Simultaneous Global Policy Actions Are Necessary, But Will They Be Sufficient?

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10/8/2008—In recent weeks, the financial crisis has intensified, driving market volatility and bringing some markets to a virtual standstill. As the effects threaten more institutions, more markets and the global economy, global policymakers have introduced unprecedented responses. PIMCO's Co-CIOs Bill Gross and Mohamed El-Erian help investors make sense of this chaotic environment, outlining the firm's key investment themes.

An unprecedented market environment and policy responses in recent weeks

- This global financial market deleveraging process is the worst we've seen in decades, and perhaps since the Depression.
- Willing and forced asset sales have lowered almost all asset prices with the exception of Treasuries in the U.S. and liquid government paper elsewhere.
- The latest round of policy responses reflect the urgency of the situation.
  - Several Euroland governments have implemented or increased guarantees of deposits.
  - The Reserve Bank of Australia cut its rate by 100 basis points on Oct. 7.
  - The $700 billion Troubled Asset Relief Program (TARP) comes in addition to several other recent policy responses:
    - On Oct. 6, the Federal Reserve announced it will pay interest on excess reserves, and will begin directly purchasing commercial paper.
    - Working in a coordinated effort with five other central banks, the Fed announced an emergency rate cut of 50 basis points on Oct. 8, which brought the target rate for federal funds down to 1.5%.

The policy response has been necessary, but will it be sufficient?

- Global policymakers have unambiguously changed their language and approach to the financial crisis for several reasons:
  - It's clear this is *no longer confined to the banking system*. It has morphed into non-bank financial institutions, which can be seen, for instance, in the repricing of insurance companies in the markets.
  - Problems have also moved *down the leverage curve*. At first, only leveraged players were affected, but unlevered players are now experiencing significant damage. Money market funds in the U.S. are one clear example of this.
  - The *crisis has gone global*, and the policy response is going global. The increasing policy measures to shore up European banks are the most recent evidence of this.
  - The *payments and settlements system is completely clogged* as companies fear almost any counterparty credit risk. This is accelerating the contagion and contamination in markets.
- The crisis is no longer a financial sector problem, but a full-blown economic problem that will affect Main Street. The situation calls for policymakers to do something different. That's important and potentially complicated because we're living in a world where there is no optimal policy response. Whatever policymakers do will be criticized, because there will be collateral damage and there are no guarantees that the actions they take will be successful in addressing the crisis.
- Facing this economic challenge, global policymakers are now morphing "sequential policy responses," which focused on each problem separately, to "simultaneous policy responses" that aim to limit the scope and spread of financial problems through coordinated and global policy responses. These

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measures are certainly necessary, but whether they're sufficient will depend on achieving four goals:
- Restoring the clogged payment and settlement system, and the flow of cash and collateral.
- Injecting much-needed capital into financial institutions, either directly via the U.S. financial rescue plan or through the effect of the rescue plan on liquidity.
- Removing troubled assets from balance sheets.
- Creating a regulatory framework that is more counter-cyclical than it is pro-cyclical.

The current state of the financial markets and PIMCO's investment strategy

- In current market conditions, it's more important to focus on the return *of* investments than return *on* investments, so PIMCO remains focused on security amid the extreme volatility. At the same time, PIMCO is evaluating strategies aimed at positioning portfolios to benefit from the massive structural changes that are occurring in the global financial system.
- Investors have sold risk assets as part of the deleveraging process, and they've also flocked to Treasuries as a safe haven, causing nearly everything but Treasuries to decline in value. Investment-grade corporate bonds have not only seen ongoing selling, but illiquidity for new issuance as well. Even Treasury Inflation Protection Securities (TIPS) have been hit as they've been sold to fund investor redemptions and as near-term inflation expectations have been tempered by the threat of a severe economic slowdown.
- Most risk asset spreads are at astronomical levels that don't seem to make sense. Technical factors of deleveraging and illiquid markets are overruling the fundamentals, and it has become very challenging to understand asset prices and the markets driving them.
- In this environment, PIMCO's Investment Committee (IC) is focused on four key strategies that portfolio managers are employing:
  - *Cash management has moved to the top of the agenda*. For months, IC deliberations have centered on preserving and raising cash positions in order to accommodate the needs for liquidity and to purchase assets when opportunities arise.
  - *Focus on the front end of the policy curves*. We are taking advantage of the front end of the Treasury and LIBOR curves. This strategy should benefit from lower policy rates and Federal Reserve purchases of commercial paper.
  - *Holding U.S. Agency mortgage-backed securities*. These are highly rated, government-backed bonds that should see increased demand as the Treasury moves forward with its program to purchase these issues.
  - *Focus on institutions that we believe are clearly under the government "umbrella," particularly those closest to the handle*. We were premature in purchasing bank capital earlier this year. While our aversion to subprime loans helped us avoid some of the worst fallout of the U.S. housing crisis, we made the mistake of investing in some financial firms that held the same subprime securities we had avoided. However, due to both the current wave of mergers and acquisitions that we are seeing among these institutions and the increasing importance of the largest banks to the financial system, we believe that, ultimately, our holdings of debt from large financial institutions will make sense.

Restoring credit markets, and gauging the effectiveness of TARP

Three main problems need to be resolved before credit markets can begin to function normally:
- *Restoring counterparty trust.* Financial institutions are currently unwilling to transact with each other. Restoring normal interaction will likely require policy action that involves the government in the payments and settlements system in some form.
- *Deleveraging.* The technical effect of mass deleveraging still needs to work through the system.
- *Economic factors.* This is no longer a Wall Street problem. It is now a Main Street problem as the frozen credit markets affect all types of lending, from car loans to student loans and from credit cards to small business borrowing.

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There are still substantial questions about the impact the Treasury rescue package legislated last week is likely to have on the credit markets and the economy. Buying subprime mortgages won't necessarily recapitalize the financial system on its own; it will only begin to unclog the financial system. The Treasury has a more effective tool in its ability to purchase preferred stock of banks, which would be a more powerful injection of capital that could provide a shot of adrenaline to the financial system. It's likely that TARP will include a combination of both options. It's important to note that the Treasury's ability to purchase subprime mortgages and manage the assets should allow it to forebear payments and lower interest rates, keeping people in their homes and potentially stemming the tide of foreclosures.

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