



Devil's Bargain

There are lots of ways to describe money: moolah, lean green, dinero ... I memorized one definition of "money" from an economic textbook way back in 1966: "A medium of exchange and a store of value," it said. Well, yes, I suppose, although it failed miserably in the latter capacity in subsequent years. My primer also neglected to mention the increasingly dominant function that money was to assume in a finance-oriented, capitalistic system: Money can be used to make money. Not that interest rates and biblical usury aren't millenniums old. I remember a story from Sidney Homer's history of finance that described how a BC-era borrower would be forced to turn over his wife as collateral upon default – wondering at the time whether that might be an incentive for a future Mesopotamian debt bubble! Still, my textbook was nowhere near contemplating the half century of financial "innovation" that was ahead and how money and its leveraging was to be the foundation for much of America's prosperity.

Money would also become the economic and political wedge for profound changes in American society. Fifty years ago, the highest paid and most prestigious professions were that of a doctor or a 707 airline pilot who flew the "golden" route from Los Angeles to Honolulu. Today the yellow brick road begins on Wall Street or the City. Aside from supernova innovators such as Steve Jobs or Mark Zuckerberg, the money is made from securitizing things instead

of booting and rebuilding America. The tallest buildings in almost every major city are banks, with tens of thousands of people shuffling and trading paper for a living. One of this country's premier investment banks paid each of its 26,000 employees an average of \$370,000 in 2010, nearly ten times the take-home pay of other American workers. Almost a quarter of the 400 wealthiest people on *Forbes* annual richest list make their money from money, whereas only 8% could make that claim in its first issue in 1982, and probably close to 0% when I first read my economic primer in 1966.

Having been part of this process and even a member of the rogue's gallery itself, I know one thing for sure: This is not God's work – it has the unmistakable odor of Mammon. PIMCO, while Mammonesque, is a company to be proud of. I can say with confidence that there are very few clients who have not benefited from our investment management over the years. Some of the rest of this industry, however, I'm not so sure of: rating agencies that perpetually fail at commonsensical quality judgments, bankers that make loans to subterranean credits and then extend the beggar's bowl for themselves, and 80% of active money managers that underperform the market. **As a profession we have failed miserably at our primary function – the efficient and productive allocation of capital:** The S&L debacle of the early 1980s, the Asian crisis, LTCM, dotcoms, subprimes, Lehman and the resurrection, instead

of the reformation, of Wall Street, are major sins of the modern era of money. Hang your heads, moneychangers. And no, it is not yet time to move on, as many banking CEOs suggest. How can bond traders make ten, one hundred, one thousand times more money than an engineer or social worker given their dismal historical performance? Why is it that some of today's doctors are using food stamps while investment banking executives complain about millions of dollars in compensation that might be deferred in case of a future bailout?

Financiers have lost their high ground and, if truth be told, we began to lose it a long time ago when we figured out that money was more than a medium of exchange or a poor substitute for a store of value. We figured out a turbocharged way to make money with money and proclaimed ourselves geniuses in the process. Well, we're not. We may be categorized as "opportunists," to be generous, but society's "paragons" and a legitimate destination for a significant percentage of college graduates? Hardly. To paraphrase Paul Volcker, the only productive invention to come out of the banking industry over the past generation was the ATM.

This country desperately requires a rebalancing of priorities. After readjusting the compensation scales via regulation and/or free market common sense, America needs to anoint a new set of Mensans who can create something more than a cash machine and make this country competitive again in the global marketplace. We need to find a new economic Keynes or at least elect a chastened Congress that can take our structurally unemployed and give them a chance to be productive workers again. We must have a President whose idea of "centrist" policy is not to hand out

presents to the right and the left and then altruistically proclaim the benefits of bipartisanship. We need a President who does more than propose "Win The Future" at annual State of the Union addresses without policy follow-up. America requires more than a makeover or a facelift. It needs a heart transplant absent the contagious antibodies of money and finance filtering through the system. It needs a Congress that cannot be bought and sold by lobbyists on K Street, whose pockets in turn are stuffed with corporate and special interest group payola. Are record corporate profits a fair price for America's soul? A devil's bargain more than likely.

This metaphorical devil's bargain has its equivalent in the credit markets these days. Central bankers have lowered the cost of money for 30 years now, legitimately following global disinflationary forces downward, but also validating increased leverage via lower real interest rates. Today's rock-bottom yields, however, have less to do with disinflation and more to do with providing fuel for an asset-based economy that promotes unsustainable wealth creation and a false confidence in perpetual capital gains. Real 10-year interest rates fell from over 5% in the early 1980s to just under 1% in recent months and have arguably been responsible for 3,000–4,000 Dow points and 2–3% annual appreciation in bonds over those three decades.

Ultimately, however, the devil gets his due or at least the central bankers run out of mathematical room to lower real yields below commonsensical floors. Today's negative real yield on a 5-year TIPS (Treasury Inflation Protected Securities) is perhaps reflective of a market that has lost its fundamental value anchor. A century-long history of

The Devil's Haircut

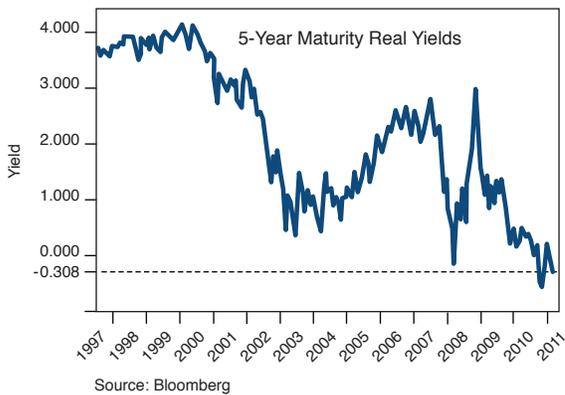


Chart 1

average 5-year real yields would point out that bond investors in Aaa 5-year sovereign space have demanded and received a real interest rate return of 1.5% instead of today's -0.1%. We are being shortchanged, in other words, by 160 basis points from the get-go, a "haircut" that is but one of four ways that governments attempt to escape from an over-levered national balance sheet.

As I pointed out in a recent *Barron's* Roundtable in early January, a "haircut" is a euphemism for government default. A bondholder can receive a "buzz" the old-fashioned way by principal default, but that rather visible and embarrassing option is usually reserved for countries like Greece, which cannot devalue its currency. The second and more surreptitious policy maneuver of currency devaluation raises import prices and lowers a country's standard of living while allowing politicians to hold up their heads higher than countries that simply say – "Hell no, we won't pay." Third on the policymakers' list of barber-shopping techniques is to assure bondholders and citizens that inflation, and importantly inflationary expectations, should be extremely low in future years. "Forget about those \$1.5 trillion annual deficits! With wages and the 'core' CPI firmly in check at 1% or

lower, there is no need to worry about the inflationary erosion of money as a 'store of value,'" they would emphasize. "Good as gold – those dollar-based bonds – and they yield 2–3% to boot! Try to match that, oh barbarous relic." Well, yes, but somehow, as is increasingly obvious in the U.K., the headline CPI seems to outdistance the core by several hundred basis points over a 5-year moving average and the barbarous relic morphs from the yellow metal to a long-term gilt that goes down in price and "haircuts" its owner by several points a year. U.S. Treasuries are not in the same egregious company as gilts, but they're hanging out in the "wrong neighborhood," as my parents used to say. Or maybe, to stick to the coiffure analogy, they're sporting a ducktail and a beehive instead of a conservative crew cut and a ponytail. Whatever the haircut, the bondholder is missing some lean green or moolah at the end of the calendar year.

Fourth, and perhaps most deceptive in the barbershop quartet of policy tools that lessen debt loads, is the aforementioned "negative" or exceedingly low real interest rate that central banks impose on savers and debt holders. I've alluded to those missing 160 basis points in prior paragraphs and even some *Investment Outlooks* where I've tortuously detailed my shock at the 0.01% return on my money market account. Even if, dear reader, your broker is offering you 0.25% (and good for you for finding an honest firm that doesn't clip all of it to justify its "expenses") you and your money are being "haircutted" by inflation at a much higher rate – core or no core.

To rebalance debt loads and re-equitize financial institutions that should have known better, central banks and

policymakers are taking money from one class of asset holders and giving it to another. A low or negative real interest rate for an “extended period of time” is the most devilish of all policy tools. And the asset class holder that it affects, or better yet, “infects,” is the small saver and institutions such as insurance companies and pension funds that hold long-term fixed income assets. It is anyone who holds bonds with coupons that cannot keep up with inflation or the depositor in a local bank who cumulatively holds trillions of dollars in time deposits that don't earn a real rate of interest. This is the framework that has been created by modern-day policymakers who have innovated far beyond their biblical counterparts. To put it bluntly, they are robbing savers and taking money surreptitiously from longer-term asset holders who are incorrectly measuring future inflation.

Well, boo-hoo, you bondholders and PIMCOs of the world. Maybe it's just that nice guys always finish last and you can't beat City Hall, Washington DC, or even Wall Street. After all, you gotta invest your money in something and even if it's a negative real interest rate – whatever that is – or 0.01%, it's probably better than nothing. So suck it up. Big boys don't cry unless their last name is Boehner, or they're a banker in need of a bailout.

Well, not so fast. This lad and this company are not going away so easily. Devils may or may not be present in this earthly world, depending on your point of view, but if they are, there's a

good chance that exorcists do too and PIMCO's got just the antidote. **Instead of accepting historical durational risk and the prospect of a barbershop quartet of possible haircuts, bondholders should recognize that yield or “spread” comes in different varieties. Maturity extension is just one of them, yet if yields are too low based on historical example, an investor should analyze other yields or other “spreads” which are not. That is what we call “safe spread” – the recognition that credit spreads, or emerging market returns, or currencies with positive and high real interest rates are more attractive than those old-fashioned gilts and Treasury bonds offering 2–3%. Those are markets that need to be “exorcised” from model portfolios and replaced with more attractive alternatives both from a risk and a reward standpoint. It is still possible to produce 4–5% returns from a conservatively positioned bond portfolio – you just have to do it with a different mix of global assets.**

Usurious? Hardly. Justification for turning your spouse over as collateral? Never. Bondholders may be presented with a devil's bargain, but exorcists are coming to life. Bondholders and citizens of America unite! Mammon may be ascendant in this secular world, but there's always space for heavenly intentions and their antidotes for policy haircuts. Practice “safe spread,” fear the devil, and avoid the barbershop.

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.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

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