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Investment Outlook

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Bill Gross

The Lending Lindy

Citigroup's Chuck Prince will likely join Irving Fisher in the annals of market history for his now infamous "As long as the music is playing, you've got to get up and dance." Unlike Fisher's quote, however, which affirmed a permanent plateau of prosperity in 1929, Prince's faux pas may have been interpreted unfairly. History books will never record the context under which his statement was made, but what if instead of subprime-specific, Mr. Prince was referring to his job as a banker? What if he had rephrased his response to "It's the job of a banker to keep on lending"? Well now, that would be a different story altogether. Today, that quote would earn him a Medal of Freedom from President Obama at a White House gala! And so I suggest in this instance we don't take him at his literal word, but take him at his role as an ex-CEO of one of the world's largest banks and see just where that takes the lot of us – sovereign, institutional and individual investors who in combination comprise what we now call our global financial system – all $150 trillion or so of it.

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Too much debt

Credit, of course, is what makes the global economy go. We wouldn't have gotten very far over the past several centuries despite Edison, Bell and Steve Jobs if barter was the accepted form of commerce. Even cash, serving as a medium of exchange and a disreputable store of value could not have promoted 3–4% real GDP growth in this gargantuan economy unless borrowers and savers were willing to exchange future promises – to utilize credit. Wimpy – in my oft-cited cartoon – said it best, "I'll gladly pay you Tuesday for a hamburger today." So McDonald's grew from a million to 500

billion served and Wimpy and his wimpalikes were delighted in the exchange, although their arteries and midsections inevitably came out a loser. **Still, the point is that our modern financial system, levered and fragile as it is, has been a beneficial and productive component of prosperity.** If it were otherwise, our global economy would resemble something out of the dark ages in the early 20th century. High fives, then, for the Princemeister and his alter ego Mr. Wimpy – they have made a great combo-platter. **But in order to promote and indeed foster continuing symbiosis, both borrower and lender need to operate in a nutrient-rich environment, a "credit" petri dish of sorts which fosters strong bones and healthy lenders and borrowers in their adult years. That unfortunately does not seem to be the case.**

Wimpy's weight-challenged midsection is an obvious testament to the overleveraged condition of today's global borrowers. Too much debt leads to forced diets and delevering, a process which has been ongoing since Lehman 2008. Not only households, but financial institutions as well as many countries have reduced their caloric intake which in turn has promoted slow growth and in some countries near recession and/or depression. Borrowers are just not in a healthy place and if history is our guide, their restoration may be almost Biblical in terms of timing: seven years of fat followed by seven years of lean – perhaps even longer.

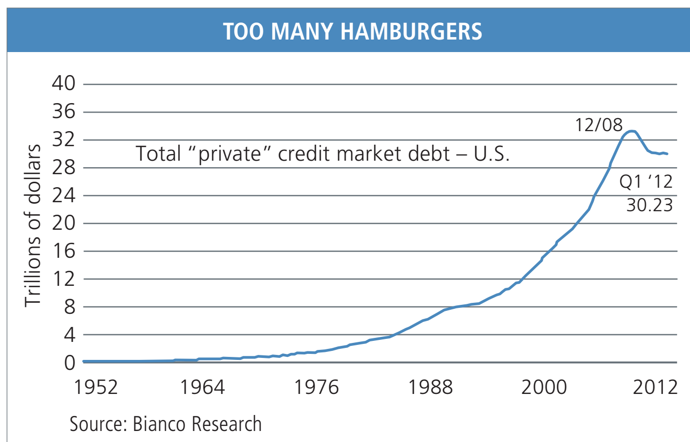

Chart 1

Too little return

Lender Chuck Prince's figurative health, however, is not so obvious. Certainly bank balance sheets and creditors in general need to downsize assets, increase equity, or both. That by itself will be a disincentive for economic growth. But in addition there is the lender's current precarious lack of return, yield, or call it "carry" that threatens additional credit extension in future years.

A lender will not easily lend money to an obese over-indebted borrower – that much is clear – but she will also not extend a check when the yield, carry and return on investment is so low that it cannot compensate for historic business model overheads. That is when Chuck Prince's dancing turns from a quick step into a waltz. When yields are too low, and acceptable risk spreads so narrow that top line interest revenue is increasingly marginalized, then lending is at risk. Excessive historical overhead represented by rents, salaries, pension and health benefits, to name just a few, force financial and lending institutions to do one of two things: They lever up to cover those costs or they slow or shut lending down to preserve equity and the ultimate franchise. The levering up is indeed difficult given the 2008 financial crisis and the ensuing follow-through of intensified regulatory oversight. And so, what we are witnessing instead is the beginning of a waltz, a dance where financial institutions such as banks, insurance companies and investment management firms fail to reap the economies of scale so reminiscent of the prior era of fat as opposed to the present one of lean. In the process, they lay off, instead of hire new workers; close branch offices or even ATM machines by the thousands as did Bank of America recently; and yes, ultimately reduce the rate of lending or credit growth which propelled the global economy so effortlessly over the past century.

If the dancing has slowed down, then the reason is not just an overweight partner. It's that the price of money (be it in the form of a real interest rate, a quality risk spread, or both) is too low. Our entire finance-based monetary system – led by banks but typified by insurance companies, investment management firms and hedge funds as well – is based on an acceptable

level of carry and the expectation of earning it. When credit is priced such that carry is no longer as profitable at a customary amount of leverage/risk, then the system will stall, list, or perhaps even tip over.

For the current shipwreck perhaps we have the Fed and other central banks to blame. Zero bound interest rates according to their historical models should inevitably and inexorably lead to dynamic real economic recovery. Who wouldn't borrow at near 0% yields – namely the banks – in order to relend at seemingly profitable spreads? Who wouldn't borrow at 3.5% for a 30-year mortgage – namely homeowners – in order to match or even reduce current rent payments? Well, they haven't. Not in the amounts they were supposed to in any case. Structured impediments such as regulatory risk standards for banks and fear of losing money for households have thrown a monkey wrench into those models. Central banks are agog in disbelief that the endless stream of QEs and LTROs have not produced the desired result. Wimpy and Chuck are waltzing, not quickstepping, even with a band playing in up tempo.

Strategy recommendations

What then is an investor to do? In a New Normal economy where lenders dance to the Blue Danube instead of the Lindy, how should we move our own feet? Carefully, I suppose, and with recognition that historic returns are just that – historic. **Last month's "dying cult of equity" Investment Outlook elicited a lot of excitement, but somehow failed to impress readers with its main point: Returns from both stocks and bonds will be stunted.** How could one argue otherwise on the bond side with investment grade bonds yielding only 1.75%? How could one argue otherwise for stocks under the assumption that bond and stock returns were at least in part mathematically conjoined at the hip? How could one argue otherwise when it is obvious that boomers and X'ers, Y's and Z'ers are likely to be disenchanted for their own good reasons for years? How could one argue otherwise when it is apparent that stock market trading has been taken over by machines – that HAL rules the stock exchange roost and does a bad job of it at that? Well, some did and some will continue to argue the counterpoint. Chart 2, however graphically displays the mood of the public as opposed to the mood of the pundits. Only time will determine who was right and who was wrong, even if stocks outperform bonds as indeed I predicted.

The Dying Cult of Equity

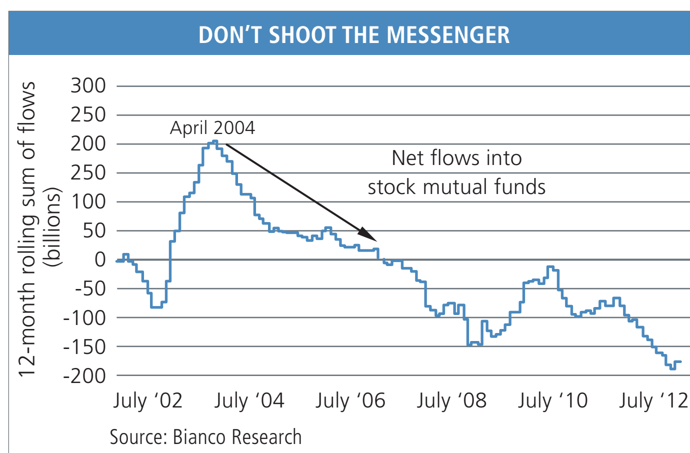

Chart 2

Most individual investors don't have the privilege of time nor the choice of risking their investment dollars while being able to recoup it only at .1% money market or CD rates. An investor, it seems, must learn a new dance to fit the diminished return size of the modern dance floor.

If I were an individual investor, I would do this: Balance your asset mix according to your age. Own more stocks if you are young, but more bonds if you are in your 60s, like myself. If you choose an investment advisor, a mutual fund, or an ETF, make sure that your fees are minimized. After all, if overall returns average 3–4% annually how can you possibly afford to give 100 basis points of it back? You cannot. And be careful. **The age of credit expansion which led to double-digit portfolio returns is over. The age of inflation is upon us, which typically provides a headwind, not a tailwind, to securities price – both stocks and bonds.**

If you are an institution be cognizant as well of the above, but in addition, recognize that higher returns – from both stocks and bonds – usually emanate in countries and economies which exhibit higher growth. And don't trust any

country, including the United States, to forever remain a clean dirty shirt. There's mud aplenty in our future, which I'll expound more about in next month's *Investment Outlook*.

Until then, like Chuck Prince and his buddy Wimpy, you should keep on dancin'. It won't likely be the Lindy or the Quickstep, because our credit-based financial system is burdened by excessive fat and interest rates that are too low. It will be a new, slower-paced dance by necessity but Chuck was right: it's better to be on the dance floor than a wallflower on the sideline. You've just got to watch your step.

William H. Gross
Managing Director

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840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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