



What's In A Name?

What's in a name? I wish I'd asked my parents how they came up with mine, because I've never really been a good "Bill." That is not to say that I'm uncomfortable in my own skin – I usually am – but I've never really been at ease with the name. Perhaps it's genetic because the discomfort seems to run in the family. Who could blame my father I suppose for insisting on "Dutch" as opposed to Sewell Gross the IV! Imagine: a nameological tyranny of four successive Sewells! It ended with him, but then there was my brother Craig who insisted on Chip and my sister Lynn who in her fifties changed her name to Lyn. At least I didn't have to worry about calling her by the wrong name, although I have boo-boomed on birthday cards. In any case, we Grosses seem to dislike our names.

Having kids, however, allowed me to set the record straight or at least mutate those genes which kept rejecting given names that seemed appropriate to parents, but not to Gross progeny. My first attempt at cracking the code came with my first son, Jeff. I liked "Jeff." It was short, masculine and was the first name of a Duke basketball star in the 1960s. I'd be a better Jeff than a Bill. Next up was Jennifer, whose name came from a Donovan number one hit song and then there was Nick. Nick was actually Sue's favorite name, but I easily conceded. Who couldn't like Nick? Saint Nick, just in the Nick of time, Nick, Nick, Nick. I would've been a good Nick.

Now at 68, however, I've run out of naming opportunities which has caused me to begin to nitpick my last name. I mean there are Smith(s) because their occupational heritage was presumably a craftsman, and Johnson(s) who were the sons of John, but Gross? What's a Gross? A Gross, as it turns out, is twelve dozen or 144. Numerology is not my bag, but the frequency of this number's occurrence is more than eerie. My first home was on 14401 La Mancha and my home for the last 25 years has been 144 Seabring Way. I was born in 1944, the 144 in this case being necessarily interrupted by a centurion digit. In addition, while my birthdate was 4/13 instead of 4/14, my mother always informed me as mothers do, that I was born at 9:36 p.m. which I only recently calculated to be 144 minutes short of the 4/14/44 date. Very strange.

Gross also means “big” in German and was adopted by the English with an E on the end as in Grosse Point, Michigan. Neither of those connections disturbs me, nor does the expression “how gross.” I always sort of shrugged and told myself to get over it. What bothers me most about it though is that I keep getting advertising pamphlets in the mail from Jewish mausoleums. Seems like half the Grosses in the world are Christian and half are Jewish. The Christians don’t seem to be concerned about my hereafter, but the followers of the Jewish faith do. For that I’m thankful, but I’d prefer not to be reminded of my impending doom, so at 68 I wish I wasn’t a Gross. Not a Bill, not a Gross – go figure. What’s in a name?

7% returns out of reach

Mayor Michael Bloomberg in a February trip to his state capital to discuss pension funding told a legislator that “if I can give you one piece of financial advice, it’s: If somebody offers you a guaranteed 7% on your money for the rest of your life, you take it and just make sure the guy’s name isn’t Madoff.” So names, it seems are important to others outside the Gross family and I probably should hold off changing the “Bill” and even the “Gross” if only because it’s not Madoff. That 7% return though – I’m not sure it’s possible in this era of the New Normal where negative real rates on Treasuries and its incumbent financial repression dominate bond and asset markets alike. Aside from the 7% return expectation however – which many pension funds and liability structures assume at a bare minimum – what struck me about the Mayor’s comment was the assumption that there were legitimate guarantors of investment returns throughout the world. Even assuming that Madoff and his Ponzi lookalikes are now under lock and key, recent events have shown that not only banks and insurance companies with their presumed “money good” guarantees, but sovereign nations as well cannot all be counted on to guarantee a return of principal, let alone a return on investment that comes anywhere close to matching 7% in nominal terms. What does Greece tell us if not that money, credit and financial investments dependent on ever expanding growth of credit are sometimes subject to buzz cut defaults with scalp level clippers, as opposed to a trimming of the bangs with haute couture scissors. 7%? Greek, Spanish and almost all non-Germanic Euroland bond investors would be happy for much less – they’d request a modern day Will Rogers haircut, which was defined in the 1930s when he said, “I’m more concerned about the return

of my money than the return on my money.” Trillions of global investment dollars, Euros and Yen would settle for just that if they could only reclaim their prior investments at par, and then silently deposit them in a mattress for safekeeping.

Debt crisis can’t be cured with more debt

What global investors, fixated on historical cyclical trends as opposed to secular delevering dynamics fail to appreciate is that economies and their financial markets historically have taken several decades as opposed to several years to renormalize once the fatal grip of too much debt wreaks havoc on the assumed perpetuity of capitalism’s prosperity machine. **Can a debt crisis be cured with more debt?** Yes, if initial debt levels are reasonable and central banks are able to rejuvenate the delicate dance between debtor and creditor – each believing that they are getting a good deal in terms of risk, reward and the deployment of funds between now and some future maturity. **But when debt as a percentage of GDP, or debt service as a percentage of household income, or the appropriateness of the term structure (short vs. long) on both borrower and lender balance sheets becomes imbalanced, then the well-oiled capitalistic engine may sputter and in some cases – as in Greece – freeze up. That’s when a debt crisis can’t be cured with more debt, be it in the form of QEs or LTROs, or implicit firewalls created or to be created by Eurobonds, ESMs, the IMF or any other agency that presumably is money good.** The fact is that the current burden of global debt is only being lightly alleviated via zero-bound interest rates. None of it, other than Greek PSI or minor amounts of private U.S. mortgage debt has been extinguished over the post-Lehman era; it has only been transferred from one pocket to another. Banks, insurance companies and mutual funds have passed the peripheral Old Maid from their hands to that of the ECB, or to Spanish and Italian banks, and ultimately on to the German core. Does it matter that Greece decides to stay with the Euro or that the Southern peripherals move towards austerity, or that the U.S. in November decides to go Red or Blue? Not much. Solutions for real growth matter only at the margin. An authentic debt crisis – which the world is now experiencing – can only be ultimately cured in two ways: 1) default on it, or 2) print more money in order to inflate it away. Both 1 and 2 are poison for bond and stock holders, which is why 7% returns – guaranteed or not – are so comical.

In search of those mythical returns, investors have shifted both bond and equity funds into what we at PIMCO call the “cleanest dirty shirt” countries. Not content to wallow in the mud of the southern Euroland PIGS despite their (coincidentally) 7% yields, investors have preferred 0% 2-year German Schatz or almost as ridiculous 0% 30-year U.K. linkers under the assumption that their principal at least will be “guaranteed.” For 30 years though, U.K. investors will guarantee themselves a return at or below their future purchasing power. Mayor Bloomberg it seems has a Sophie’s Choice – 7% with debt-laden, mud-caked Spanish polo shirts or 0% with bleached but still stained knock-offs. His Honor – and all other investors – must decide if as Shakespeare posed “a rose is a rose by any other name.” Is a clean dirty shirt a dirty shirt by another name? And if not, in the midst of a global debt crisis can there actually be such a thing as a clean dirty shirt that justifies near 0% yields? The fit, it seems, may be a tad tight the closer bonds get to zero.

Is the U.S. shirt really clean?

This observer must obviously admit – as do rating services – that some countries are better than others. Those with initial debt conditions that don’t exceed historical norms, those that can print and issue debt in their own currencies, those that have reasonable trade balances, those that emphasize the sanctity of property rights, those that dominate the global military stage, those with innovation and education, those.... I could go on. **Many of the above conditions point investors to the ultimate “safe haven,” the cleanest of the dirty shirts, the champion of champions, rose of all roses – the United States. I will not dispute it, market movements have confirmed it and my own experience in 2011 is a testament to it. Don’t underweight Uncle Sam in a debt crisis. Money seeking a safe haven will find it in America’s deep and liquid (almost Aaa rated) bond and equity markets.**

Yet there may come a time when the king adorned in his clean dirty shirt may be redressed or perhaps undressed to reveal he has no clothes – just like Greece – just like many or most of the rest of them. **The chart below shows America’s debt/GDP which at close to 100% is not near-term threatening, but if continued upward on trend could be absolutely debilitating. 7-8% annual deficits while alleviated and tempered by the financing**

of them with negative real interest rates, promise to raise that 100% number to 125% within five years if nothing is done. Yet as stunning and as Greek-like as that percentage is, it comes nowhere close to the actual liabilities of the U.S. government that represent promises nearly as sacrosanct as the interest and principal on a 30-year Treasury. Social Security, Medicare and Medicaid liabilities when measured on the same present value basis as our current \$15 trillion of outstanding debt, total four times as much: \$66 trillion according to unbiased, non-political, Office of Management and Budget (OMB) estimates of future liabilities. In addition, studies estimated the unfunded liabilities of state and local governments at an additional \$38 trillion. All together they would accelerate the line in chart 1 to 800% of GDP. And we look down on the Greeks?

“DIRTY” BY ANY OTHER NAME

**Chart 1
USA: gross federal government debt to GDP**



Source: Haver Analytics, as of Q1 2012

Mayor Bloomberg was on to something when he told Albany legislators to look for anyone or any firm with a name other than Madoff to seek out their vaunted 7%. What he didn’t say is that our U.S. President – past, present and future – heads a financing scheme that has similar characteristics. Think of the U.S. balance sheet with its \$66 trillion dollars of liabilities as one giant PIK bond – Payment In Kind. The corporate bond market has PIKs although they tend to be junk market rated. **Instead of paying actual current interest they promise to pay future bills with more and more bonds – payment in kind. That’s what Social Security (\$8 trillion) is; that’s what Medicare is (\$23 trillion); and that’s essentially**

what Medicaid is (\$35 trillion) although the latter is appropriated annually and therefore disguised as an actual debt. U.S. Treasuries are one giant PIK bond that can only partially be paid off under assumptions of Old Normal 3% real growth rates, or check writing by the Federal Reserve that inflates away the debt and a bondholder's real principal at the same time.

So Mr. Mayor, I would tell investors this: There are very few clean dirty shirts in this world. Timing in investment markets is critical and at the moment the U.S. is considered to be the cleanest. That's why PIMCO owns them. But things change. A blossoming rose wilts over time. A good name can be slandered, a great opportunity to change fiscal direction squandered within a few short years. This debt crisis should be considered global as opposed to regional, and investors should recognize that clean dirty shirts are not forever thus. Over time, they may have to change their name, their rating, or at least their reputation as a clothes horse.

William H. Gross
Managing Director

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840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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