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Investment Outlook

PIMCO

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Off With Our Heads!

The mating rites of mantises are well known: a chemical produced in the head of the male insect says, in effect, "No, don't go near her, you fool, she'll eat you alive." At the same time a chemical in his abdomen say, "Yes, by all means, now and forever yes."

While the male is making up what passes for his mind, the female tips the balance in her favor by eating his head. The male, absorbed in the performance of his vital functions, holds the female in a tight embrace. But the wretch has no head – he has hardly a body. And, all that time, that masculine stump, holding on firmly, goes on with the business!

–Annie Dillard, Pilgrim at Tinker Creek

If you're ever in the mood for a glimpse of raw nature that closely parallels the human condition, read Annie Dillard's Pulitzer Prize winning *Pilgrim at Tinker Creek*. We are all, in her well-documented tale, mantises eating and being eaten, mindlessly thrusting and flailing about in activity that would make little sense to a visitor from another space-time. What mimics the pelvic thrust of the male mantis is really the struggling ego of the human being, stretching for more habitable space, gasping (metaphorically) for purer air, reaching for dominance over what we know not. Herman Melville, speaking through the visage of Captain Ahab in *Moby-Dick*, writes that "all mortal greatness is but a disease." The egos that seek renown, however, are hard to kill and expert at masquerading and wearing disguises. Even those advocating or living by the Golden Rule can be held suspect to some chemical – this time above the belt – that says, "Look at me, look at me." Presidents, Dalai Lamas, and yes, bond managers are more than likely <u>infected</u> and <u>affected</u> as opposed to philanthropically or altruistically <u>directed</u> and intentioned.

If so, I'm not sure how one escapes from the philosophical darkness of this self-described "Tinker Creek." Eastern religions speak to seeking the Buddha mind – an "unconscious" consciousness that supposedly confirms an "inner worldly" worldliness. Theoretically this can lead to Nirvana, which is the absence of ego – an antibody against Ahab's mortal disease. "Nirvana" it is said, "soars on wings that whisper." Perhaps, but almost all of us come into this world screaming and the decibels diminish but never really whisper as the chemicals of old age work their will. We are all, more than likely, doomed to be mantis-like – some of us eating, some of us being eaten, but none quite aware as to why we are at the dinner table in the first place.

Americans, unlike their developed world counterparts, have been eating their fill lately, and supping at a dinner table laden with pork and tax breaks for all. Unequivocally, we have been playing the part of the female mantis, munching on the theoretical heads of future generations, while paying no mind to the wretches that will eventually be called upon to pay the bills.

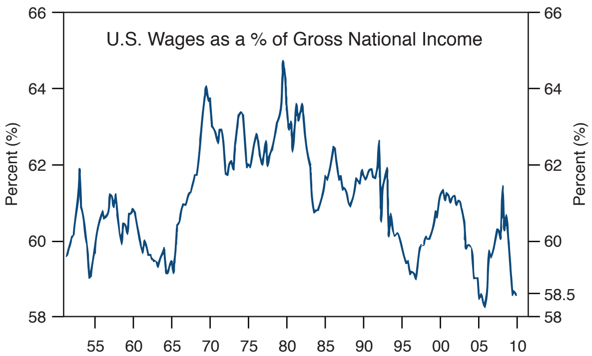
I liked the op-ed on this subject by comedian Larry David in *The New York Times* the other day. He thanked Congress and, of course, President Obama for being able to afford more blueberries in his granola. Job creation for more berry pickers would be Washington's convoluted rationale, I suppose. But, if so, they will assuredly be temporary instead of permanent jobs and the $800-$900 billion price tag may add up to 3% of GDP to the U.S. deficit annually for which future wretches will thrust headlessly to service. The American hegemon knows no limits, it seems, when it comes to spending other people's money for their own consumption. **Unlike Euroland or the United Kingdom, which appear to have gone on an extreme fiscal diet, the American answer to a bulging waistline is always "mañana." Debt commission recommendations are tossed in the trashcan, tea party election rhetoric eventually focuses on miniscule and merely symbolic earmarks, and both Democrats and Republicans congratulate each other on their ability to reach a bipartisan agreement for the good of the nation. Munch! Munch! Off with our heads!**

The problem is that politicians and citizens alike have no clear vision of the costs of a seemingly perpetual trillion dollar annual deficit. As long as the stock market pulsates upward and job growth continues, there is an abiding conviction that all is well and that "old normal" norms have returned. Not likely. There will be pain aplenty and it's imperative that we recognize <u>now</u> what the ultimate cost of blueberries will mean for American citizens of <u>tomorrow</u>. Four major factors come to mind:

(1) American wages will lag behind CPI and commodity price gains.

Because policy stimulus is focused on maintaining current consumption as opposed to making the United States more competitive in the global marketplace, American workers' real wages will almost necessarily lag historical norms. Chart 1 points out the graphical evidence of an erosion of labor's share of the American economic pie, falling from 62% of GDP just recently to a current anemic 58%. Blame it on poor education, blame it on globalization, but an ongoing rebalancing of rich country/poor country wages inevitably will keep U.S. wages compressed as deficit spending serves to reflate commodity and end product prices in future years but not paychecks. Americans will feel the pain but like the male mantis, probably not understand why they've lost their head.

A Smaller Piece of Mud Pie



Source: Haver Analytics
As of Q3 2010

Chart 1

(2) Dollar depreciation will sap the purchasing power of U.S. consumers, as well as the global valuation of dollar denominated assets.

Unique amongst almost all other global citizens, Americans are ignorant of the merits (and the negatives) of currency depreciation. Unless they are smacked with the reality of an expensive hotel or a meal in a foreign port of call during summer vacation, we have few concerns when the dollar depreciates against a basket of foreign currencies. If our stock market goes up 10% annually in dollar-denominated terms, we assume we are 10% richer even if the dollar sinks at the same time. If the cost of imported goods and especially gasoline goes up more than our paychecks, we blame it on a political conspiracy. The fact is that annual budget deficits in the trillions of dollars add a like amount to the stock of outstanding dollars, resulting in currency depreciation, higher import inflation, and a degradation of dollar based assets in global financial markets. We become less, not more wealthy, losing our heads while we "hold on firmly and go on with (our) business"!

(3) One of the consequences of perpetual trillion dollar deficits is the need to finance them, and at attractively low interest rates for as long as possible.

Currently, the Fed is doing both, holding short term interest rates near zero, and engaging in Ponzi like Quantitative Easing II purchases of longer dated Treasuries in the open market. The combination offers bondholders about as an attractive situation as the one facing a male praying mantis: zero percent interest rates if you stay in cash, or probable principal losses if you take durational risk by buying 5 and 10 year maturities. Eventually, as reflationary policies take hold, long-term bondholders lose their heads (and a portion of their principal as well), as yields rise to reflect higher future inflation. Bondholders' metaphorical warning: "don't go near those longer term bonds you fool."

(4) Trillion dollar annual deficits add up, and eventually produce a stock of debt that can become unmanageable: witness Greece, Ireland, or a host of Latin American countries of generations past.

According to Carmen Reinhart and Kenneth Rogoff's excellent research in *This Time Is Different*, once a country's debt approaches 90% of GDP (as the U.S. is now doing), its economic growth slows by up to 1% annually as the interest payments drain resources that should be going for productivity enhancements. Sovereign credit risk increases and yield spreads rise relative to global competitors. **Future generations pay the price for their parents' mindless thrusting.**

Investment Implications

(1) An astute mantis-like investor must defer immediate gratification, make a 180˚ turn from that sexy looking female with those long green legs (long term bonds) and mend his ways fast! **It is still possible to earn an attractive return from bond strategies (such as PIMCO's Total Return strategy in 2010), and the way to do it is to focus on "safe spread" that emphasizes credit, as opposed to durational risk.**

(2) These "safe spreads" include: emerging market corporates and sovereigns with higher initial real interest rates and wider credit spreads; floating as opposed to fixed interest obligations; and **importantly currency exposure other than the dollar.**

(3) For those inclined to lunch on stocks, remember to go where the growth is – developing as opposed to developed markets. If the U.S. must pay an eventual price for mindless deficit spending, **then find countries and currencies that appear to have their act under control: Canada, Brazil, and yes even Mexico with its drug related violence.** Mexico has a net national savings rate that exceeds our own by 20% of GDP.

(4) Above all, remember that all investors should fear the consequences of mindless U.S. deficit spending as far as the mantis eye can see. Higher inflation, a weaker dollar and the eventual loss of America's AAA sovereign credit rating are the primary consequences. Fear your head – fear your head.

William H. Gross
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"Safe Spread" is defined as sectors that we believe are most likely to withstand the vicissitudes of a wide range of possible economic scenarios. All investments contain risk and may lose value.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. Sovereign securities are generally backed by the issuing government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Duration is the measure of a bond's price sensitivity to interest rates and is expressed in years. The credit quality of a particular security or group of securities does not ensure the stability or safety of an overall portfolio. The Quality ratings of individual issues/issuers are provided to indicate the credit worthiness of such issues/issuer and generally range from AAA, Aaa, or AAA (highest) to D, C, or D (lowest) for S&P, Moody's, and Fitch respectively.

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