



## Rocking-Horse Winner



There once was a family who lived in a fine house on Main Street USA sometime in the 1980s. It was a handsome house with a big yard and a white picket fence, but something always seemed to be missing. There was never enough of this or that – a fancier car, another TV, it didn't seem to matter – there was never enough. And so, the house came to be haunted by an unspoken phrase, "there must be more money, there must be more money." The walls seemed to whisper it in the middle of the night, and even during the day everyone heard it although no one dared say it aloud. The chair spoke, the bedroom armoire, and even five-year-old Billie's toy rocking horse would eerily demand almost in unison, "there must be more money, there must be more money."

One day, sensing the family's distress, little Billie asked his father, "What is it that causes you to have money?" "Well, you go to school, get a good job, and get raises," his Dad said, "but these days there just doesn't seem to be enough." But Billie, being just a little boy didn't understand and so he went off to ride his rocking horse, searching for the "clue" to "more money." The horse was a special toy because not only did it whisper like the walls and the living room chair, but it seemed to answer questions if you only rode it fast enough. And so Billie would sit on top of his horse when no one was looking, charging madly up and down, back and forth in a frenzied state to a place where only he and his pony could go. "Take me to where there is money," he would command his steed.

At first, Billie could not make the horse answer the way it had when he asked about Christmas presents or what kind of ice cream Mom would bring home from the store. Finding money seemed too hard of a question for a toy horse, but it made him try even harder. He would mount it again and again, whipping its head with the leather straps, forcing it faster and faster until it seemed its mouth would foam. "Where is the money, where is the money?" Billie would scream, and at last the horse in full gallop cried out, "borrow the money, borrow the money!"

At just that moment Billie's Mom came around the corner and into his room and his eyes blazed at her as he fell to the floor. She rushed to his side, but he was unconscious now, yet still whispering the horse's answer. He continued in that condition for the next 25 years, full grown, and confined comatose to his hospital bed. His family would visit, hoping for his revival, and then miraculously one day in 2008 he awoke with his father

and mother at his side. "Did I find the money?" he asked, as if it were still the same afternoon. "Did you borrow it?" "We did," his Dad answered, "but we borrowed too much." Billie's eyes seemed to close at that very instant and he died the next night.

Even as he lay dead, his mother heard his father's voice saying to her, "My God, we became rich – or what we thought was rich – and we thought that was good, yet now we're poor and a lost soul of a son to the bad. But poor devil, poor devil, he's best gone out of a life where he rode to his doom in order to find a rocking horse winner."

*Adapted from a short story by D.H. Lawrence  
"The Rocking Horse Winner"*

For readers lost in the literative metaphor of another of my lengthy introductions to investment markets, let me connect the dots and suggest that it is symbolic of the perversion of American-style capitalism over the past 30 years – a belief that wealth was a function of printing, lending, and of course borrowing money in order to make more money. Our "horse" required more and more money every year in order to feed asset appreciation, its eventual securitization and the borrowing that both promoted. That horse, like Billie, however, died in 2008 and we face an uncertain and lower growth environment as a result.

**The uncertainty comes from a number of structural headwinds in PIMCO's analysis: deleveraging, reregulation, and the forces of deglobalization** – most evident now in the markets' distrust of marginal sovereign credits such as Iceland, Ireland, Greece and a supporting cast of over-borrowed lookalikes. All of them now force bond and capital market vigilantes to make more measured choices when investing long-term monies. Even though the government's fist has been successful to date in steadying the destabilizing forces of a delevering private market, investors are now questioning the staying power of public monetary and fiscal policies. 2010 promises to be the year of choosing "which government" can most

successfully substitute the governments' fist for Adam Smith's invisible hand and for how long? Can individual countries escape a debt crisis by creating even more debt and riding another rocking horse winner? Can the global economy?

The answer, from a vigilante's viewpoint is "yes," but a conditional "yes." There are many conditions and they vary from country to country, but basically it comes down to these:

- 1) Can a country issue its own currency and is it acceptable in global commerce?
- 2) Are a country's initial conditions (outstanding debt, structural deficit, growth rate, demographic balance) moderate and can it issue future public debt as a substitute for private credit?
- 3) Can a country's central bank be allowed to reflate via low or negative real interest rates without creating a currency crisis?

These three important conditions render an immediate negative answer when viewed from an investor's lens focused on Greece for instance: 1) Greece can't issue debt in its own currency, 2) its initial conditions and demographics are abominable, and 3) its central bank – The ECB – believes in positive,

not negative, real interest rates. Greece therefore must extend a beggar's bowl to the European Union or the IMF because the private market vigilantes have simply had enough. Without guarantees or the promise of long-term assistance, Prime Minister Papandreou's promise of fiscal austerity falls on deaf ears. Similarly, the Southern European PIGS face a difficult future environment as its walls whisper "the house needs more money, the house needs more money." It will not come easily, and if it does, it will come at increasingly higher cost, either in the form of higher interest rates, fiscal frugality, or both.

Perhaps surprisingly, some of the countries on PIMCO's "must to avoid" list are decently positioned to escape their individual debt crises. The U.K. comes immediately to mind. PIMCO would answer "yes" to all of the three primary conditions outlined earlier for the U.K. in contrast to Greece. We as a firm, however, remain underweight Gilts. The reason is that the debt the U.K. will increasingly issue in the future should lead to inflationary conditions and a depreciating currency relative to other countries, ultimately lowering the realized return on its bonds. If that view becomes consensus, then at some point the U.K. may fail to attain escape velocity from its debt trap. For now though, "crisis" does not describe their current predicament, yet that bed of nitroglycerine must be delicately handled. Avoid the U.K. – there are more attractive choices.

Could one of them be the United States? Well, yes, almost by default to use a poor, but somewhat ironic phrase, because a U.S. Treasury investor must satisfactorily answer "yes" to my three conditions as well, and the U.S. has more favorable demographics

and a stronger growth potential than the U.K. – promising a greater chance at escape velocity. But remember – my three conditions just suggest that a country can get out of a debt crisis by creating more debt – they don't assert that the bonds will be a good investment. Simply comparing Greek or U.K. debt to U.S. Treasury bonds is not the golden ticket to alpha generation in investment markets. U.S. bonds may simply be a "less poor" choice of alternatives.

**The reason is complicated, but at its core very simple. As a November IMF staff position note aptly pointed out, high fiscal deficits and higher outstanding debt lead to higher real interest rates and ultimately higher inflation, both trends which are bond market unfriendly.** In the U.S. in addition to the 10% of GDP deficits and a growing stock of outstanding debt, an investor must be concerned with future unfunded entitlement commitments which portfolio managers almost always neglect, viewing them as so far off in the future that they don't matter. Yet should it concern an investor in 30-year Treasuries that the Congressional Budget Office estimates that the present value of unfunded future social insurance expenditures (Social Security and Medicare primarily) was \$46 trillion as of 2009, a sum four times its current outstanding debt? Of course it should, and that may be a primary reason why 30-year bonds yield 4.6% whereas 2-year debt with the same guarantee yields less than 1%.

The trend promises to get worse, not better. The imminent passage of health care reform represents a continuing litany of entitlement legislation that will add, not subtract, to future deficits and unfunded liabilities. No investment vigilante worth their salt or outrageous annual bonus would dare argue

that current legislation is a deficit reducer as asserted by Democrats and in fact the Congressional Budget Office. Common sense alone would suggest that extending health care benefits to 30 million people will cost a lot of money and that it is being “paid for” in the current bill with standard smoke, and all too familiar mirrors that have characterized such entitlement legislation for decades. An article by an ex-CBO director in *The New York Times* this past Sunday affirms these suspicions. “Fantasy in, fantasy out,” writes Douglas Holtz-Eakin who held the CBO Chair from 2003–2005. Front-end loaded revenues and back-end loaded expenses promote the fiction that a program that will cost \$950 billion over the next 10 years actually reduces the deficit by \$138 billion. After all the details are analyzed, Mr. Holtz-Eakin’s numbers affirm a vigilante’s suspicion – it will add \$562 billion to the deficit over the next decade. Long-term bondholders beware.

So I’m on this rocking horse called PIMCO, a “co”-jockey appropriately named Billie, I suppose, and I’m whipping that horse in a frenzy, “The house needs more money, the house needs more money.” Hopefully my fate is not the same as the one created by D.H. Lawrence, nor is the horse’s answer. Billie’s rocking horse was a toy created in the 1980s and abused for two decades thereafter. Today’s chastened pony cannot cry out “borrow money,” but simply the reverse – “lend prudently.” In today’s marketplace, prudent lending must be directed not

only towards sovereigns that can escape a debt trap, but ones that can do so with a minimum of reflationary consequences and currency devaluation – whether it be against other sovereigns or hard assets such as gold. Investment strategies should begin to reflect this preservation of capital principal by positioning bond portfolios on front-ends of selected sovereign yield curve subject to successful reflation (U.S., Brazil) and longer ends of yield curves that can withstand potential debt deflation (Germany, Core Europe). In addition, as increasing debt loads add impetus to higher real interest rates worldwide, a more “unicredit” bond market argues for high quality corporate spread risk as opposed to duration extension. In plain English, that means that a unit of quality credit spread will do better than a unit of duration. Rates face a future bear market as central banks eventually normalize QE policies and 0% yields if global reflation is successful. Spreads in appropriate sovereign and corporate credits are a better bet as long as global contagion is contained. If not, a rush to the safety of Treasury Bills lies ahead.

Above all, however, lend prudently, lend prudently if you want to be a rocking horse winner. And for you would be jockeys: be careful when you put your foot in the stirrups. Riding a thoroughbred can be a thrilling but risky proposition. Just look what happened to Billie – poor devil.

William H. Gross  
Managing Director

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*PIGS refers to Portugal, Italy, Greece, and Spain.*

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