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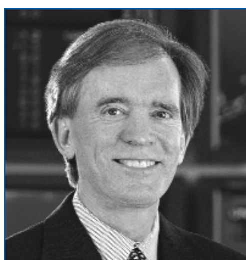
Investment Outlook

by PIMCO's Bill Gross

There's a Bull Market Somewhere?



Bill Gross
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Wall Street SAT Exam Question:

Louis Rukeyser is to Jim Cramer like:

(A) A healthy head of hair is to bald
(B) Uptown Manhattan is to Brooklyn
(C) The Pony Express is to e-mail
(D) All of the above

OK, if you picked (D), you scored 800 on this part of the exam. Despite their being polar opposites though, I must tell you I was a fan of Lou's and I'm a fan of Jim's, even if they occupy(d) the investment stage of public opinion with entirely different personalities and a broadband disparity of decibel levels. Rukeyser's Wall $treet Week was a monologue-scripted, spontaneous pun-inflicted, Friday night-"quipp-ded" diatribe, concluding in part that analysts and portfolio managers would better serve the world by joining the military. Cramerica is a daily light show, a smite-the-idiots show, a battle between the clueless and smart money, with the ultimate conclusion that those who "know nothing… know nothing" would be better off teaching as opposed to doing. Both Rukeyser and Cramer were probably correct and that is why I guess I sort of like(d) them both.

When it comes to Cramer, you may be wondering why one would bother with a late afternoon "lightning round" conclusion to a busy investment day. Well, he's entertaining, first of all, and I never get tired of the multiple "booyahs!" that listeners come up with. I find, though, that there are more than appetizers on Cramer's menu. He has the instincts of a money manager (because he was one), but the unequivocating courage of convictions that not many of us have.

To take on the Fed in the moment of the market's deepest despair took guts. It would be like a passenger rushing from the dining room of the Titanic and heading straight for the bridge: "Get your hands off that wheel, Captain, there's icebergs ahead!" Indeed there were. Yet, aside from the entertainment and courage, there's a commonsensical lesson plan that pops up almost every day. To be sure, the lightning round is intentionally prefab as opposed to lath and plaster, but interspersed and intertwined around all of it are entreaties to diversify and to be aware that markets don't always go up. Rukeyser, in fact, was a perpetual bull. Cramer is a cat with one eye on the mouse hole and the other on a side door that just might usher in a roaring predator. If you can filter the schmaltz from the chicken you just might learn something. That's what I tell myself, anyway, on many Monday—Friday afternoons. Booyah, Jim!

The reason I bring up Mr. Cramer and his ascension to at least a portion of the investment media throne is to discuss one of his oft-quoted phrases: "Remember, there's always a bull market somewhere!" In its simplicity that's hard to dispute. There are always some stocks that go up in bear markets and some bonds as well. The bond market long ago, for instance, split mortgages into what are known as POs and IOs, where you could take your pick between principal repayment or the interest component of the mortgage. One was effectively a bet on yields going down, the other on rates going up. Currencies are probably the purest form of the Cramer thesis because one could easily argue that if the dollar is in a bear market, then there have to be multiple currencies that will be going the other way.

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Taken one step further, Jim Grant of Grant's Interest Rate Observer would surely acknowledge the idiosyncratic movement of individual currencies but argue that they all were deflating versus gold. Voila! Even in Mr. Grant's world there's a bull market somewhere.

So, the lesson must be to go forth and find the bull market, wherever it is. Almost always—but not now **because in a global financial marketplace in the process of delevering, assets that go up in price are rare diamonds as opposed to grains of sand.** For the past several months our PIMCO Investment Committee blackboard has continued to display the following lesson plan:

What Happens During Delevering

(1) Risk spreads, liquidity spreads, volatility, term premiums—they all go up.

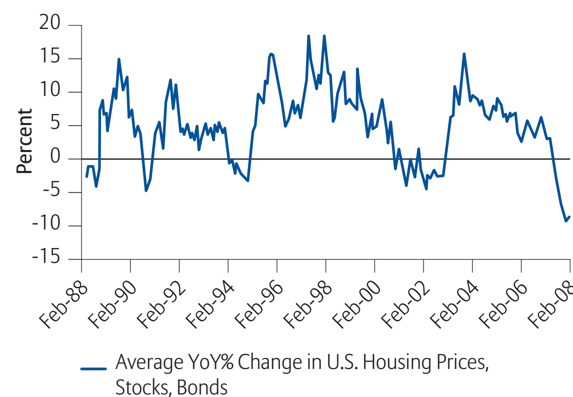
(3) Delevering slows/stops when assets have been liquidated and/or sufficient capital has been raised to produce an equilibrium.

(3) The raising of sufficient capital now depends on the entrance of new balance sheets. Absent that, prices of almost all assets will go down.

The above might seem simplistic to us at PIMCO but it is not necessarily clear to all readers. Term premiums? Risk spreads? Volatility? What do they have to do with bull or bear markets? Well, what Step 1 really says is that as GSEs, banks, investment banks, global hedge funds and even individual households delever their balance sheets by shedding assets, they lower the prices of not just what they are selling, but other securities that are arbitrageable within the marketplace. The past 12 months, for instance, have focused on subprime and alt-A mortgages and their drastically lowered prices. Stocks of companies that own them are of course marked down, but so are other assets of impeccable quality. Because junk mortgages now in some cases yield 15%, money at the margin is pulled out of the agency mortgage market where implicit guarantees and explicit Treasury promises to provide standby capital lead to bona fide AAA quality ratings. We estimate that the process of delevering has lowered the price on FNMA and FHLMC mortgages by as much as 3-4% and raised the yield on their 30-year fixed paper by as much as 75 basis points.

Similarly, the volatility associated with asset liquidation as well as the observable lack of liquidity adds additional risk spread premia, which in turn lower the price of almost any stock, bond or piece of real estate that you or anyone else owns. In combination, the current delevering has managed to sink all three primary asset classes in aggregate, as shown in Chart 1. At first, one might wonder why all the fuss. As the chart demonstrates, there have been prior periods when this trio has not done well and the U.S. economy has hardly blinked. However, the current year-over-year decline of over 10% has never really been witnessed since the Great Depression. That, in and of itself, is a potential red flag. **Yet, a 10% aggregate asset price decline does more than make us all 10% less wealthy. Because many of these assets are leveraged and margined, the more they decline, the more frequent and frenzied the margin calls, and if the additional cash flow is not provided, not only an asset liquidation but a debt liquidation follows. It is the debt liquidation that potentially turns a stagnant/recessionary economy into something much worse.** In the housing market for instance, it is one thing to observe a 15% national decline in home prices. It is much more serious however, when margin calls in the form of monthly mortgage payments (many of which are increasing due to adjustable or option-related contractual provisions) lead to foreclosures, which in turn cause a debt liquidation. The bank in this case, takes possession of the home and dumps it back on the market, lowering the price even further, which leads to more foreclosures, which leads to….

CHART 1
Oh Where, Oh Where Has My Bull Market Gone?



Source: PIMCO
This chart is not indicative of the past or future performance of any Allianz Global Investors product.

This rarely observed systematic debt liquidation is what confronts the U.S. and perhaps even the global financial system at the current time. Unchecked, it can turn a campfire into a forest fire, a mild asset bear market into a destructive financial tsunami. Central bankers, of course, adopting the cloak and demeanor of firefighters or perhaps lifeguards, have been hard at work over the past 12 months to contain the damage. And the private market, in its attempt to anticipate a bear market bottom and snap up "bargains," has been constructive as well. Over $400 billion in bank- and finance-related capital has been raised during the past year, a decent amount of it, by the way, having been bought by yours truly and my associates at PIMCO. Too bad for us and for everyone else who bought too soon. There are few of these deals now priced at par or above, which is bondspeak for "they are all underwater." We, as well as our SWF and central bank counterparts, are reluctant to make additional commitments.

Step 2 on our delevering blackboard therefore has stalled and is inevitably morphing towards Step 3. Assets are still being liquidated but there is an increasing reluctance on the part of the private market to risk any more of its own capital. Liquidity is drying up; risk appetites are anorexic; asset prices, despite a temporarily resurgent stock market, are mainly going down; now even oil and commodity prices are drowning. There may be a Jim Cramer bull market somewhere, but it's primarily a mirage unless and until we get the entrance of new balance sheets, and a new source of liquidity willing to support asset prices.

New balance sheets? Is this now some Deloitte & Touche metaphor? Hardly. What I mean, what our blackboard and our Investment Committee point out is that to ultimately stop this asset/debt deflation, a fresh and substantial new source of buying power is required. This became all too obvious as the Treasury's attempt to entice additional capital into Freddie and Fannie came up empty. Yet this same dilemma is and will continue to confront all highly levered institutions in the throes of asset liquidation. Without a new balance sheet, their only resort is to sell assets, which in many cases leads to further price declines, or ultimately debt liquidation/default.

A Depression-era bank robber named Willie Sutton once said that the reason he robbed banks was because "that's where the money is." Illegal for sure, but close to an 800 SAT score for logic if you were in the business of stealing other people's money. And now, while some will compare current government bailouts to Slick Willie, citing moral hazard, near criminal regulatory neglect, and further bailouts for Wall Street and the rich, common sense can lead to no other conclusion: if we are to prevent a continuing asset and debt liquidation of near historic proportions, we will require policies that open up the balance sheet of the U.S. Treasury–not only to Freddie and Fannie but to Mom and Pop on Main Street U.S.A., via subsidized home loans issued by the FHA and other government institutions. A 21st century housing-related version of the RTC such as advocated by Larry Summers amongst others could be another example of the government wallet or balance sheet that is required during rare periods when the private sector is unable or unwilling to step forward.

The bill for our collective speculative profligacy, obvious in the deflating asset markets, can be paid now or it can be paid later. Those aspiring for a perfect 800 on the Wall Street policy exam would conclude that the tab will be less if paid up front, than if swept under a rug of moral umbrage intent on seeking retribution for any and all of those responsible. Now that the Fed has spent 12 months proving that it "knows something… knows something," it is time for the Treasury to do likewise.

Booyah, Hank?

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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.

As a reminder, an audio file of this *Investment Outlook* will be available on www.allianzinvestors.com.

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Each sector of the bond market entails risk. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest. Shares of mutual funds that invest in them are not guaranteed. Mortgage-backed securities are subject to prepayment risk. The value of some mortgage-related or asset-backed securities may be particularly sensitive to interest rate changes, and there is no assurance that private insurers of the underlying mortgages or assets will meet their obligations. With Corporate bonds there is no assurance that issuers will meet their obligations. High-yield bonds typically have a lower credit rating than other bonds. Lower rated bonds generally involve a greater risk to principal than higher rated bonds. Investing in non-U.S. securities may entail risk as a result of foreign economic and political developments; this risk may be enhanced when investing in emerging markets. In an environment where interest rates may trend upward, rising rates will negatively impact most bond funds, and fixed income securities held by a fund are likely to decrease in value. Bond funds and individual bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

"GSE" stands for "Government-Sponsored Enterprise." "SWF" stands for "Sovereign Wealth Fund." "FHA" stands for "Federal Housing Administration." "RTC" stands for "Resolution Trust Corporation."

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