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Investment Outlook

P I M C O

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Better Late Than Never

"Better early than never," I always say. And since never is a long, long, time – being late is OK too, but early – yeah early – is a portfolio manager's best maxim. In this case it has nothing to do with birds getting the worm or being the first runner out of the starting blocks, but more about being positioned when markets move into crisis mode. Risk assets in a highly levered, financed-based global economy can move so quickly to the downside that by the time you hear the birds chirping or see the starter's gun smoking the race may be already half over. Admittedly, there's a price to be paid for sitting out the frenetic last thrust of any bull market. In stocks, it comes in the form of being labeled old-fashioned or out of touch as Warren Buffett was in the dot.com craze or even in the first half of 2007. In bonds, it shows up as lost carry when yield spreads compress and high quality government bonds are shunned for derivative structures offering double-digit levered rewards. But when risk markets perceive a change in the wind – a turn in profits, a potential recession, and most importantly as was the case in mid-2007, an implosion in the pyramid scheme, chain letter driven structure of modern finance – then

you'd better be already positioned. Exit doors lock automatically as illiquidity and the psychological frailties of the human mind prevent quick action in order to preserve capital.

Economists, TV talking heads, (and yours truly) can be early or late to a party as well. I marvel at the seemingly countless number of "celebrity" experts espousing the continuation or even extension of wealthy tax cut, supply side, freer regulatory policies that have lost not only their potency but their constituency as we turn the corner into 2008. Describing these pundits as being "late" in recognizing the increasing threats that their laissez-faire ideology poses to the U.S. economy, would be more than generous. "Never" is more likely the reality. One economist, however, who while early is more than likely to guide future policy solutions is Paul Krugman, op-ed columnist for *The New York Times*. Long before he accepted his current assignment at the *Times* he was a world-respected economist at MIT, proposing revolutionary solutions for the Japanese recessionary malaise of the 1990s and writing a book in 1998 entitled The Return of Depression Economics.

While his book's title features the "D" word, the content proposed nothing of the sort, but simply referred to the fact that the crucial task of future policy would be to bolster demand as was the case in the FDR-driven 1930s as opposed to encourage supply which has been the case since the Reagan revolution. Although Krugman doesn't comment, in my opinion, it's not that Reagan was wrong – he was in fact brilliantly correct and timely in his supply-side revolution.

That pendulum, however, appears to have swung too far in the direction of the private market. But Krugman (and yours truly) was a tad early in his forecast for reversal I think, because of the failure to recognize the potency and the inventiveness of modern finance. Until recently, U.S. and therefore global demand has been driven by the ability to lower interest rates and extend credit to an increasing majority of Americans. Mortgages, auto finance, and credit cards were offered on increasingly liberal terms and continually lower yield and risk spreads because of Wall Street ingenuity and – importantly – the naïve endorsement of their black magic by rating services willing to sell AAAs for a fee. If you're offered a new home with nothing down and nothing to lose, you'd take it and many Americans did. If you're offered a new car with 0% financing for 5 years, you'd buy it and many Americans still do. Demand, as Krugman would likely retrospectively recognize, was bolstered and supported

by innovative, securitized finance which in turn was nurtured by lax regulation and a belief that things could not go wrong – and if they did – that policy makers, both monetarily and fiscally oriented, would make things right. The repair, if needed, was labeled the "Keynesian compact" and it made for a deal with the American public: it would be OK to have free markets because policymakers know enough to prevent another Great Depression. Demand could always be stimulated with a combination of easy money/budget deficits. Prosperity in effect, was guaranteed.

Well "probably" guaranteed – but the historic growth rate of that prosperity may now be threatened. Because demand in the form of consumption has been artificially and fictitiously stimulated in recent years by financial engineering run amuck, there is a legitimate question as to whether its black hole imploding destructiveness can be totally countered with another dose of lower yields and deficit spending packages. The \$150 billion "return to sender" deficit plan advanced by Bush and the Congress, for instance, amounts to just 1% of GDP and is labeled temporary. It will be of marginal benefit to long-term prosperity. To understand why, consider that the productivity of our economy ultimately depends on its ability to 1) innovate, and 2) save and invest, and that there is little of either in this stimulus package. Some have even suggested – and with my somewhat grudging concession – that this

package will help the Chinese economy more than ours. Americans will use the rebates to buy Chinese imports offered at Wal-Mart and the \$150 billion will then wind its way inevitably back to Asian coffers. The U.S. needs a Krugman “demand-based” fiscal package alright, but a \$300-\$500 billion permanent one, in addition to the proposed temporary package, because as mentioned in last month’s *Outlook*, as the system of modern day levered shadow finance slows to a crawl or even contracts at the edges, its ability to systemically fertilize economic growth must be called into question. But government writing checks for American consumers which then flow to foreign central banks is not the permanent solution; it only makes sense in the short-term as a life preserver. To provide a stable recovery path, government spending needs to fill the gap – not consumption. Public works programs, badly needed infrastructure repairs, as well as spending on research and development projects should form the heart of our path to recovery. Assistance for homeowners? That too – figure out a fiscal/regulatory way to stop the slide in housing prices and foreclosures but please – no traffic jams at the Wal-Mart checkout counter in 2009 and beyond.

Approaches to monetary policy must change as well. 1% short rates were so effective 5 years ago that they not only bolstered demand but created a housing bubble of Frankensteinian proportions.

Those days, however were influenced by the creation and implementation of adjustable-rate mortgages (ARMs) that were priced at the short end of the yield curve. Millions of ARMs were issued at 2% and 3% teaser rates, many with terms of up to 5 years before their inexorable adjustment upwards. Surfeits of houses were bought at artificial prices because of these generous terms and billions in home equity loans were taken out – both driving demand and the economy forward. But adjustable-rate mortgages are a dying relic. Originators will no longer offer them except on onerous terms. No more teasers or pleasers of that ilk; there are regulators to deal with, and lawyers on the prowl with class action lawsuits in their briefcases.

And so the monetary attempt to halt housing’s – and therefore the economy’s – downward slide rests on the shoulders of the 30-year mortgage. If so, then Mr. Bernanke – we have a problem. First of all these 6-7% 30-year mortgages now require a significantly higher down payment than in prior years. 20% down? Say what? Where does a 30-year-old couple get that kind of money? Secondly, however, and just as important, what motivates a future homeowner to pay 6%+ interest for an asset that is going down in price? It was an easy decision to pay subprime yields of that and then some when housing prices were accelerating at double-digit annual percentages; the benefit was obvious. Now however,

with prices in negative territory, the risk/reward is tilted towards the renter.

My point is that Chairman Bernanke must recognize the reduced benefits and obvious dangers of a déjà vu trek to 1% short rates. Those yields produced 5% 30-year mortgage rates to the homeowner for a 2-3 month period in 2003 and they could do so again, but bubble creating, inflation inducing damage to the U.S. dollar would be the likely result now. Best to stop far short of 1% and at the same time encourage reforms in FHA government assisted programs that would permit subsidized mortgage rates with minimal down payments.

An artificially low, 1% short-term interest rate was an elixir during the days of a burgeoning shadow banking system. It cannot be the solution now.

In combination, a well constructed, more than temporary fiscal/monetary stimulus plan is what is required to rejuvenate a U.S. economy reeling from a low punch

delivered by a private market economy gone too far. Its “Rosemary’s Baby” took the form of a shadow banking system based on leverage and the fateful conclusion that a finance-based economy alone can deliver prosperity. It cannot. **As Keynes theorized and then Krugman affirmed, when private demand falters, it becomes the responsibility of government to fill the breach. Because it likely will not do so effectively until after a new Administration is elected in late 2008, the U.S. economy and its somewhat coupled global companion will sleep walk for some time and a resumption of prosperity as we knew it will be dependent on reforms of monetary and fiscal policy resembling the 1930s more than our past decade. Better late than never.**

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