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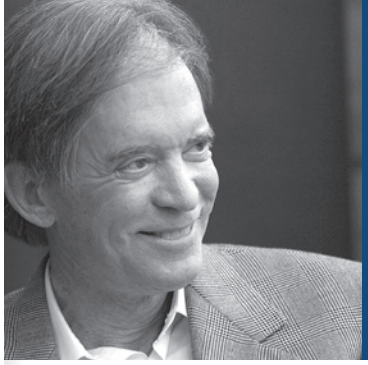


Investment Outlook

October 2013

Bill Gross

Survival of the Fittest?

I hate crows and my wife Sue hates bugs, but like most married couples we have learned to live with our differences. Crows eat bugs though, and bugs eat bugs, and that scientific observation sets the context for the next few paragraphs of this month's *Investment Outlook*.

About those crows: They screech, they jabber, they complain from the treetops and then once on the ground they hop, hop, hop all over the street looking for garbage. Flying seems beyond them – too much effort to flap those ebony wings. They prefer to play chicken with my car rolling into the driveway at 5 mph. "Get out of my way," they seem to be saying. "We're probably on the endangered species list and if you hit us, you're the one that'll be sorry." Probably true – damn crows. About those bugs: Sue hates any kind of bug, but especially those with lots of legs. Creepy crawly legs. Centipedes, Millipedes, even Octapedes and there are no eight-legged bugs. And of course there's the world's perennial favorite – the cockroach. Who could love "La Cucaracha?" Not Sue, that's for sure.

Our hatred of bugs and crows though is perhaps too strong of a word. "Dislike" or "not like" might be better. Nature itself is rather neutral when it comes to any living thing – including us humans – so perhaps we Grosses should take a lesson from the grand Mother. And to think of it, perhaps it is nature and its rather incomprehensible neutrality that "bugs" me the most – not crows. Why, I wonder, is it that nature seems so indifferent to life, that it promotes, even encourages the Grim Reaper as a necessary condition for living and evolving? Why must it create multiple examples of a living species and then rather innocently step aside as they voraciously consume one another? Must Darwin and his survival of the fittest be God's philosophical guidepost? Why couldn't a loving and theoretically omniscient creator just make it simple as opposed to infinitely complex? Why couldn't the Mother,

for instance, pattern an outcome that produced a pride of one or two perfectly healthy lion cubs as opposed to three or four with flaws – the latter two becoming hyena food because they were too slow or insufficiently hyena-aware. So the hyenas could live, you say? Then why create hyenas in the first place – leave them out of the plan and prevent the needless suffering. Of course we would then probably all become grazing cows, chewing our cuds in a more pastoral but less painful setting. Perhaps – but better a cow, I think, than millions of crows eating billions of bugs. Hindus would agree. If I were the creator I'd do it better, but then I'm not. As for this life – count me in by necessity. I'll play the game but reluctantly. My rage and incomprehension at the pain and death of living things – especially two-legged ones – is as old as Mother time herself, but forever fresh and completely unanswerable.

Speaking of questions with no answers: 1) investors wonder what happened to the taper, 2) why the Fed seemed to change its mind and 3) where of course do we go from here? A few days before the September meeting, I tweeted that the Fed would "tinker rather than taper," which was close to the end result, but still not totally accurate. They refused to budge, with an uncertain economy being the explanation. Ben Bernanke sort of sat back and did nothing, just like Mother Nature with her crows and bugs. The debate though is actually only so much noise in the scheme of things. **The Fed will have to taper, cease and then desist someday. They can't just keep adding one trillion dollars to their balance sheet every year without something negative happening – either accelerating inflation, a tanking dollar or a continued unwillingness on the part of corporations to invest because of the resultant low and unacceptable returns on investment. QE (quantitative easing) has to die sometime.** Just like Mother Nature, death and creative destruction seem to be part of the Grand Economic Scheme.

What matters most for bond and other investors though is not timing of the taper nor the endpoint of QE, but the policy rate: 1) how long it stays where it is, 2) what is the long-term neutral rate in a highly levered economy and 3) can a chastened central bank convince investors that it knows the answer and can be trusted to stick to it?

It's the policy rate, both spot and forward, that prices markets and drives economies and investment decisions. QEs were simply a necessary medicine for rather uncertain and illiquid times. Now that more certainty and more liquidity have been restored, it's time for the policy rate and forward guidance to assume control. Janet Yellen, future Fed Chairperson, would agree, as would oft-quoted Michael Woodford, Columbia University professor and 2012 Jackson Hole speaker, who seems to have become the private sector's philosophical guru for guidance and benchmarks, that will now attempt to convince an investment public that what you hear is what you get.

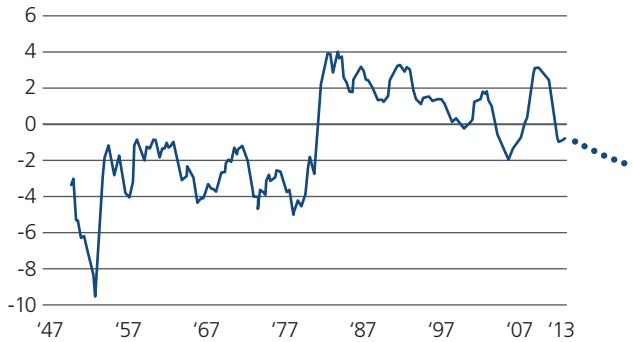
But if QE is soon to be out, and guidance soon to be what remains, I think investors should listen and invest accordingly. Not with total innocence, but sort of like a totally hyena-aware lion cub – knowing there's bad things that can happen out there in the jungle, but for now enjoying the all clear silence of the African plain. In bond parlance, the all clear sign would mean that the Fed believes what it says, and if their guideposts have any credibility, they won't be raising policy rates until 2016 or even beyond. **The critical question to ask in terms of the level and eventual upward guide path of the policy rate is how high a rate can a levered economy stand? How much wood can a woodchuck chuck? How high a rate can a homebuyer handle? No one really knows, but we're beginning to find out. The increase of over 125 basis points in a 30-year mortgage over the past 6–12 months seems to have stopped housing starts and importantly mortgage refinancings**

in its tracks. It was the primary "financial condition" that Chairman Bernanke cited in his September press conference that shifted the "taper to a tinker to a chance" that maybe they might do something next time.

The 30-year mortgage rate of course is connected to the policy rate and its pricing in forward space. All yields in composite are what an economy has to hurdle in order to grow at historically hoped-for rates at 2–3% real and 4–5% nominal: Treasury yields, mortgage yields, corporate yields and credit card yields, all in composite. Ray Dalio and company at Bridgewater have the concept down pat. The objective, Dalio writes, is to achieve a "beautiful deleveraging," which assumes minimal defaults and an eventual return of investors' willingness to take risk again. The beautiful deleveraging of course takes place at the expense of private market savers via financially repressed interest rates, but what the heck. Beauty is in the eye of the beholder and if the Fed's (and Dalio's) objective is to grow normally again, then there is likely no more beautiful or deleveraging solution than one that is accomplished via abnormally low interest rates for a long, long time. It is PIMCO's belief that Yellen, Woodford and Dalio are right. **If you want to trust one thing and one thing only, trust that once QE is gone and the policy rate becomes the focus, that fed funds will then stay lower than expected for a long, long time. Right now the market (and the Fed forecasts) expects fed funds to be 1% higher by late 2015 and 1% higher still by December 2016. Bet against that.**

The reason to place your bet on the "don't come" 2016 line is what we have just experienced over the past few months. We have seen a 3% Treasury yield and a 4½% 30-year mortgage rate and the economy peeked its head out its hole like a groundhog on its special day and decided to go back inside for another metaphorical six weeks. No spring or summer in sight at those yields. The U.S. (and global economy) may have to get used to financially repressive – and therefore low policy rates – for decades to come. As the accompanying chart shows, the last time the U.S. economy was this highly levered (early 1940s) it took over 25 years of 10-year Treasury rates averaging 3% less than nominal GDP to accomplish a "beautiful deleveraging." That would place the 10-year Treasury at close to 1% and the policy rate at 25 basis points until sometime around 2035! I'm not gonna stick my neck out for that – April, May and June of 2013 have taught me a lesson that low yields can become high yields almost overnight. But they should stay abnormally low. A highly levered U.S. and global economy cannot deleverage "beautifully" without repressive future policy rates, which in turn help to contain 5s and 10s although with much less confidence and more volatility as investors have seen recently.

FIGURE 1: BEAUTIFUL DELEVERAGING AHEAD



Source: Federal Reserve, Haver Analytics

Investment Implications

In betting on a lower policy rate than now priced into markets, a bond investor should expect a certain pastoral quietude in future years, much like that grazing cow, I suppose. Not that exciting, but what the hay, it's an existence! Portfolios should emphasize front end maturity positions that are stabilized by the Fed's forward guidance as

well as volatility sales explicitly priced in 30-year agency mortgages. Because of the inflationary intention of low policy rates, TIPS (Treasury Inflation-Protected Securities) and the avoidance of anything compositely longer than say 7–10 years of maturity should be favored (long liability structures such as pension funds excepted). PIMCO believes that such a modeled portfolio could likely return 4% in future years.

A bond investor's focus must simplistically be this: In this new age where short-term yields cannot go lower, let the yield curve, volatility and acceptably priced credit spreads be your North Star. Duration and its empowering carry are fading from the nighttime sky, especially for 10- and 30-year maturities. Mother Nature nor Mother Market cares not a whit for your losses nor your hoped for double-digit return from an equity/bond portfolio that is priced for much less. Be a contented cow, not a voracious crow, and graze wisely with increasing certainty that the Fed and its forward guidance is your best bet for survival.

"Survival" Speed Read

1) Focus on front-end yields, because the Fed can't raise policy rates in a levered economy.

2) Respect all living things, even crows and bugs.

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