not the time to be affirming their bipolarity. Asset price rebounds (aside from the historic highs in gold) have followed even more dramatic slumps. A 60% rise in the stock market does not compensate for a 60% decline. Strangely enough, investors are still out 36% of their money once this down elevator/up elevator example plays out. And the simple analysis is that the private sector has still not taken the baton from government policymakers: There has been no public/private sector handoff. Bank lending is still contracting in the U.S. and weak in most other G-10 countries. Unemployment is still rising and approaching historic (ex-Depression) cyclical peaks.

Raise interest rates with 15 million jobless and 25 million part-time working Americans? All because gold is above \$1,100? You must be joking or smoking – something. We will need another 12 months of 4-5% nominal GDP growth before Bernanke and company dare lift their heads out of the 0% foxhole – mini-bubbles or not. Instead, the heavy lifting or the charging of enemy lines in the case of this metaphor will likely be done by other central banks – already in Australia and Norway. In addition, and importantly, China may abandon its dollar peg within six months' time and with it, its own easy monetary policy that has fostered more significant mini-bubbles of lending and asset

appreciation on the Chinese mainland. With renewed upward appreciation of the yuan may come potentially volatile global asset price reactions to the downside – higher Treasury yields, and lower stock prices – which the Fed must surely be leery of before making any upward move, of its own, and before moving on, let me state the obvious, but often forgotten bold-face fact: **The Fed is trying to reflate the U.S. economy. The process of reflation involves lowering short-term rates to such a painful level that investors are forced or enticed to term out their short-term cash into higher-risk bonds or stocks. Once your cash has recapitalised and revitalised corporate America and homeowners, well, then the Fed will start to be concerned about inflation – not until.** To date that transition is incomplete, mainly because mortgage refinancing and the purchase of new homes is being thwarted by significant changes in down payment requirements. The Treasury as well, has a significant average life extension of its own debt to foist on investors before the Fed can raise short-term Fed Funds.

OK, so where does that leave you, the individual investor, the small saver who is paying the price of the .01%? Damned if you do, damned if you don't. Do you buy the investment grade bond market with its average yield of 3.75% (less than 3% after upfront fees and annual expenses at most run-of-the-mill bond funds)? Do you buy high yield bonds at 8% and assume the

risk of default bullets whizzing at you? Or 2% yielding stocks that have already appreciated 65% from the recent bottom, which according to some estimates are now well above their long-term PE average on a cyclically adjusted basis? Two suggestions. First, as emphasised in prior *Investment Outlooks*, the New Normal is likely to be a significantly lower-returning world. Diminished growth, deleveraging, and increased government involvement will temper profits and their eventual distribution to investors in the form of dividends and interest. As banks, auto companies and other corporate models become more regulated and therefore more like utilities and less like Boardwalk and Park Place, they will return less.

Which brings up the second point. If companies are going to move toward a utility model, why suffer the transformational revaluation risk of equities with such a low 2% dividend return? Granted, Warren Buffett went all-in with the Burlington Northern, but in doing so he admitted it was a 100-year bet with a modest potential return. Still, Warren had to do something with his money; the .01% was eating a hole in his pocket too. Let me tell you what I'm doing. I don't have the long-term investment objectives of Berkshire Hathaway, so I'm sort of closer to an average investor in that regard. If that's the case, I figure, why not just buy

utilities if that's what the future American capitalistic model is likely to resemble. Pricewise, they're only halfway between their 2007 peaks and 2008 lows – 25% off the top, 25% from the bottom. Their growth in earnings should mimic the U.S. economy as they always have, and most importantly they yield 5-6% not .01%! **In a low growth environment, it seems to me that a company's stock should yield more than its less risky debt, and many utilities provide just that opportunity.** Utilities and even quasi-utility telecommunication companies now yield between 5 and 6%, whereas their 10- and 30-year yield less and at a higher tax rate to you the investor.

So come on you frustrated Will Rogers lookalikes. Join the wimp who pulled his money out of the bank just 14 months ago. Look at your monthly statement, zero in on that .01 yield and say to yourself, "I'm as mad as hell, and I'm just not going to take this anymore!" You can't buy the Burlington Northern – Warren Buffett has scooped that up – and most other choices offer tempting returns, but potential bullets as well. Buy some utilities. It may not be as much fun as running a railroad, but at least you'll know who to call if the lights go out.

William H. Gross
Managing Director

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P I M C O

London

PIMCO Europe Ltd
(Registered in England and
Wales, Company No. 2604517)

Registered Office
Nations House
103 Wigmore Street
London W1U 1QS
England
+44 (0) 20 7872 1300

Amsterdam

PIMCO Europe Ltd
Amsterdam Branch
(Registered in The Netherlands,
Company No. 24319743)

Registered Office
Schiphol Boulevard 315
Tower A6
1118 BJ Luchthaven Schiphol
The Netherlands
+31 (0) 20 655 4710

Munich

PIMCO Europe Ltd
Munich Branch
(Registered in Germany,
Company No. 157591)

Registered Office
Seidlstraße 24-24a
80335 Munich