



The Caine Mutiny (Part 2)

The Gross household is a robe-wearing household – at least on the distaff side. Sue has a closet full of them, all white, and is thrilled each and every Christmas with a new white one under the tree. Go figure. I on the other hand am a little more casual about nighttime attire, a habit I picked up or at least observed during my Navy years in the South China Sea. But I am getting ahead of myself. Back in 1969, yours truly was a lowly ensign whose responsibility among other things was to substitute for the captain when he was sleeping. Vietnam era captains couldn't be at the helm 24/7 so during relatively calm hours, the benchwarmers got a chance to quarterback the ship. Such was the case on a warm September evening, making 20 knots on our way home to San Diego in the middle of the vast and totally empty Pacific Ocean, 2,000 miles west of Honolulu. I was standing the dreaded "mid-watch" – midnight to 4:00 am – and under instructions to wake the captain if anything "unusual" took place; FAT chance, aside from the occasional mermaid or sea monster sightings, and no one ever woke the captain up for that.

Well, around 2:00 am there was a sighting – quite remarkable, actually, because the Pacific is BIG and the occasional freighter was rare indeed. Ten miles at 15° off the bow, I spotted an oil tanker on the horizon,

apparently headed our way. There is a Navy axiom that even an idiot ensign can remember, which tells a navigator whether or not a mid-ocean collision is possible – "constant bearing, decreasing range," or CBDR for short. If, for instance, that tanker was closing to five miles and was still positioned 15° off the bow, well, there would be a growing chance that we would meet head-on five miles later. Ah, wouldn't you know it – this tanker had a CBDR and yours truly was the only one who was aware of it. Tankers set their controls on automatic pilot during the midnight hours, so the approaching ship wasn't about to change course. I was the only officer awake. Not for long, though – I called up the captain like the good little ensign I was, and here, dear reader, is where I finally circle back to the underwear. A captain in full dress uniform is an impressive sight – four stripes on the epaulets, heavily starched white shirt. "Yes Sir!" is the almost automatic response. But an unshaven, 60-year-old, pot-bellied captain in his underwear? Now there's a disconcerting sight. "I got the deck," he said, which meant he was assuming control as he plopped into the captain's chair with a toot and an expulsion of natural gas worthy of the prior evening's pork and beans.

Well, to this point, the incident was a paragon of human comedy not tragedy, but

it quickly turned serious. Two miles 15°, one mile 15°, 1000 yards 15° – “Captain – constant bearing, decreasing range!” Ah, but El Capitan wasn’t hearing me – he was asleep at the helm, and half-naked no less: in command, in his underwear, and off somewhere in la-la land. **Twenty seconds after my warning, the tanker came within 20 yards of cutting us and 150 young sailors in half.** I in my fascination with a captain in his jockey shorts had assumed he was awake and knew what he was doing. He in his Fruit of the Looms and 2:00 am exhaustion was incapacitated, temporarily incompetent, and anything but a Naval captain. “What the hell was that?!” he screamed as it passed astern after nearly disemboweling our 300-foot destroyer. I was speechless and subject to a potential court martial, so I meekly replied, “A tanker, sir”. “The Grim Reaper” would have been a better description. It is with that as a reminder that there are no white robes under the Christmas tree for yours truly. I wear a t-shirt and jockey shorts if only to remind me of a sleeping pot-bellied captain and that old Navy adage – constant bearing, decreasing range – constant bearing, decreasing range.

Forty years later, I find myself in a similar position, this time, however, displaying the four-striped epaulets myself as a co-captain of the SS PIMCO, a \$1.2 trillion carrier designed to travel the world and the seven seas in a quest for principal protection and alpha generation. And I thought the mid-watch was a hassle! Whatever it is, Mohamed and I either alternately or in unison maintain 24-hour surveillance for tankers on a collision course with your

investment portfolios and savings. There should be no “what the hell was that!” moments at PIMCO, even on Lehman Day 2008. Indeed, there was not. While the global financial tanker was on automatic pilot, we had changed course well in advance and it has been relatively smooth sailing since.

The metaphor begs the question however as to what tanker is now on a constant bearing decreasing range, and indeed there would seem to be many such blips on the radar screen: global imbalances in trade, finance and currencies; excessive private and sovereign debt levels; growing disparities in wealth between the rich and the poor; aging demographics threatening aging and younger generational priorities. Lots of ships out there. Our upcoming Secular Forum will analyze these topics and many more next week, after which Mohamed and I will alert you to the prospects.

For now I would like to continue down the route of previous months’ *Investment Outlooks* and discuss the immediate threat to investment portfolios represented by low policy rates (fed funds in the U.S.) and the increasing negative real yields that they engender as inflation accelerates. I spoke last month to the reality of investors being “skunked” and having their pockets picked simply by receiving yields less than inflation, and suggested that as a major reason why the PIMCO ship was carrying a limited supply of Treasuries on board. Although we have warned for several years of the deteriorating creditworthiness of America’s AAA rating, our de minimis Treasury positions had less to do with

much more immediate issues than America's balance sheet prospects. We are highly sensitive to the pocket-picking policies that governments in general deploy to right the ship.

Well, ahoy matey, as quick as you can shout "thar she blows," an academic working paper by Carmen Reinhart and M. Belen Sbrancia affirmed the same thing but in much more grounded, well-ballasted research. The paper, titled "The Liquidation of Government Debt," contains a historical analysis of how governments attempt to get out from under the crushing burden of a debt crisis. For developed countries such as the United Kingdom and the United States, the period beginning in the mid-1940s (when depression and WWII sovereign debt loads were oppressive) was used as a starting point for pocket picking, "skunking," or what they term "financial repression." While the ancient Romans used to shave metal coins in an attempt to monetize existing debts, our evolving financial system has used more sophisticated techniques. With inflation accelerating, due to WWII and post-war demands on commodities, the Treasury capped long-term bond yields at 2½% and in so doing ensured that its debt/GDP ratio would be reduced. If savers received an average 2% on their Treasuries while the nominally based economy was advancing at 5% or more annualized growth rates, then debt to GDP could be lowered from its peak level of 116% to 112%, to 109%...etc. every 12 months. In fact, the authors found that "for the United States and the United Kingdom, the annual liquidation of debt via **negative real interest rates** amounted

on average to 3 or 4% percent of GDP a year...which quickly accumulated (without compounding) to a 30 to 40% of GDP debt reduction in the course of a decade." **Even after interest rate "caps" were removed in 1951 via the Fed-Treasury Accord, extremely low/negative real interest rate policies continued until the Volcker revolution in 1979.** By that time, U.S. (and U.K.) debt levels had been normalized, primarily at the expense of savers who had been "repressed" (and depressed!) for over three decades. At that historical turning point, government bonds were labeled "certificates of confiscation." Not only had savers received Treasury bill rates that were negative for over 25% of the nearly four decades, but they were holding long-term AAA rated bonds trading at 30 to 40 cents on the dollar.

The point of the Reinhart paper was not to state the obvious – that inflation is bad for bonds. **Their financial repressory thesis points out that bond prices don't necessarily have to go down for savers to get skunked during a process of "debt liquidation."** **The argument over whether the end of QEII on June 30 will result in higher yields and lower Treasury bond prices is, in a sense, a secondary one.** **Even if 10-year Treasuries stay where they are at 3.30%, and fed funds close to 0%, savers and financial intermediaries are being shortchanged by both of these yields and everything in between.** Today's rates resemble the interest rate caps prior to the 1951 Accord. Either through QEI, QEII or the Fed's "extended period of time" language reinforced at Chairman Bernanke's recent press conference,

U.S. Treasuries and the bond market in general are being “repressed,” “capped” or simply overvalued compared to the prior 30 years. Bond investors forced to invest in dollar government bonds either through indexation, convention, regulatory guidelines or simply falling asleep at the helm are being shortchanged by 1 to 2% annually compared to historical norms and in many cases receive negative real yields, as shown in Chart 1. If Reinhart’s history is any guide, an investor should expect these overvaluations to be with us for years if not decades. While that still leaves open the question of price behavior following QEII, there should be little doubt that simply holding Treasuries at these yield levels for an extended period of time represents an abdication of responsibility.

Bond – and stock – investors have been sailing on the “Good Ship Lollipop” for over 30 years following the Volcker Revolution and the return of high real interest rates to investment markets. Now, however, with governments attempting to impose financial repression, bond investors should revolt. Their ship should more likely be christened the “USS Caine” in memory of a silver screen mutiny that, while traumatic, eventually returned all sailors safely to port. **PIMCO advocates not so much a mutiny but a renewed vigilance on this new ship, stressing bond market**



Chart 1

“safe spread” alternatives available globally, including developing/emerging market debt at higher yields denominated in non-dollar currencies. Many of these countries have more pristine balance sheets and higher real interest rates than those currently being imposed in some developed markets subject to current and future “repression.” If AAA quality is your requirement, then Canadian or Australian bonds may also fit your horizon. Join us, along with Carmen Reinhart, in shouting “constant bearing/decreasing range!” The Treasury market is on a collision course with financial repression and it is time to adjust your rudder to starboard to get home safely.

William H. Gross
Managing Director

“Safe Spread” is defined as sectors that we believe are most likely to withstand the vicissitudes of a wide range of possible economic scenarios. All investments contain risk and may lose value.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

The credit quality of a particular security or group of securities does not ensure the stability or safety of an overall portfolio. The Quality ratings of individual issues/issuers are provided to indicate the credit worthiness of such issues/issuer and generally range from AAA, Aaa, or AAA (highest) to D, C, or D (lowest) for S&P, Moody’s, and Fitch respectively.

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