PIMCO

Your Global Investment Authority

Investment Outlook

November 2012

Bill Gross

Time To Vote!

So I pulled out my magic lamp that for some reason works only every October 22nd, and rubbed until the Genie appeared in his red and white checkered cloak with a 10-inch diameter Flavor Flav clock hanging ceremoniously around his neck. Being a rather forward, although not disrespectful Genie, he immediately said, "Mr. G, instead of the yield on the 10-year Treasury, perhaps this year you should wish to know who is going to win the Presidential election?" After some thought I replied, "Nah, I need some breaking news, Mr. Genie, something that will make a difference, something that will shock the world, like when does the iPhone 6 come out?" Obama/Romney, Romney/Obama – the most important election of our lifetime? Fact is they're all the same – bought and paid for with the same money. Ours is a country of the SuperPAC, by the SuperPAC, and for the SuperPAC. The "people" are merely election-day pawns, pulling a Democratic or Republican lever that will deliver the same results every four years. "Change you can believe in?" I bought that one hook, line and sinker in 2008 during the last vestige of my disappearing middle age optimism. We got a more intelligent President, but we hardly got change. Healthcare dominated by corporate interests – what's new? Financial regulation dominated by Wall Street – what's new? Continuing pointless foreign wars – what's new?

I'll tell you what isn't new. Our two-party system continues to play ping pong with the American people, and the electorate is that white little ball going back and forth over the net. This side's better – no, that one looks best. Elephants/Donkeys, Donkeys/Elephants. **Perhaps the most farcical aspect of it all is that the**

choice between the two seems to occupy most of our time. Instead of digging in and digging out of this mess on a community level, we sit in front of our flat screens and watch endless debates about red and blue state theologies or listen to demagogues like Rush Limbaugh or his ex-cable counterpart Keith Olbermann. To express my discontent, Genie, along with my continuing patriotism, I've created a modern-day version of our Pledge of Allegiance. Place your hand over your clock and recite after me:

I pledge allegiance to the flag of
the fragmented state of America,
and to the plutocracy for which now it stands,
a red and blue nation,
under financial gods
indistinguishable,
with liberty and justice for the 1(%).

"Well," said the Genie, with a little bit less respect in his voice, "you sound a little discouraged Mr. G – a tad cranky perhaps and showing all of your 68 years." I suppose, I agreed. But during all those years, I've liked Ike and despised Bush Junior, been enraptured with Kennedy and enraged by Johnson, been put to sleep by both Ford and Carter and then invigorated by Reagan. And now – well, we've got the best government that money can buy, but I ain't buying it. Now get back in your lamp and come up with something meaningful I can use this time come October 2013. And don't fake me out with a picture of a skinnier but faster iPhone 6. I'm still trying to buy the "5" with the .01% interest on my money market account.

Perhaps I should have asked Flavor Flav something more important. iPhones and next year's 10-year Treasury yield aside, the biggest bet being wagered in financial markets these days is the bet on "financial repression," "quantitative easing," and **the ultimate effect of both on the real economy.** Of course even a genie couldn't come up with a simple answer to that complex question. Sounds like something to be asked of a shrink from a couch, as opposed to a genie in a bottle. Whatever. But let me try and answer the repression and QE question with a little anecdote that I tell visiting clients.

About four years ago I opened up our family brokerage statement and searched with some effort to find the yield on our money market account. Interest rates, as I knew from my desk in Newport Beach, were plunging and I wondered just how much of a penalty we were being charged for the privilege of holding cash. My eyes finally fixed on the appropriate disclosure – hidden though it was – and it said ".01%." Impossible! I thought. There must be a mistake here. Surely the decimal point was misplaced. Wasn't ".01%" really 1% or even .1%, but definitely not ".01%." That was close to nothing! Having counted cards at the blackjack table in my youth, I quickly calculated that over the next 12 months, our $10,000 balance would earn exactly $1.00. "Buy yourself a pair of shoes," I said to Sue standing near my shoulder, "a pair of sandals at the weekend garage sale." The remark was not well received. It seemed Sue was as sensitive about shoes as I was about interest rates. Note to self: Do not mention shoes with Sue except in the phrase "what a cute pair of shoes."

Financial repression

Anyway, I quickly drifted back to my childhood days when I had a passbook at the local bank. Deposit rates were usually 4% or so back then, so I wondered how much money I would have needed *then* to produce the same $1.00 of interest I was receiving now. Twenty-five bucks! Whoa, $25 vs. $10,000! Seems like it was much better to be a saver back in 1958 and much better to be a spender in 2012. I could now take the $9,975 difference, spend it, and still have the same $1.00 of interest that I had back then! And that, Mr. Genie, with the Flavor Flav clock, is what is known as "financial repression." By lowering interest rates to near zero through Fed Funds policy and quantitative easing, Ben Bernanke and his fellow central bankers are trying to force all of us to spend money.

Admittedly, the Fed's theoretical foundation takes a different route to the same destination than does mine. Chairman Bernanke would say that by lowering yields, investors would logically sell their bonds to the Fed (QE I, II and III) and invest in something riskier and higher returning (high yield bonds, stocks and real estate). My $10,000 then, would do what capital has always done – gravitate to the highest reward/risk ratio available and in the process, stimulate investment and create jobs. The theoretical $9,975 that I might have chosen to "spend" in my first example would in the Chairman's construct be eventually spent as well but in this case via investment and job creation, which in turn would lead to a virtuous cycle resembling the "old" as opposed to the "new" normal.

The difference between these two hypothetical models is critical. Is the money that is being made "available" through zero-based interest rates and quantitative easing being "spent" – or is it being "invested?" If it's being spent, then at some point the game will come to an end – my $9,975 will have provided me and the economy some breathing room and some time to kick the future "big R" or "little d" down the road; but it will end. If it is being invested and invested productively, then we might eventually see the Old Normal on the horizon, reduce unemployment to less than 6% and return prosperity to the middle class.

Well, as President Obama might tell Governor Romney – "just do the math." Or as Chris Berman might say on ESPN – "let's go to the tape." In the past three years of quantitative easing and financial repression, can we see a noticeable effect on investment as opposed to consumption? Is the Bernanke model working or is the $9,975 being spent on consumption? At first blush, an observer might vote for the Bernanke model. After all, the stock market has doubled in three-plus years, risk spreads are at historical lows, and housing prices are moving up – 10% higher in Southern California alone. Yet the real economy itself seems no different – still in New Normal gear. Surely by now, if the Bernanke model was as advertised, we would be seeing a pickup in investment as a percentage of GDP and a willingness to start saving "seed corn" as opposed to eating "caramel corn." As Chart 1 points out – we are not. At the same time, we continue to consume at an "Old Normal" pace as shown in Chart 1 as well.

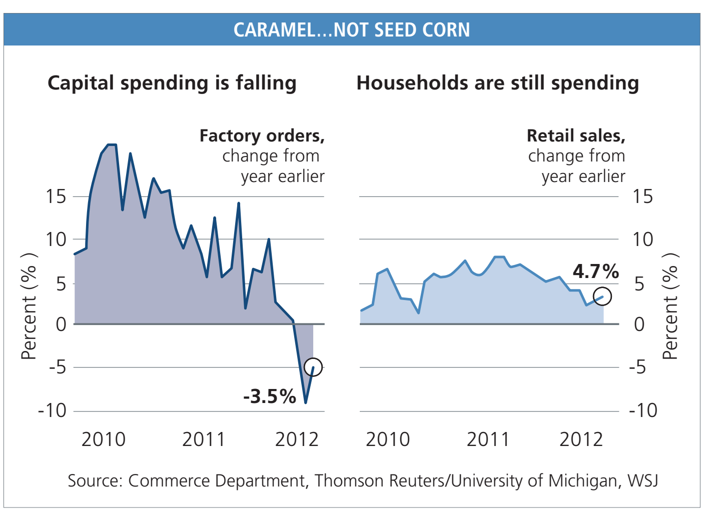

Chart 1

To confirm the point, let me introduce additional evidence for the prosecution, a chart that is periodically presented to our investment committee by PIMCO's Saumil Parikh, who is turning out to be potentially a Pro Bowl replacement for recently retired All-Star Paul McCulley. It's a little complicated sounding – "net national savings rate," but it really speaks to the heart of the question. Net national savings is the amount of government, household and corporate savings that is left over after our existing investment stock is depreciated. Think of a building decaying and depreciating over 30 years so that you'd need to save each and every year to build and pay for a new one three decades down the road. If you don't save, you can't buy one: Net national savings.

Well, Chart 2 confirms the evidence. Over the past three years, our net national savings rate has been negative, and lower than it has ever been in modern history. The last time this occurred was in the Great Depression.

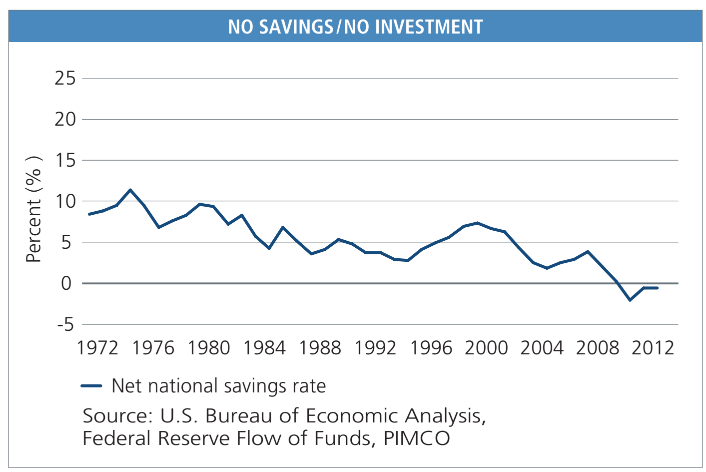

Chart 2

Aside from a little squiggle back close to 0% over the last year or so, there is no evidence that investment is being incented by quantitative easing. **All of the money being created and freed up is elevating asset prices, but those prices are not causing corporations to invest in future production. Admittedly, the chart shows this downward spiral has been underway for decades, but financial repression and quantitative easing were supposed to be the extraordinary monetary policies that kick-started the real economy in the other direction. They have not. We have been using the lower interest rates, the $9,975 of free money, to consume as opposed to invest.**

To be fair, Ben Bernanke has been operating with one arm behind his back and has been calling for cooperative stimulation from the fiscal side of this government. He has received little response – not from Democrats, not from Republicans. They have all focused on re-electing themselves as opposed to constructively plotting a way forward. That is why Election Day seems like such a futile gesture to me. Red/Blue; Republican/Democrat. What kind of choice do we have when we pull the lever? If monetary policy has shown its impotent limits, can we now trust Washington to constructively reverse a downward slide in our net national savings rate? I suspect not. I doubt if either Obama, Romney, or many of their economic advisors even know what the definition is, let alone how to reverse it.

Investment strategy

Investors should recognize that asset and currency prices ultimately rest on the ability of a real economy to grow. If growth cannot be boosted by monetary policy, and fiscal policy is in the hands of a plutocracy more concerned about immediate profits as opposed to long-term vitality, then no Genie or Flavor Flav with a magic clock can make a difference. If, therefore, real economic growth is stunted in the United States and globally, **then portfolio strategies should acknowledge bite-sized future returns and the growing risk that the negative consequences of misguided monetary and fiscal policy might lead to disruptive financial markets at some future point.** The approaching fiscal cliff might be the first of a series of future disruptions. Although PIMCO expects a middle ground fiscal compromise from Washington, when that is combined with the fading influence of QE monetary policies, it leads only temporarily to 2% real growth in the U.S. at best – growth that is clearly not "Old Normal." We are in a "New Normal" world where the negative effects of private sector deleveraging are only being <u>weakly</u> addressed by monetary and fiscal authorities. **If so, then Treasury yields should stay low and my money market fund should continue to read ".01%." The "cult" of equity – or better yet the cult of "total return" – for both bonds and stocks – is over, if that definition presumes a resumption of historical patterns anywhere close to double digits. The era of financial repression continues.**

I must explain these things to my Genie, I fear. Despite his New Age appearance, his forecasts seem to be a bit old-fashioned and out-of-date.

William H. Gross
Managing Director

P.S. Flavor Flav just made an extraordinary appearance on October 31st. He told me to write that no matter who is elected, you can't keep the U.S. down for long, and that while Sandy was a monster storm, America is a gigantic positive force whether Red or Blue.

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