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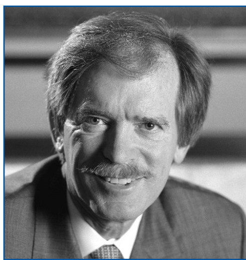
Investment Outlook

by PIMCO's Bill Gross

Where's Waldo?
Where's W?



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During times of market turmoil it helps to simplify and get basic—explain things to a public and even yourself in terms of what can be easily understood. Goodness knows it's not a piece of cake for anyone over 40 these days to understand the maze of financial structures that now appear to be unwinding. They were created by youthful financial engineers trained to exploit cheap money and leverage who showed no fear and who have, until the last few weeks, never known the sting of the market's lash. They are wizards of complexity. I, however, having just turned 63, am a professor of simplicity.

So forgive my perhaps unsophisticated explanation to follow of how the subprime crisis crossed the borders of mortgage finance to swiftly infect global capital markets. What Citigroup's Chuck Prince, the Fed's Ben Bernanke, Treasury Secretary Hank Paulson, and a host of other sophisticates should have known is that the bond and stock market problem is the same one puzzle players confront during a game of "Where's Waldo?"—Waldo in this case being the bad loans and defaulting subprime paper of the U.S. mortgage market. While market analysts can guesstimate how many Waldos might actually show their face over the next few years—100 to 200 billion dollars worth is a reasonable estimate—no one really knows where they are hidden. First believed to be confined to Bear Stearns hedge funds and their proxies, Waldos have been popping up with regularity in seemingly staid institutions such as German and French Banks that have necessitated state-sanctioned bailouts reminiscent of the Long Term Capital Management Crisis of 1998. IKB, a German bank, and BNP Paribas, its French counterpart, both encountered subprime meltdowns on either their own balance sheet or investment funds sponsored by them. Their combined assets total billions although their Waldos are yet to be computed or even found.

Those looking for clues to the extent of the spreading fungus should understand that there really is no comprehensive data to allow anyone to know how many subprimes actually rest in individual institutional portfolios. Regulators have been absent from the game, and information release has been left in the hands of individual institutions, some of whom have compounded the uncertainty with comments about volatile market conditions unequaled during the lifetime of their careers. And too, many institutions including pension funds and insurance companies, argue that accounting rules allow them to mark subprime derivatives at cost. Defaulting exposure therefore, can hibernate for many months before its true value is revealed to investors and importantly, to other lenders.

The significance of proper disclosure is, in effect, the key to the current crisis. Financial institutions lend trillions of dollars, euros, pounds, and yen to and amongst each other. In the U.S., for instance, the Fed lends to banks, which lend to prime brokers such as

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Goldman Sachs and Morgan Stanley which lend to hedge funds, and so on. The food chain in this case is not one of predator feasting on prey, but a symbiotic credit extension, always for profit, but never without trust and belief that their money will be repaid upon contractual demand. When no one really knows where and how many Waldos there are, the trust breaks down, and money is figuratively stuffed in Wall Street and London mattresses as opposed to extended into the increasingly desperate hands of hedge funds and similarly levered financial conduits. These structures in turn are experiencing runs from depositors and lenders exposed to asset price declines of unexpected proportions. In such an environment, markets become incredibly volatile as more and more financial institutions reach their risk limits at the same time. Waldo morphs and becomes a man with a thousand faces. All assets with the exception of U.S. Treasuries look suspiciously like every other. They're all Waldos now.

The past few weeks have exposed a giant crack in modern financial architecture, created by youthful wizards and endorsed as a diversifying positive by central bankers present and past. While the newborn derivatives may hedge individual institutional and sector risk, they cannot eliminate the Waldos. In fact, the inherent leverage that accompanies derivative creation may foster systemic risk when information is unavailable or delayed in its release. Nothing within the current marketplace allows for the hedging of *liquidity* risk and that is the problem at the moment. Only the central banks can solve this puzzle with their own liquidity infusions and perhaps a series of rate cuts. The markets stand by with apprehension.

But should markets be stabilized, the fundamental question facing policy makers becomes, "what to do about the housing market?" Granted a certain dose of market discipline in the form of lower prices might be healthy, but market forecasters currently project over two million defaults before this current cycle is complete. The resultant impact on housing prices is likely to be close to -10%, an asset deflation in the U.S. never seen since the Great Depression. Granted, stock markets have periodically retreated by significantly more, but stocks have never been the savings nest egg for a majority of Americans. 70% of American households are homeowners, and now many of those that bought homes in 2005-2007 stand a good chance of resembling passengers on the Poseidon—upside down with negative equity. A 10% "hook" in national home prices is serious business indeed. It's little wonder that Fed, Treasury, and Congressional leaders are shifting into high gear.

Housing prices could probably be supported by substantial cuts in short-term interest rates, but even cuts of 200–300 basis points by the Fed would not avert a built-in upward adjustment of ARM interest rates, nor would it guarantee that the private mortgage market —flush with fears of depreciating collateral—would follow the Fed down in terms of 15–30 year mortgage yields **and** relaxed lending standards. Additionally, cuts of such magnitude would almost guarantee a resurgence of speculative investment via hedge funds and levered conduits which have proved to be the Achilles heel of the current crisis. Secretary Paulson might also have a bone to pick with this "Bernanke housing put" since it more than likely would weaken the dollar—even produce a run—which would threaten the long-term reserve status of greenbacks and the ongoing prosperity of the U.S. hegemon.

The ultimate solution, it seems to me, must not emanate from the bowels of Fed headquarters on Constitution Avenue, but from the West Wing of 1600 Pennsylvania Avenue. Fiscal, not monetary policy should be the preferred remedy, one scaling Rooseveltian proportions emblematic of the RFC, or perhaps to be more current, the RTC in the early 1990s when the government absorbed the bad debts of the failing savings and loan industry. Why is it possible to rescue corrupt S&L buccaneers in the early 1990s and provide guidance to levered Wall Street

investment bankers during the 1998 LTCM crisis, yet throw 2,000,000 homeowners to the wolves in 2007? If we can bail out Chrysler, why can't we support the American homeowner? The time has come to acknowledge that there are precedents aplenty in the long and even recent history of American policy making. This rescue, which admittedly might bail out speculators who deserve much worse, would support millions of hard working Americans whose recent hours have become ones of frantic desperation. And for those who would still have them eat some Wall Street cake as opposed to Midwest meat & potatoes (*The Wall Street Journal* editorial page suggested they should get darn good and used to renting once again) look at it this way: your stocks and risk-oriented levered investments will spring to life like the wild flowers in Death Valley after a flash flood. And if you're a Republican office holder, you'd win a new constituency of voters—"almost homeless homeowners"—for generations to come. Get with it Mr. President and Mr. Treasury Secretary. This is your moment to one-up Barney Frank and the Democrats. Reestablish not the RFC or the RTC, but create an RMC—Reconstruction Mortgage Corporation. If not, make some modifications in the existing FHA program, long discarded as ineffective. Write some checks, bail 'em out, prevent a destructive housing deflation that Ben Bernanke is unable to do. After all "W", you're "the Decider," aren't you?

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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.

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