Excerpts from

Investment Outlook

William H. Gross | November 2010

Run Turkey, Run

- *The Fed's announcement of a renewed commitment to Quantitative Easing has been well telegraphed and the market's reaction is likely to be subdued.*
- *We are in a "liquidity trap," where interest rates or trillions in asset purchases may not stimulate borrowing or lending because consumer demand is just not there.*
- *The Fed's announcement will likely signify the end of a great 30-year bull market in bonds and the necessity for bond managers and, yes, equity managers to adjust to a new environment.*

There's another important day next week and it rather coincidentally occurs on Wednesday – the day after Election Day – when either the Donkeys or the Elephants will be celebrating a return to power and the continuation of partisan bickering no matter who is in charge. Wednesday is the day when the Fed will announce a renewed commitment to Quantitative Easing – a polite form disguise for "writing checks." The market will be interested in the amount (perhaps as much as an initial $500 billion) as well as the targeted objective (perhaps a muddied version of "2% inflation or bust!"). The announcement, however, has been well telegraphed and the market's reaction is likely to be subdued. More important will be the answer to the long-term question of "will it work?" and perhaps its associated twin "will it create a bond market bubble?"

Whatever the conclusion, not only investors, but the American people should recognize that Wednesday, even more than Tuesday, represents a critical inflection point in determining our future prosperity. Of course we've tried it before, most recently in the aftermath of the Lehman crisis, during which the Fed wrote $1.5 trillion or so in "checks" to purchase Agency mortgages and a smattering of Treasuries. It might seem a tad dramatic then, to label QEII as "critical," sort of like those airport hucksters, I suppose, that sold whale blubber for a living. But two years ago, there was the implicit assumption that the U.S. and its associated G-7 economies needed just an espresso or perhaps an Adderall or two to get back to normal. Normal just hasn't happened yet, and economic historians such as Kenneth Rogoff and Carmen Reinhart have since alerted us that countries in the throes of delevering can take many, notseveral, years to return to a steady state.

The Fed's second round of QE, therefore, more closely resembles an attempted hypodermic straight to the economy's heart than its mood elevator counterpart of 2009. If QEII cannot reflate capital markets, if it can't produce 2% inflation and an assumed reduction of unemployment rates back towards historical levels, then it will be a long, painful slog back to prosperity. Perhaps, as a vocal contingent suggests, our paper-based foundation of wealth deserves to be buried, making a fresh start from admittedly lower levels. The Fed, on Wednesday, however, will decide that it is better to keep the patient on life support with an adrenaline injection and a following morphine drip than to risk its demise and ultimate rebirth in another form.

We at PIMCO join with Ben Bernanke in this diagnosis, but we will tell you, as perhaps he cannot, that the outcome is by no means certain. **We are, as even some Fed Governors now publically admit, in a "liquidity trap," where interest rates or trillions in QEII asset purchases may not stimulate borrowing or lending because consumer demand is just not there. Escaping from a liquidity trap may be impossible, much like light trapped in a black hole.** Just ask Japan. Ben Bernanke, however, will try – it is, to be honest, all he can do. He can't raise or lower taxes, he can't direct a fiscal thrust of infrastructure spending, he can't change our educational system, he can't force the Chinese to revalue their currency – it is all he can do, and as he proceeds, the dual questions of "will it work" and "will it create a bond market bubble" will be answered. We at PIMCO are not sure.

Still, while next Wednesday's announcement will carry our qualified endorsement, I must admit it may be similar to a Turkey looking forward to a Thanksgiving Day celebration. Bondholders, while immediate beneficiaries, will likely eventually be delivered on a platter to more fortunate celebrants, be they financial asset classes more adaptable to inflation such as stocks or commodities, or perhaps the average American on Main Street who might benefit from a hoped-for rise in job growth or simply a boost in nominal wages, however deceptive the illusion. **Check writing in the trillions is not a bondholder's friend; it is in fact inflationary, and, if truth be told, somewhat of a Ponzi scheme. Public debt, actually, has always had a Ponzi-like characteristic**. Granted, the U.S. has, at times, paid down its national debt, but there was always the assumption that as long as creditors could be found to roll over existing loans – and buy new ones – the game could keep going forever. Sovereign countries have always implicitly acknowledged that the existing debt would never be paid off because they would "grow" their way out of the apparent predicament, allowing future's prosperity to continually pay for today's finance.

Now, however, with growth in doubt, it seems that the Fed has taken Charles Ponzi one step further. Instead of simply paying for maturing debt with receipts from financial sector creditors – banks, insurance companies, surplus reserve nations and investment managers, to name the most significant – the Fed has joined the party itself. Rather than orchestrating the game from on high, it has jumped into the pond with the other swimmers. One and one-half trillion in checks were written in 2009, and trillions more lie ahead. The Fed, in effect, is telling the markets not to worry about our fiscal deficits, it will be the buyer of first and perhaps last resort. There is no need – as with Charles Ponzi – to find an increasing amount of future gullibles, they will just write the check themselves. I ask you: Has there ever been a Ponzi scheme so brazen? There has not. This one is so unique that it requires a new name. I call it a Sammy scheme, in honor of Uncle Sam and the politicians (as well as its citizens) who have brought us to this critical moment in time. It is not a Bernanke scheme, because this is his only alternative and he shares no responsibility for its origin. It is a Sammy scheme – you and I, and the politicians that we elect every two years – deserve all the blame.

Still, as I've indicated, a Sammy scheme is temporarily, but not ultimately, a bondholder's friend. It raises bond prices to create the illusion of high annual returns, but ultimately it reaches a dead-end where those prices can no longer go up. **Having arrived at its destination, the market then offers near 0% returns and a picking of the creditor's pocket via inflation and negative real interest rates.** A similar fate, by the way, awaits stockholders, although their ability to adjust somewhat to rising inflation prevents such a startling conclusion. Last month I outlined the case for low asset returns in almost all categories, in part due to the end of the 30-year bull market in interest rates, a trend accentuated by QEII in which 2- and 3-year Treasury yields approach the 0% bound. Anyone for 1.10% 5-year Treasuries? Well, the Fed will buy them, but then what, and how will PIMCO tell the 500 billion investor dollars in the Total Return strategy and our equally valued 750 billion dollars of other assets that the Thanksgiving Day axe has finally arrived?

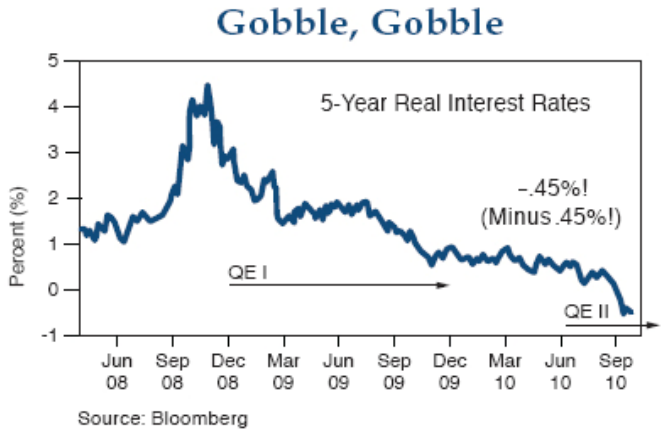

Chart 1

We will tell them this. Certain Turkeys receive a Thanksgiving pardon or they just run faster than others! We intend PIMCO to be one of the chosen gobblers. We haven't been around for 35+ years and not figured out a way to avoid the November axe. We are a survivor and our clients are not going to be Turkeys on a platter. You may not be strutting around the barnyard as briskly as you used to – those near 10% annualized yields in stocks and bonds are a thing of the past – but you're gonna be around next year, and then the next, and the next. Interest rates may be rock bottom, but there are other ways – what we call "safe spread" ways –to beat the axe without taking a lot of risk: developing/emerging market debt with higher yields and non-dollar denominations is one way; high quality global corporate bonds are another. Even U.S. Agency mortgages yielding 200 basis points more than those 1% Treasuries, qualify as "safe spreads." While our "safe spread" terminology offers no guarantees, it is designed to let you sleep at night with less interest rate volatility. The Fed wants to buy, so come on, Ben Bernanke, show us your best and perhaps last moves on Wednesday next. You are doing what you have to do, and it may or may not work. **But either way it will likely signify the end of a great 30-year bull market in bonds and the necessity for bond managers and, yes, equity managers to adjust to a new environment.**

William H. Gross
Managing Director

"Safe Spread" is defined as sectors that we believe are most likely to withstand the vicissitudes of a wide range of possible economic scenarios. All investments contain risk and may lose value.