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# Investment Outlook

by PIMCO's Bill Gross

## Shadow Dancing

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*When the music's over,*

*turn out the lights.*

—Jim Morrison, The Doors, 1967

Citigroup's Chuck Prince was a dancer. Not by profession mind you, or even as an amateur Foxtrotter with the Stars on ABC. Prince danced with subprime mortgages and the financial conduits that contained them. "As long as the music is playing," he foreswore in early July, "you've got to get up and dance. We're still dancing." Prince's observation may not top that of Irving Fisher in 1929 who proclaimed a permanently higher plateau for the stock market, but it will suffice for a generation of modern day investors and their iconic leaders who should have known when to exit the floor. He—they—dance no more with their subprime partners. Still, someone had to be the last to know that the music was over and to be caught when Jim Morrison's proverbial lights were dimming, if not flickering out. And to be fair, there were millions of dancing investors still on that floor when the unraveling of Bear Stearns' hedge funds gave the party its first hint that this was going to be the last dance.

A critic should also admit that the music had been playing for a long, long time—almost before Prince graduated from Cotillion. Subprimes were actually the last stanza in a song that described the financialization of the U.S. economy beginning way back in the 1970s. The delinking of the dollar from gold and the deregulation of banking and interest rates via the abolition of Regulation Q were necessary conditions in unleashing the potential for the hedge funds of the 21st millennium. What really provided the impetus however, were other expansive trends: global deregulation of capital, computer technology, and the birth of potentially speculative instruments that could accommodate leverage and create credit outside the banking system. Financial futures geared towards currencies, stocks, and bonds were followed by options, swaps, credit default securities and a host of anachronistic three-letter conduits that we now know as CDOs, SIVs, and—well, make up your own combination—it's probably been marketed already.

Some would vehemently argue, although probably not the current Fed Chairman, that the pace of financialization was not matched by the steadying arm of regulation. The sorry state of mortgage origination with its "no docs" and "liar loans" is perhaps the most recent testament to that. In combination, the loose regulation and financial innovation of the past 35 years have spawned what PIMCO's Paul McCulley has labeled a "shadow banking system" where credit is composed on a keyboard as opposed to a printing press. Economic historians marvel at the ability of the Weimar Republic in the late 1920s to have printed paper money so fast that workers would lower their afternoon wages in a basket to waiting wives in order to front run rampaging six-digit inflation. Surely they could not have imagined shadow investment bankers

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and their minions spawning financial derivatives in the hundreds of trillions, far beyond the reach of central bankers and Treasury officials alike. If old-fashioned banking's pace could be described as a waltz, then their thoroughly modern shadow counterparts would resemble funk, hip-hop, grinding, and then some.

It is certainly true that the shadow system with its derivatives circling the globe have democratized credit. Subprimes are just another way to characterize mortgages assumed by less than blue-blooded homeowners. As benefits of cheaper credit became available to the many as opposed to the few, placating and calming waves of higher productivity and widespread diversification led to accelerating economic growth, incomes, and corporate profits. But trend reversal or momentum interruptus in the shadow as opposed to the regular banking system can offset many of the benefits. Since derivative creation and credit extension are dependent upon the animal spirits of capitalists as opposed to the interest rate metronome of central bankers, the ability to restart a stagnating or even recessionary economy is more problematic. Ask yourself how quickly individual investors will be willing to invest new money in hedge funds heralding the tarnished magic of subprime mortgages. Contemplate the future of asset-backed commercial paper. If these credit conduits contract, then a Federal Reserve seeking to resurrect a faltering economy with 25-basis point cuts in interest rates may confront the same unmanageable response from the private sector during an easing cycle, as it did during the past several years of steadily higher Fed funds.

Traditionalists would point out that the regular banking system has its hands full without throwing in the complications of the modern day shadow. That is undeniable. Mortgage write-offs, credit card losses, and increasing defaults on small business loans will squeeze bank balance sheets and income statements for the next several years. That pressure in turn will result in more conservative lending practices, which will induce not a **contraction** in credit growth, but a noticeable slowdown. Regulators, the press, and politicians will do their part as well, characteristically closing the barn door after the subprime mortgage horse has escaped from the barn. There's nothing like the strong arm of new laws and/or newspaper headlines to straighten the spine of a lender faster than you can pronounce "Barney Frank," or "Gretchen Morgenson." Ask Countrywide's Angelo Mozilo how many marginal loans his company will be making now that he's being publicly pilloried for personal stock sales that allegedly got him out before public shareholders. And too, observe the Chancellor of the Exchequer Alistair Darling's plea for the private market to "return to old-fashioned banking." Better late than never I suppose, but the return journey will exact a cost in the form of more restrictive credit, inducing a danger of further asset deflation in housing and other markets.

So, both old-fashioned banks and their derivative, conduit-fed shadow counterparts will be growing their balance sheets a lot more slowly in future months and quarters. That rather immediately translates into a slower economy and the need for government assistance in the form of lower interest rates or liquidity pushes like Treasury Secretary Paulson's "Super SIV." Whether Paulson's "Committee to Save the World—Part II" will succeed like Bob Rubin's original during the Long Term Capital crisis is debatable. The idea, first of all, is counterproductive because it continues to hide subprime asset prices in the "shadows." Secondly, Rubin confronted no regulatory headwinds back in 1998, nor did he have to deal with today's behemoth shadow banking system in the process of losing its brave face. Rubin in fact, along with his all-star committee featuring Alan Greenspan and Larry Summers,

had a near hurricane force tailwind with 24 months more of dotcom IPOs yet to come. No wonder that Chairman Greenspan needed to cut short rates by only 75 basis points before stabilizing the economy nearly a decade ago.

Ben Bernanke has no such luxury. While he does have the backstop of a global economy powering on at a 4%–5% annual clip, today's U.S. IPOs were more a creation of leverage and the shadow banking system's ability to create productivity gains through finance, as opposed to technological innovation. With banks and their shadows in retreat and modern day "world saving committees" relatively impotent, Bernanke must do some heavy lifting as opposed to the light housework required of Alan Greenspan in 1998. An increasingly recessionary looking U.S. economy will likely require 1% real short rates and 3½% Fed Funds in order to stabilize a potential growth contraction in lending not witnessed since the early 1970s or, to be honest, Roosevelt's depressionary 1930s. We can only hope that Bernanke, Paulson, and their cohorts recognize the danger and that the music keeps playing with the lights still turned on.

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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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**Regulation Q** was a Federal Reserve Board regulation that limited the interest rate that banks and other savings institutions could pay on savings and other time deposits.

**Collateralized debt obligations** (CDOs) include types of asset-backed securities and structured credit products which gain exposure to the credit of a portfolio of fixed income securities and apportion the credit risk among different tranches.

**Structured investment vehicles** (SIV) are credit arbitrage funds which invest in a range of asset-backed securities as well as corporate bonds.

**"No docs"** or **"liar loans"** are terms used to describe mortgages that require little or no documentation of income and may be provided based on exaggerated income levels.

An **Initial Public Offering (IPO)** is a company's first offering of stock to the public.

The target **federal funds rate** is the interest rate published by the Federal Open-Market Committee (FOMC) of the Federal Reserve Board as a target for overnight, inter-bank loans. The rate is a leading economic indicator of interest rate movements and Federal Reserve monetary policies.

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