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Investment Outlook
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Life – and Death Proposition

Where do we go when we die?
We go back to where we came from
And where was that?
I don't know, I can't remember
Virginia Woolf, "The Hours"

I don't remember much of this life, and like Virginia Woolf, nothing of the herebefore. How then, could I expect to know of the hereafter? I know at least that we all exist at and of the moment and that we make up those moments as we go along. I became a grandfather for the first time a few months ago and proud son Jeff asked for some fatherly advice as to how to go about raising his baby daughter Caroline. "We all do it in our own way, Jeff, you'll make it up as you go along," I said. Parenting, and life itself, is one giant experiment. From those first infant steps, to adolescent peer testing, flying from and departing the parental nest, gene replication and family building of our own, maturity and acquiescence, aging, decay and inevitable death – we experiment as best we can and make it up as we go along.

That death part though, oh where do we go after we have done all the making? There was another Jeff in our family, beloved brother-in-law Jeff Stubban who was as kind a man as there ever could be. Dying within three months of an initial diagnosis of pancreatic cancer, our family sobbed uncontrollably at his bedside as his breath, his spirit, his soul, departed almost on cue while a priest recited the rosary. Where had he gone, where is he now, what will become of him and all of us? Like many grieving families we look for signs of him and in turn for clues to our own destination. A lucky penny in the street, a random mention of his beloved New Orleans, an exterior resemblance of his shiny bald head in a mingling crowd. Where are you, Jeff? Tell us you are safe so that we might meet again.

Having now matured to trust reason more than faith I offer not so much a resolution, but an alternative to the unanswerable question of Virginia Woolf and the departed souls of Jeff Stubban and billions of others. If we don't meet again – up there – then perhaps we'll meet once more – down here. After all, the one thing I know for sure is that we got here once – and because we did, we could do it again. Rest easy, dear Jeff, and welcome to this world, dear Caroline. We'll all just have to make it up as we go along.

The transition from a levering, asset-inflating secular economy to a post bubble delevering era may be as difficult for one to imagine as our departure into the hereafter. A multitude of liability structures dependent on a certain level of nominal GDP growth require just that – nominal GDP growth with a little bit of inflation, a little bit of growth which in combination justify embedded costs of debt or liability structures that minimize the haircutting of or defaulting on prior debt commitments. Global central bank monetary policy – whether explicitly communicated or not – is now geared to keeping nominal GDP close to historical levels as is fiscal deficit spending that substitutes for a delevering private sector.

Yet the imagination and management of the transition ushers forth a plethora of disparate policy solutions. Most observers, however, would agree that monetary and fiscal excesses carry with them explicit costs. Letting your pet retriever roam the woods might do wonders for his "animal spirits," for instance, but he could come back infested with fleas, ticks, leeches or worse. Fed Chairman Ben Bernanke, dog-lover or not, preannounced an awareness of the deleterious side effects of quantitative easing several years ago in a significant speech at Jackson Hole. Ever since, he has been open and honest about the drawbacks of a zero interest rate policy, but has plowed ahead and unleashed his "QE bowser" into the wild with the understanding that the negative consequences of not doing so would be far worse. At his November 2011 post-FOMC news briefing, for instance, he noted that "we are quite aware that very low interest rates, particularly for a protracted period, do have costs for a lot of people" – savers, pension funds, insurance companies and finance-based institutions among them. He countered though that "there is a greater good here, which is the health and recovery of the U.S. economy, and for that purpose we've been keeping monetary policy conditions accommodative."

My goal in this *Investment Outlook* is not to pick a "doggie bone" with the Chairman. He is makin' it up as he goes along in order to softly delever a credit-based financial system which became egregiously overlevered and assumed far too much risk long before his watch began. My intent really is to alert you, the reader, to the significant costs that may be ahead for a global economy and financial marketplace still functioning under the assumption that cheap and abundant central bank credit is always a positive dynamic. When interest rates approach the zero bound they may transition from historically stimulative to potentially destimulative/ regressive influences. Much like the laws of physics change from the world of Newtonian large objects to the world of quantum Einsteinian dynamics, so too might low interest rates at the zero-bound reorient previously held models that justified the stimulative effects of lower and lower yields on asset prices and the real economy.

It is instructive to mention that this is not necessarily PIMCO's view alone. Chairman Bernanke and Fed staff members have been sniffin' this trail like the good hound dogs they are for some time now. In addition, Credit Suisse, in their "2012 Global Outlook," devoted considerable pages to specifics of zero-based money with commonsensical historical comparisons to Japan over the past decade or so. The following pages of this *Outlook* will do the same. **At the heart of the theory, however, is that zero-bound interest rates do not always and necessarily force investors to take more risk by purchasing stocks or real estate, to cite the classic central bank thesis.** First of all, when rational or irrational fear persuades an investor to be more concerned about the return of her money than on her money then liquidity can be trapped in a mattress, a bank account or a five basis point Treasury bill. But that commonsensical observation is well known to Fed policymakers, economic historians and certainly citizens on Main Street.

What perhaps is not so often recognized is that liquidity can be trapped by the "price" of credit, in addition to its "risk." Capitalism depends on risk-taking in several forms. Developers, homeowners, entrepreneurs of all shapes and sizes epitomize the riskiness of business building via equity and credit risk extension. But modern capitalism is dependent as well on maturity extension in credit markets. No venture, aside from one financed with 100% owners' capital, could survive on credit or loans that matured or were callable overnight. Buildings, utilities and homes require 20- and 30-year loan commitments to smooth and justify their returns. Because this is so, lenders require a yield premium, expressed as a positively sloped yield curve, to make the extended loan. A flat yield curve, in contrast, is a disincentive for lenders to lend unless there is sufficient downside room for yields to fall and provide bond market capital gains. This nominal or even real interest rate "margin" is why prior cyclical periods of curve flatness or even inversion have been successfully followed by economic expansions. Intermediate and long rates – even though flat and equal to a short-term policy rate – have had room to fall, and credit therefore has not been trapped by "price."

When all yields approach the zero-bound, however, as in Japan for the past 10 years, and now in the U.S. and selected "clean dirty shirt" sovereigns, then the dynamics may change. **Money can become less liquid and frozen by "price" in addition to the classic liquidity trap explained by "risk."**

Even if nodding in agreement, an observer might immediately comment that today's yield curve is anything but flat and that might be true. Most short to intermediate Treasury yields, however, are dangerously close to the zero-bound which imply little if any room to fall: no margin, no air underneath those bond yields and therefore limited, if any, price appreciation. What incentive does a bank have to buy two-year Treasuries at 20 basis points when they can park overnight reserves with the Fed at 25? What incentives do investment managers or even individual investors have to take price risk with a five-, 10- or 30-year Treasury when there are multiples of downside price risk compared to appreciation? At 75 basis points, a five-year Treasury can only rationally appreciate by two more points, but theoretically can go down by an unlimited amount. **Duration risk and flatness at the zero-bound, to make the simple point, can freeze and trap liquidity by convincing investors to hold cash as opposed to extend credit.**

Where else can one go, however? We can't put $100 trillion of credit in a system-wide mattress, can we? Of course not, but we can move in that direction by delevering and refusing to extend maturities and duration. Recent central bank behavior, including that of the U.S. Fed, provides assurances that short and intermediate yields will not change, and therefore bond prices are not likely threatened on the downside. Still, zero-bound money may kill as opposed to create credit. Developed economies where these low yields reside may suffer accordingly. It may as well, induce inflationary distortions that give a rise to commodities and gold as store of value alternatives when there is little value left in paper.

Where does credit go when it dies? It goes back to where it came from. It delevers, it slows and inhibits economic growth, and it turns economic theory upside down, ultimately challenging the wisdom of policymakers. We'll all be making this up as we go along for what may seem like an eternity. A 30-50 year virtuous cycle of credit expansion which has produced outsize paranormal returns for financial assets – bonds, stocks, real estate and commodities alike – is now delevering because of excessive "risk" and the "price" of money at the zero-bound. We are witnessing the death of abundance and the borning of austerity, for what may be a long, long time.

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