

Don't Care

I haven't gone to a cocktail party in over 10 years. Granted, perpetually watching Seinfeld reruns on Friday and Saturday nights makes for a dull boy, but the alternative is excruciating. Uh, which would I prefer – solitary confinement or water boarding? I lean strongly in the direction of a warm bed and peace as opposed to a glass full of tinkling ice cubes and a room resonating with high- decibel blather. I suppose the parties wouldn't be so bad if there was something original to be said, or if "you" had a genuine interest in "me" as opposed to "you," but let's face it folks, no one does. The only reason any of us really cares about cocktail conversations is to quickly redirect someone else's stories into autobiographies that we assume to be instant bestsellers if only in print. If not, if the doe-eyed listener seems simply *fascinated* by what you're saying, you can bet there's a requested personal favor coming when you finally shut up. "Say Bill, I was wondering if you knew somebody at...that could..." Yeah right! But, as my chart shows, 90 seconds into a typical conversation, no one gives a damn about you and your problems – maybe those shoes and that dreadful eye shadow you're wearing, but not anything audible coming out of your mouth.

During that unbearable minute-and-a-half, however, you're likely to have covered some of the following topics:

Cocktail Party Empathy Chart

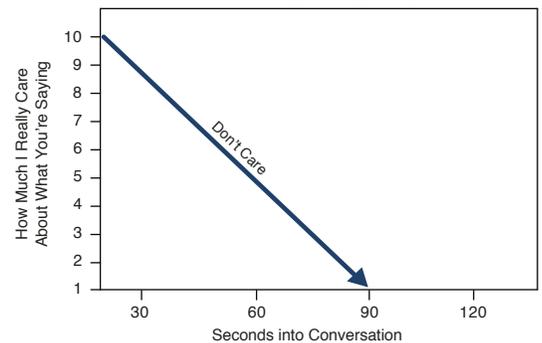


Chart 1

- 1) Where are you from? (If it's not a place where I've been or have a distant second cousin – don't care.)
- 2) How's the family? (If Johnnie is in advanced placement courses and my kids aren't – don't care. Don't care about your kids' soccer games either or that upcoming wedding.)
- 3) Medical problems. (Unless you're dying from cancer – don't care. Your artificial hip and kidney stone stories are important only to let me tell you about mine.)
- 4) How's work? (Forgot where you work, but it's a good lead in. Don't really care though unless you can direct some business my way.)
- 5) Can you believe Tiger? (Now there's something I care about, but the wife is only five feet away.)

Actually, the “afterparty” is the best party of all – driving home with your partner and dising all of the guests. Still, give me a home where Seinfeld roams, I suppose. Boring is better – cocktail parties are so 1990s.

In contrast to those cocktail parties, I’ve got so much to say in this *Investment Outlook* that I don’t know where to start. Don’t be lookin’ around for something more important though, like you do at a cocktail party; I need your undivided attention for the full 90 seconds allotted me.

To begin with, let’s get reacquainted with the fundamental economic problem of our age – lack of global aggregate demand – and how we got to where we are today:

(1) Twenty years of accelerated globalization incrementally undermined the real incomes of most developed countries’ workers/citizens, forcing governments to promote leverage and asset price appreciation in order to fill in what is known as an “aggregate demand” gap – making sure that consumers keep buying things. When the private sector assumed too much debt and asset prices bubbled (think subprimes and houses, or dotcoms/NASDAQ 5000), American-style capitalism with its leverage, deregulation, and religious belief in lower and lower taxes reached a dead end. There was a willingness to keep on consuming, there just wasn’t the wallet. Vigilantes – bond market or otherwise – took away the credit card like parents do with a mall-crazed teenager. (2) The cancellation of credit cards led to the Great Recession and private sector deleveraging, the beginning of government policy reregulation, and gradual deglobalization – a reversal of over 20 years of trade policies and free market orthodoxy.

In order to get us out of the sinkhole and avoid another Great Depression, the visible fist of government stepped in to replace the invisible hand of Adam Smith. Short-term interest rates headed to 0% and monetary policies of central banks incorporated new measures labeled “quantitative easing,” which essentially involved the writing of trillions of dollars of checks to replace the trillions of dollars of credit that disappeared after Lehman Brothers. In addition, government fiscal policies, in combination with declining revenues, led to double-digit deficits as a percentage of GDP in many countries, a condition unheard of since the Great Depression. (3) For awhile it seemed that all was well, that the government’s checkbook could replace the private market’s wallet and credit cards. Risk markets returned to normal P/Es as did interest rate spreads, and GDP growth resumed; it was only a matter of time before job growth would assure the world that we could believe in the tooth fairy again. Capitalism based on asset price appreciation was back. It would only be a matter of time before home prices followed stock prices higher and those refis and second mortgages would stuff our wallets once again. (4) Ah, but Dubai, Iceland, Ireland and recently Greece pointed to a potential flaw in the model. Shaking hands with the government was a brilliant strategy in 2009 when it was assumed that governments had an infinite capacity to leverage themselves.

But what if they didn’t? What if, as Carmen Reinhart and Kenneth Rogoff have pointed out in their book, “This Time is Different,” our modern era was similar to history over the past several centuries when financial crises led to sovereign defaults or

at least uncomfortable economic growth environments where real GDP was subpar based on onerous debt levels – sovereign and private market alike. **What if – to put it simply – you couldn't get out of a debt crisis by creating more debt?**

You are now up-to-date and I've used up all of my 90 seconds, but bear with me, patient reader. I may not be able to get your kid a job at PIMCO, but maybe I could give you an idea or two as to what lies ahead. Let's explore the last line in the previous paragraph first – **can you get out of a debt crisis by piling on another layer of debt?** The answer, of course, is that "it depends." Replacing corporate and mortgage debt with a government checkbook is initially beneficial because the sovereign is assumed to be more creditworthy than its private market serfs. It taxes, it prints, it confiscates wealth if need be and so this substitution is medicinal in the early stages of a financial crisis aftermath – especially if debt/GDP levels are low to begin with. That is the case currently at most G7 countries, with the exception of Japan, although the balance sheets of Germany/France are obviously contaminated by its weaker EU members, and that of the U.S. by its Agencies and other off-balance-sheet liabilities. But based on existing deficit trends and the expectation that not much progress will be made in reducing them, markets are raising interest rates on sovereign debt issuance either in anticipation of higher future inflation, increased levels of credit risk, or both. This places a potential "cap" on the "debt" that supposedly can be created to get out of the "debt crisis."

The threat of credit deterioration is clearly evidenced in the CDS or credit default

market for sovereign countries. Greece has taken the headlines with its 350–400 basis point cost of "protection," but even Japan and the U.K. approach 100 and the U.S. is nearly half of that. Markets, in fact, are demanding 20–30 basis points of higher insurance premiums for the best of credits relative to levels prior to Dubai and Greece. The inflation component of sovereign issuance is obvious as well. Potential serial reflators such as the U.K. and U.S. both show an increase of 50 basis points in their 10-year notes since the Dubai crisis in late November. While a portion of that 50 may in fact be credit related as pointed out above, the combination of credit and inflationary protection demanded by the market suggests, as Reinhart and Rogoff point out in their book, that government securities following a financial crisis are subject to huge increases in supply and accordingly, significant increases in risk and real yield levels.

It is interesting to observe that over the past few months when investors have begun to question the ability of governments to exit the debt crisis by "creating more debt," that increases in bond market yields have been confined almost exclusively to Treasury/Gilt-type securities, and long maturities at that. There has even been a developing debate in the press (and here at PIMCO) as to whether a highly-rated corporation could ever consistently trade at lower yields compared to its home country's debt. I suspect not, but the narrowing in spreads since late November solicits an interesting proposition: **Government bailouts and guarantees such as those evidenced and envisioned in Dubai and Greece, as well as those for the last 18 months with banks and large**

industrial corporations across the globe, suggest a more homogeneous “unicredit” type of bond market. If core sovereigns such as the U.S., Germany, U.K., and Japan “absorb” more and more credit risk, then the credit spreads and yields of these sovereigns should look more and more like the markets that they guarantee. The Kings, in other words, in the process of increasingly shedding their clothes, begin to look more and more like their subjects. Kings and serfs begin to share the same castle.

This metaphor doesn’t really answer the critical question of whether a debt crisis can be cured by issuing more debt. The answer remains: It depends – on initial debt levels and whether or not private economies can be reinvigorated. **But it does suggest the likely direction of sovereign yields IF global policymakers are successful with their rescue efforts: Sovereign yields will narrow in spreads compared to other high-quality alternatives. In other words, sovereign yields will become more credit like.** When sovereign issues become more credit-like, as evidenced in Greece, Spain, Portugal, and a host of others, they move closer in yield to the corporate and Agency debt that supposedly rank lower in the hierarchy. That process of course can be accomplished in two ways: high-quality non-sovereigns move down to lower levels or governments move up. The answer to which one depends significantly on future inflation, the aftermath of quantitative easing programs, and the vigor of the private economy going forward. But the contamination of sovereign credit space

with past and future bailouts is a leveler, a homogenizer, a negative for those sovereigns that fail to exert necessary discipline. **Only if global economies stumble and revisit the recessionary depths of a year ago should the process reverse direction and place Treasuries, Gilts, et al. back in the driver’s seat.**

Investors should obviously focus on those sovereigns where fundamentals promise lower credit or inflationary risk. Germany and Canada are amongst those at the top of our list while a rogues’ gallery of the obvious, including Greece, Euroland lookalikes, and the U.K. gather near the bottom. PIMCO’s “Ring of Fire” remains white hot and action, as opposed to cocktail blather, is required to maintain or regain trust in sovereign credits approaching the rocks. Just last week Bank of England Governor Mervyn King said that it would be difficult to cut government spending quickly, but that there needs to be a clear plan for doing so. Not good enough, Mr. King. Don’t care. Show investors the money, not vice-versa. An investor’s motto should be, “Don’t trust any government and verify before you invest.” The careful discrimination between sovereign credits is becoming more than casual cocktail conversation. A deficiency of global aggregate demand and the potential impotency of policymakers to close the gap are evolving into a life or death outcome for the weakest sovereigns, with consequences for credit and asset markets worldwide.

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