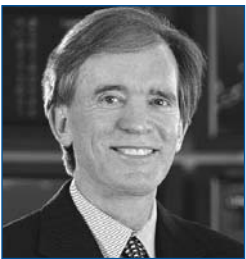


# Investment Outlook

by PIMCO's Bill Gross

## Hairy Lips Sink Ships



**Bill Gross**  
Founder and CIO,  
PIMCO

"Where's the bottom?" someone shouted at a recent PIMCO staff meeting. "Which market?" I shot back, which sort of ended the conversation, but provided little else in the way of an answer. The fact is (I should have said) that financial delevering affects most markets in the same way; they are similar trades. As unwinding leverage fails to be cushioned by a government check, prices go down on risk assets. Only the strong—or in this case—the highest quality assets survive. And so the bottom for risk assets is divorced and distinct from government guaranteed assets. "Where's the bottom and where's the top?" would have been a better question. No one knows of course, but we make educated guesstimates and try to communicate them to an enquiring public. We believe in giving a listener, as well as any one of our more than eight million individual clients, their money's worth.

One thing I've never done however, is provide expert testimony in front of a congressional subcommittee. Newport Beach probably doesn't have the cachet of Wall Street, or perhaps my style has always been a little irreverent or my brain a little irrelevant—I'm not sure. In any case, I thought I'd create my own virtual testimony to a hypothetical committee delving into the complexities of our financial crisis. What follows is what might have taken place last week:

**Question:** Mr. Gross, is this a recession or a depression?

**Answer:** We don't know yet, Madame Congresswoman. Recessions are cyclical downturns of a relatively brief time frame, characterized by inventory corrections and addressed by low interest rates and mild doses of fiscal stimulus. Depressions are more extreme with double-digit levels of unemployment but defined more importantly by credit contraction and debt liquidation. The deflation that normally accompanies a depression is dangerous not because prices are going down, but because the "for sale" sign goes up on the credit markets which have always made capitalism possible. At the moment, you policymakers are attempting to prevent that. We shall see.

**Question:** How did this happen so fast?

**Answer:** Trillions of dollars of credit have been sucked out of the financial system over the past 12 months. Banks may be lending but the larger shadow banking system is not. All of those SIVs and credit default swaps that once generated credit are now contracting and pulling the real economy down with them. Think of it this way: If you had three or four pints of blood drained from your body you'd be on life support, very quickly. Same thing now. The solution is for government spending to simulate a transfusion of whole blood, plasma, or whatever's available.

**Question:** How bad could this get?

**Answer:** No one knows for sure, but common sense would provide a good guess. If the government cannot substitute credit to the same extent that it is disappearing from the private system, then the U.S. and global economies will retreat. If the economy is viewed as a bathtub filled with water (credit) at two different times with two different levels, then draining it back down to the lower first level might reduce economic activity proportionately. Liquidate debt (credit) to 2003 totals and you just might reduce economic activity (GDP) to 2003 numbers as well. Whoops! That would mean a 10%+ contraction in the economy with unemployment approaching the teens. Keep that bathtub full!

**Question:** What can be done?

**Answer:** Keeping the tub sufficiently full means advancing policies in content and magnitude never contemplated since the days of FDR. The U.S. and global financial systems require credit creation and foreclosure prevention, not bank nationalization as currently contemplated by some. Trillions will be required in the U.S. alone and it is critical that there be a high degree of policy coordination among all nations, which avoids protectionist measures reflective of failed policies in the 1930s. To date, PIMCO's Mohamed El-Erian's imperative of "shock and awe" has been more like "don't bother us, we're working on it." Get moving. Risk being bold—Washington.

**Question:** Are there no negative consequences from "shock and awe?" Will these policies destroy capitalism while trying to save it?

**Answer:** Good question. The substitution of the benevolent fist of government for the invisible hand of Adam Smith involves risk. The private system is the heart of capitalism and generates most of its productivity, so more government usually involves less prosperity and certainly more inflation. PIMCO recommends a 180-degree turn towards government only as a last resort. They have the only credible checkbook in town. Will those checks create inflation? Let's hope so provided it is low and stable over time. Policymakers are more than vocal about attempting to **reflate** the economy, which in essence means a hoped

for return to **nominal** GDP growth levels of 5–6%, the majority of which might actually come in the form of higher prices as opposed to increased production. This Faustian bargain would be acceptable if only to stabilize what now appears to be an even more dangerous deflationary debt liquidation.

**Question:** Why do we assume that the U.S. can unilaterally do whatever it wants?

**Answer:** Much like we are the world's strongest nation militarily, we entered this crisis with certain economic and financial strengths relative to all other nations. Our reserve currency status was the primary one which means that we can write checks in our own currency and they are accepted all over the world—sort of like American Express Travelers Cheques. This privilege, however, can be and is being abused. Travelers Cheques are acceptable only when redeemed at 100 cents on the dollar. Lately, quasi-American dollars in the form of Aaa CDOs, corporate bonds, and even national champion bank stocks have floundered closer to zero than par. There is fear on foreign shores that even U.S. agency debt may not be honored and that U.S. Treasury debt itself, when "repoed" as in prior years, may now suffer from counterparty risk. Global willingness to accept American dollars is being tested. Granted, the U.S. currency has appreciated strongly against its counterparts during most of this crisis, but technical short covering as opposed to a flight to quality may have been the dominant consideration. Watch the dollar. If it falls hard, there may be nothing policymakers can do to restore the ensuing financial chaos.

**Question:** What do you think about nationalizing the banks?

**Answer:** I think Roubini, Dodd and Greenspan haven't thought this one through. The U.S. isn't Sweden, and not just because our blondes aren't au naturel. Their successful approach revolved around a handful of banks but we have 7,500, as well as many S&Ls and credit unions, which would have to be flushed into government hands. Regulators are overwhelmed as it is, and if you thought Lehman Brothers was a mistake, just standby and see what nationalizing Citi or BofA would do. Our banks remain at the heart of domestic/global financial

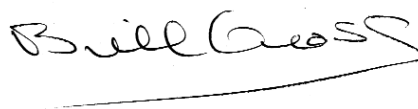
transactions and daily clearing, while those Scandinavian banks were not. PIMCO would not dispute the need to further capitalize systemically important banks via convertible bonds held by the government, which unfortunately dilute shareholders' interests. To go further, however, and "haircut" senior debt or even existing preferred stock similar to that issued via the TARP would create an instability policymakers should not want to risk. In turn, forcing creditors to take haircuts would undermine other financial sectors such as insurance companies and credit unions. The goal of future policy should be to recapitalize lending institutions while maintaining the basic infrastructure of credit markets. Outright nationalization and haircutting of creditors will do just the opposite.

**Question:** Enough already about this still confusing crisis—how should I invest my own money?

**Answer:** I'd give you an invitation to our PIMCO client conference next month in Newport Beach if you weren't so busy here in Washington. Its theme is titled "Evolution or Revolution—The Future of Investing." No golf or vintage wines though—just cheeseburgers and interesting conversation. But come on out if you care. I'm sure we'll stress our current theme of "shake hands with Uncle Sam"—buying agency mortgages, and other developing areas of government policy support in the credit markets. But we'll talk about the future of stocks too, leveraging and deleveraging, globalization and deglobalization, and why safe secure income may be the most desirable investment in this evolving economic and financial crisis. Tell you what, Madame Congresswoman, if you can't make it I'll write it up in next month's *Investment Outlook*.

**Question:** Well thanks, Mr. Gross, but one last thing. Whatever happened to your mustache?

**Answer:** My mother always said there was something shady about a man with hair on his lip, but then she'd never met Mohamed El-Erian and Paul McCulley whose mothers undoubtedly approve. I think my mom watched too many Charlie Chan movies in her day, but I can't be sure. We feel the same way about this economy though, Madame Congresswoman. It's hard to trust policymakers; there's too little consistency, not enough boldness, and too much political game playing. Say a little prayer will ya, but tell those Congressmen to shave their lips just in case.



William H. Gross  
Managing Director

## About the Author

Bill Gross is Co-Founder and Managing Director of PIMCO, one of the country's foremost fixed income managers with a client list that includes many of the largest U.S. corporations. Regarded by many as America's most influential authority on the bond market, Mr. Gross makes frequent appearances on TV and in the business press.

As a reminder, an audio file of this *Investment Outlook* will be available on [www.allianzinvestors.com](http://www.allianzinvestors.com).

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Gross Domestic Product (GDP) is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance.

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