



Investment Outlook

2 + 2 = 4

A photograph of Bernard Baruch looms ominously on the far corner of my PIMCO office wall. Vested, with pocket watch and protruding chin thrust prominently toward the observer, this well-known financier of the early 20th century at times appears almost alive. It was Baruch who almost schizophrenically cautioned investors during the stock market's speculative blow-off in the late 20s that "two plus two equals four and no one has ever invented a way of getting something for nothing." Three years later during the depths of economic and financial gloom he opined just the opposite: "Two plus two still equals four," he said, "and you can't keep mankind down for long." Homo sapiens, as it turns out, stayed on the deck for much longer than Baruch envisioned – some historians having suggested that it was only war and not the rejuvenating economic spirits of a capitalistic peace that eventually turned the tide – but his words, first of caution and then of optimism, typify the way that fortunes were, and still are, made in the financial markets: Get your facts straight, apply them to the current valuation of the market, take decisive action, and then hold on for dear life as the mob hopefully comes to the same conclusion a little way down the road.

I stare into Baruch's eyes almost every day – not that we are simpatico or kindred spirits of any sort – but when I do, it's as if I can hear him almost whispering to me over the portals of time: "Two plus two," he commands, "two plus two, two plus two." The message – fortunately, I suppose – ends there. If you thought I was receiving market calls from the ghost of Bernard Baruch I suspect PIMCO would have far fewer clients than we do today. But his lesson nonetheless remains clear: separate reality from exuberance either on the up or the downside and you have the ingredients for a successful market strategy.

Through my years here at PIMCO there have been numerous demarcation points where Baruch's whispers almost turned into screams. Two plus two screamed four in September of 1981 with long-term Treasury yields approaching 15%, and two plus two boomed four in 2000 when the Dot Coms rose to prices that discounted the hereafter instead of the next 30 years. Similarly, 2007 was a screaming mimi with the subprimes – if only because the liar loans and no-money-down financing were reminiscent of a shell game, Ponzi scheme, or some other type of wizardry that was bound to lead to tears.

2009 is a similar demarcation point because it represents the beginning of government policy counterpunching, a period when the public with government as its proxy decided that private market, laissez-faire, free market capitalism was history and that a “private/public” partnership yet to gestate and evolve would be the model for years to come. If one had any doubts, a quick, even cursory summary of President Obama’s comments announcing Chrysler’s bankruptcy filing would suffice. “I stand with Chrysler’s employees and their families and communities. I stand with millions of Americans who want to buy Chrysler cars (sic). I do not stand...with a group of investment firms and hedge funds who decided to hold out for the prospect of an unjustified taxpayer-funded bailout.” If the cannons fired at Ft. Sumter marked the beginning of the war against the Union, then clearly these words marked the beginning of a war against publically perceived financial terror.

Make no mistake, PIMCO had no dog in this fight, and has infinitesimally small holdings of GM bonds as well. In turn, the rebalancing of wealth from the rich to the “not so rich” is a long overdue reversal, one that I have encouraged in these *Outlooks* for at least the past several years. But promoting and siding with the majority of the American public in their quest for change does not mean that as investors, we at PIMCO stand star-struck like a deer in front of the onrushing headlights,

doing nothing to protect clients. Our task is to identify secular transitions and to preserve and protect capital if indeed it is threatened. Now appears to be one of those moments.

The threat, of course, falls under the broad umbrella of “burden sharing” and is a difficult one to interpret and anticipate, if only because the concept is evolving in the minds of policymakers as well. But clearly, as this financial crisis has morphed from Bear Stearns to FNMA, Lehman Brothers, AIG and now Chrysler, the claims of stockholders and in some cases senior debt holders have suffered. Please hear me on this. That is the way it should be. Capitalism is about risk taking and if you’re not a risk taker, you should have your money in the bank, Treasury bills, or a savings bond, not the levered investment of a bank or an aging automobile company. Let there be no company too big, too important, or too well-connected to fail as long as the systemic health of the economy is not threatened.

Having acknowledged that, however, let me be clear that these risks, long swept under the rug of prior Administrations, are now rising to a boil. The pressure to “survive well” or simply survive period is now clearly shifting to Wall Street as opposed to Main Street. The worm has turned, and our President, whom I voted for and still strongly support, has shed his predecessor’s regal robes for a populist’s cloak.

How does one invest during such a transition? Investors should recognize that this grassroots trend signals – most importantly – an increasing uncertainty of cash flows from financial assets. Not only will redistribution and reregulation lead to slower economic growth, but the financial flows from it will be haircutted and “burden shared” by stakeholders. In turn, the present value of those flows should reflect an increasing risk premium and a diminishing multiple of annual receipts. PIMCO’s Paul McCulley, famous for a catchy phrase or a light-bulb-generating truism, asked a group of clients the other day to compare FedEx and UPS to the U.S. Post Office, if it were a public corporation. “Which one would you pay more for?” he asked. If FedEx deserves a P/E of 12, wouldn’t the value of the Post Office be substantially less? His point, and mine as well, is that as wealth is redistributed, and the invisible private hand of Adam Smith begins to resemble more and more the public fist of government, then asset values should be negatively affected. First comes the haircutting and burden sharing, most recently evidenced by Chrysler and soon to be played out via the stress testing and equity dilution of government ownership of ailing banks. In those footsteps, however, will follow a slower rate of economic growth, not just in the U.S., but worldwide as heretofore libertarian capitalism is bridled, saddled and taught to trot instead of gallop over the investment plains.

This *Outlook* is not to bemoan this transition, but to recognize it. Slower growth can be a public good if it avoids the cataclysmic effects of double-digit unemployment, escalating foreclosures, and fear of financial insecurity. But the Obama cannon shot will have financial consequences. Do not be deceived by the euphoric sightings of “green shoots” and the claims for new bull markets in a multitude of asset classes. Stable and secure income is still the order of the day. Shaking hands with the new government is still the prescribed strategy, although it should be done at a senior level of the balance sheet. If the government indeed becomes your investment partner, you should keep the big Uncle in clear sight and without back turned. Risk will not likely be rewarded until the global economy stabilizes and the Obama rules of order are more clearly defined.

The ghost of Bernard Baruch still counsels that $2 + 2 = 4$, but the repercussions of getting something for nothing should dominate the hopes that mankind will get off the deck and revert to a mean or median standard representative of outdated political and economic philosophies. Mohamed El-Erian’s and PIMCO’s “new normal” should trump green shoot exuberance for years to come.

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