



Towards the Paranormal

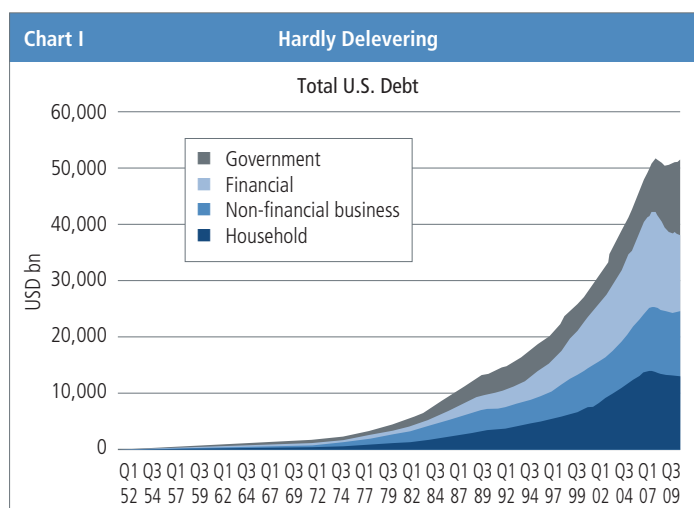
How many ways can you say “it’s different this time?” There’s “abnormal,” “subnormal,” “paranormal” and of course “new normal.” Mohamed El-Erian’s awakening phrase of several years past has virtually been adopted into the lexicon these days, but now it has an almost antiquated vapor to it that reflected calmer seas in 2011 as opposed to the possibility of a perfect storm in 2012. The New Normal as PIMCO and other economists would describe it was a world of muted western growth, high unemployment and relatively orderly delevering. Now we appear to be morphing into a world with much fatter tails, bordering on bimodal. It’s as if the Earth now has two moons instead of one and both are growing in size like a cancerous tumor that may threaten the financial tides, oceans and economic life as we have known it for the past half century. Welcome to 2012.

The Old/New Normal

But before ringing in the New Year with a rather grim foreboding, let me at least describe what financial markets came to know as the “old normal.” It actually began with early 20th century fractional reserve banking, but came into its adulthood in 1971 when the U.S. and the world departed from gold to a debt-based credit foundation. Some called it a dollar standard but it was really a credit standard based on dollars and unlike gold with its scarcity and hard money character, the new credit-based standard had no anchor – dollar or otherwise. All developed economies from 1971 and beyond learned to use credit and the expansion of debt to drive growth and prosperity. Almost all developed and some emerging economies became hooked on credit as a substitution for investment in tangible real things – plant, equipment and an educated labor force. They made paper, not things, so much of it it seems, that they debased it. Interest rates were lowered and assets securitized to the point where they could go no further and in the aftermath of Lehman 2008 markets substituted sovereign for private credit until it appears that that trend can go no further either. Now we are left with zero-bound yields and creditors that trust no one and very few countries. The financial markets are slowly imploding – delevering – because there’s too much paper and too little trust. Goodbye “Old Normal,” standby to redefine “New Normal,” and welcome to 2012’s “paranormal.”

2012 Paranormal

This process of delevering has consistently been a part of PIMCO's secular thesis but "implosion" and "bimodal fat tailed" outcomes are New Age and very "2012ish." Perhaps the first observation to be made is that most developed economies have not, in fact, delevered since 2008. Certain portions of them – yes: U.S. and Euroland households; southern peripheral Euroland countries. But credit as a whole remains resilient or at least static because of a multitude of quantitative easings (QEs) in the U.S., U.K., and Japan. Now it seems a gigantic tidal wave of QE is being generated in Euroland, thinly disguised as an LTRO (three-year long term refinancing operation) which in effect can and will be used by banks to support sovereign bond issuance. Amazingly, Italian banks are now issuing state guaranteed paper to obtain funds from the European Central Bank (ECB) and then reinvesting the proceeds into Italian bonds, which is QE by any definition and near Ponzi by another!



Source: Bianco Research

So global economies and their credit markets instead of delevering and contracting, continue to mildly expand. Yet there is bimodal fat-tailed risk in early 2012 that was seemingly invisible in 2008. Granted, the fat right tail of economic expansion and potentially higher inflation has existed for the 3+ year duration. QEs and 500 billion euro LTROs can do that. At the other tail, however, is the potential for "implosion" and actual delevering. To the extent that **most sovereign debt is now viewed as "credit" in addition**

to "interest rate" risk, then its integration into private markets cannot be assured. If only Italian banks buy Italian bonds, then Italian yields are artificially supported – even at 7%. If so, then private bond markets and non-peripheral banks in particular may refuse to play ball the way ball has been played since 1971– purchasing government debt, repoing the paper at their respective central banks and using the proceeds to aid and assist private economic expansion. Instead, fearing default from their sovereign holdings, any overnight or term financing begins to accumulate in the safe haven vaults of the ECB, Bank of England (BOE) and Federal Reserve. Sovereign credit risk reintroduces "liquidity trap" and "pushing on a string" fears that seemed to have been long buried and forgotten since the Great Depression in the 1930s.

But delevering now has a new **spectre to deal with. Not just credit default but "zero-bound" interest rates may be eating away like invisible termites at our 40-year global credit expansion.** Historically, central banks have comfortably relied on a model which dictates that lower and lower yields will stimulate aggregate demand and, in the case of financial markets, drive asset purchases outward on the risk spectrum as investors seek to maintain higher returns. Near zero policy rates and a series of "quantitative easings" have temporarily succeeded in keeping asset markets and real economies afloat in the U.S., Europe and even Japan. Now, with policy rates at or approaching zero yields and QE facing political limits in almost all developed economies, it is appropriate to question not only the effectiveness of historical conceptual models but entertain the possibility that they may, counterintuitively, be hazardous to an economy's health.

Importantly, this is not another name for "pushing on a string" or a "liquidity trap." Both of these concepts depend significantly on perception of increasing risk in credit markets which in turn reduces the incentive of lenders to expand credit. Rates at the zero bound do something more. Zero-bound money – credit quality aside – creates no incentive to expand it. Will Rogers once fondly said in the Depression that he was more concerned about the return of his money than the return on his money. But from a system-wide perspective, when the return on money becomes close to zero in nominal terms and substantially negative in real terms, then normal functionality may breakdown. We all start to resemble Will Rogers.

A good example would be the reversal of the money market fund business model where operating expenses make it perpetually unprofitable at current yields. As money market assets then decline, system-wide leverage is reduced even if clients transfer holdings to banks, which themselves reinvest proceeds in Fed reserves as opposed to private market commercial paper. Additionally, at the zero bound, banks no longer aggressively pursue deposits because of the difficulty in profiting from their deployment. It is one thing to pursue deposits that can be reinvested risk-free at a term premium spread – two/three/even five-year Treasuries being good examples. But when those front end Treasuries yield only 20 to 90 basis points, a bank's expensive infrastructure reduces profit potential. It is no coincidence that tens of thousands of layoffs are occurring in the banking industry, and that branch expansion is reversing industry-wide.

In the case of low borrowing rates, this paradox at first blush seems illogical. If a bank can borrow at near 0% then theoretically it should have no problem making a profit. What is important, however, is the flatness of the yield curve and its effect on lending across all credit markets. Capitalism would not work well if fed funds and 30-year Treasuries perpetually co-existed at the same yield, nor if commercial paper and 30-year corporates did as well. It is not only excessive debt levels, insolvency and liquidity trap considerations that delever both financial and real economic growth; it is the zero-bound nominal yield, the assumption that it will stay there for an "extended period of time" and the resultant flatness of yield curves which are the culprits. **That front ends of yield curves are relatively flat at near zero percent interest rates is critical as well. If they were flat at 5% as in 2007, then banks and investors could extend maturities with the possibility of capital gains. Now at 1% or lower, they cannot. Leverage is constrained.**

Conceptually, when the financial system can no longer find outlets for the credit it creates, then it de-levers. The point should be understood from a yield as well as a credit risk point of view. When both yield and credit are at risk the mix can be toxic. The recent example of MF Global emphasizes the concept, as does the behavior of depositors in some struggling European economies. If an investor has money on deposit with an investment bank/broker that not only appears to be at risk but returns nothing, then why maintain the deposit? Perhaps an investor would be more

comfortable with a \$100 bill at home in a mattress than a \$100 bill on deposit with a broker – Securities Investor Protection Corporation notwithstanding. If so, system wide delevering takes place as opposed to the credit extension historically necessary for an expanding economy.

This new duality – credit **and zero-bound interest rate risk** – is **what characterizes our financial markets of 2012. It offers the fat-left-tailed possibility of unforeseen – delevering - or the fat-right-tailed possibility of central bank inflationary expansion.** I expect the January Fed meeting to mirror in some ways what we have first witnessed from the ECB. It won't take the form of three-year financing by a central bank – but will give assurances via language that the cost of money will remain constant at 25 basis points for three years or more – until inflation or unemployment reach specific targeted levels. QE by another name I suggest. If and when that doesn't work then a specific QE3 may be announced – probably by mid-year – and the race to reflate will shift into high gear. But the outcome of left-tailed delevering or right-tailed inflation is not certain. Both tails are fat.

Investment Implications

The critical question of course is whether efforts by the ECB, BOE, and Fed will work. Can they reinvigorate animal spirits in the face of "credit" and "zero bound money" risk? We shall see. An investor however should hedge his/her bets until the outcome becomes more obvious.

Bond Markets:

- (1) Durations and average maturities should be at their maximum permissible limits. Even if reflation is successful it will only be because the Fed and other central banks keep policy rates low for an "extended period of time." Financial repression depends on negative real yields and until inflation moves higher for a period of at least several years, central banks will hibernate at the zero bound.
- (2) The bulk of sovereign bond holdings should be in the U.S. as long as Euroland credit implosion is possible investors should gravitate to the "cleanest dirty shirt" sovereigns with the least encumbered balance sheets. Anything short of a 5-year maturity however yields relatively nothing and provides minimal rolldown. Focus on 5–9 year Treasury maturities to guard against inflation which create opportunities to take advantage of rolldown capital gains.

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- (3) Long Treasury maturities should be held in TIPS form. If inflation really is coming, then an investor will want assets that offer inflation-protection.
 - (4) Corporate credit purchases should be in higher-rated A and AA paper. Senior as opposed to subordinated holdings in finance/bank debt should be considered as well. Haircuts ahead?
 - (5) U.S. municipals represent an opportunity from the stand point of valuation. Their yields of 5–6% are near historically high ratios to Treasuries. They do, however, entail risk – not only volatility but occasional default risk. This is not a Meredith Whitney echo but simply a recognition that you usually get what you pay for in this world and nothing comes for free. Be selective and avoid states/municipalities with pension and funding problems.
 - (6) Continue to avoid Venus fly trap peripheral Euroland paper. Italian bonds at 7% for instance are enticing but have trap door possibilities that could see further “price” defaults in 2012.

Stocks and Commodities:

- (1) Stocks yield more than bonds and will tend to do better in anything but a delevering fat left tail. That, however, is what worries us. Equity allocations, therefore should favor higher yielding companies in sectors with relatively stable cash flows: Electric utilities (yes they appear overbought), big pharma and multinationals should head your shopping list.
- (2) Commodities could go either way depending on the tails but scarcity and geopolitical considerations (Iran) favor a positive tilt. Gold at \$1550 seems pricey but it has upward legs if QEs continue.

Currencies:

- (1) The dollar is king with a left-tailed delevering scenario – pauper in a right-tailed global reflationary expansion.

Summary

For 2012, in the face of a delevering zero-bound interest rate world, investors must lower return expectations. 2–5% for stocks, bonds and commodities are expected long term returns for global financial markets that have been pushed to the zero bound, a world where substantial real price appreciation is getting close to mathematically improbable. Adjust your expectations, prepare for bimodal outcomes. It is different this time and will continue to be for a number of years. The New Normal is “Sub,” “Ab,” “Para” and then some. The financial markets and global economies are at great risk.

William H. Gross
Managing Director

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