



Your Global Investment Authority

Buy Cheap Bonds with Safe Spread

Because the QEs cover an extraordinary period of monetary policy with a limited time frame, there is not enough data to indicate whether the end of QEII will lead to higher or even lower rates, although higher is our strong preference. “Who will buy them?” remains a critical question to be answered. There is, however, overwhelming evidence – now provided by Carmen Reinhart among others – that existing Treasury yields fail to adequately compensate investors for the risk of holding them, when measured on a historical basis.

I’m going to one-up Mark Twain in the quantity department and spin two yarns about jumping frogs, one which has been frequently told, the other not so much. Neither of them have anything to do with Samuel Clemens’ heralded short story, but both, metaphorically at least, describe our current investment markets and how to think about the future. My first story is the one you’ve all heard about. Put a frog in a kettle of boiling water and he’ll jump out faster and further than any of those blue ribbon winners at the Calaveras County jumping frog contest. Put him in a pot at room temperature, however, slowly turn up the temperature to boiling, and you’ll have frog legs for dinner. This latter, more unfortunate toad temporarily adapted to his external environment, which seemed like a practical thing to do, until – well, until he reached 212° at which point he was cooked.

Today’s bond investors are experiencing a similar fate with nary a “ribbet” of complaint. “Total returns” for the first five months for almost all bond categories show positive price performance, which when combined with coupon interest income, produce portfolios 3% or so higher in value than at year-end 2010. That number may not match stocks or some of the high-flying commodities, but its annualized total return of 6½ –7% beats inflation however you want to measure it – core, headline or median CPI. Well – as I frustratingly tried to explain to my mother for years – this total return concept

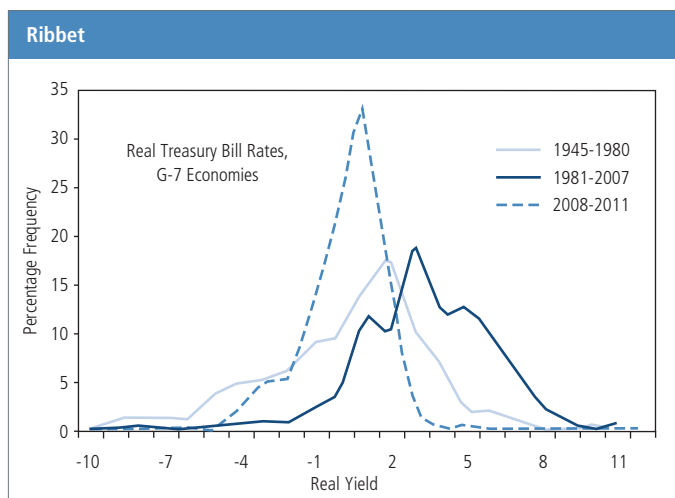
of price and yield appeals primarily when yields come down and bond prices go up. Think of bonds, Mom, as you would a teeter-totter, I would say. Interest rates go down – bond prices up. Vice versa too, except that beginning in 1981, the totter rarely teetered in the negative price direction. Bull markets in bonds, stocks and real estate rode an asset appreciation escalator that induced an artificial euphoria on the part of many investors expecting the ride to never end. Even conservative old-fashioned bonds – more famous for “coupon clipping” than capital gains – were bolstered by this secularly positive, total return concept.

Well, much like the Tower of Babel, Treasury bond prices cannot be heaven bound but have more earthly limitations. While stock values are often complicated by growth rate assumptions and P/E ratios making their ultimate destination uncertain, bond yields at least have a mathematical zero bound below which they cannot journey for more than a few nanoseconds. Investors don't give up their money for the promise of less money in return and so negative nominal yields are a mathematical impossibility aside from fears of government confiscation and temporary liquidity considerations. But here is where it gets tricky and where our soon-to-be-boiled frog comes into play. Much like gradually turning up the temperature on poor froggy's kettle of water, monetary policy in developed countries has been lowering the temperature and absolute level of yields for the past 2½ years post Lehman Brothers. Teeter-totter yields down, teeter-totter prices up, and froggy's total return euphoria at present seems to know no bounds. But once the potential for even lower interest rates is minimized by the zero floor, our future frog-legged entrée is left with a rather uncomfortable feeling. He's resting inertly in this caldron as prices near the boiling point with the Fed, the Chinese and the banks all buying up whatever Treasury bonds are offered. Everything appears well. But bond investors with a survival instinct

(being one and the same as our cooking frog) should reflect on that old teeter-totter metaphor and realize that prices near the boiling point automatically imply yields near subzero. Granted, 5-year Treasury rates near 1.70% are not zero and 10s and 30s are even better, but much of the Treasury yield curve now rests in negative territory when compared with expected future inflation, and that should send our bond investor into a hoppin' funk. Prices are already nearing the boiling point and his coupons are subzero, CPI adjusted. Total return...and our frog...are cooked, or if not they are certainly trapped in a future low return kettle of water.

Carmen Reinhart and coauthors writing for the National Bureau of Economic Research have exposed this dilemma in more sophisticated prose. In her second research paper, entitled “The Return of Financial Repression,” she affirms PIMCO's thesis of skunking, pocket-picking and frog cooking by describing a century-old policy maneuver used by governments facing a debt crisis. Rather than outright default, many countries attempt rather successfully to keep nominal interest rates lower than would otherwise prevail. Reinhart characterizes this as “financial repression” because over the long term it results in a transfer of wealth from savers to borrowers. Governments, having taken on too much debt, rather stealthily lower interest rates via central-bank-enforced policy rates or maneuvers such as “quantitative easing.” The artificial yields, in effect, act as a tax on savings, undercompensating asset holders and transferring the haircut benefits to the debtor nation. Coincidentally (and certainly serendipitously), corporate and some household balance sheets are re-equitized as the negative or historically low real interest rates allow economic growth, profits and some wage earners to build up a margin of safety for future expansion.

Chart 1 shown below is graphic evidence of Reinhart's financial repression over the past century, comparing two repressive periods (1945–1980 and 2008–2011) to a more normal interest rate environment without artificial government yield dampeners (1981–2007). Both periods of repression show bell-shaped curves shifted markedly to the left, with today's current cycle offering 2½% less yield for the average G-7 nation than what bond investor frogs have gotten used to since 1981. Actually, in the U.S., May's month-end estimate for real Treasury bill yields shown in Chart 1 would be 5% less than what Reinhart shows as the average compensation for the last 30 years!



Source: Reinhart and Sbrancia (2011), *International Financial Statistics*

Chart 1

All right fellow frogs, so we're being repressed and shortchanged in order to allow Uncle Sam to balance its books. Whatta we gonna do about it? "Frogs of the world unite," as Lenin might have said, and so here's where I harken back to Mark Twain and my second lesser-told frog story. There was this other frog who instead of being tossed into a pot of hot water was left to cool its heels in a pitcher of cold milk. Unable to jump out, he churned and churned

those frog legs until eventually the milk turned into butter and the hardened butter allowed him the platform to leap to froggy freedom! Well, let's get churnin', fellow frogs. If the U.S. or the U.K. or any other government is going to attempt to boil us alive, let's make butter! **Butter in this instance is what PIMCO characterizes as "cheap bonds."** Potentially confusing, "cheap bonds" is really a simple concept – sort of like the teeter-totter. Any bond, even a Treasury bond, is composed of several pieces – sort of like an atom with its neutrons, electrons, protons, positrons, neutrinos (whoops, don't wanna go too far here). There's an interest rate or yield piece, commonly measured by "duration." There's a credit piece, typically referred to as a "spread" when you buy a corporate bond. And there's a volatility piece, a liquidity piece and other little bits and particles that will go unexplained for now. The important point, though, is that if the government is going to artificially repress yield, then an intelligent frog should focus on the parts of a bond that are less repressed! You can, for instance, produce a 1% expected return in today's market in a number of ways. Buy a repressed 3-year Treasury note at just under 1%, or purchase an A-rated corporate floating rate note (FRN) with little to no durational risk at a 3-month LIBOR +75 basis points spread, currently returning 1%. Which is the better deal? Well, they both appear to lead you to the same place but our cheap bonds argument would maintain that the FRN gets you there with a lot less risk. The credit piece, in other words, is a safer spread than the duration piece.

Journalists, financial advisors, and perhaps even some clients marvel at how PIMCO can be doing so well in 2011 while being underweight the Treasury/durational component of the bond market. Folks – we're making butter. If you're being repressed, our strategy is to churn those legs, get out of the pitcher, and above all stay away from boiling pots of water.

Recent press coverage has focused on the end of QEII and what it may or may not do to Treasury prices. Let me reaffirm what we've said for many months now. Because the QEs cover an extraordinary period of monetary policy with a limited time frame, there is not enough data to indicate whether the end of QEII will lead to higher or even lower rates, although higher is our strong preference. "Who will buy them?" remains a critical question to be answered. There is, however, overwhelming evidence – now provided by Carmen Reinhart among others – that existing Treasury yields fail to adequately compensate investors for the risk of holding them when measured on an historical basis.

We suggest buying "cheap bonds" focusing on "safe spread," which means buying more floating and fewer fixed rate notes, adding an additional credit component – be it investment grade, high yield, non-agency mortgage or emerging market related – and shading your portfolio in the direction of non-dollar emerging market currencies. Investors shouldn't give their money away, and at the moment, the duration component of a bond portfolio comes close to doing just that – not because a bear market is just around the corner come July 1, but because it doesn't yield enough relative to inflation. Come on frogs, make butter, not someone else's dinner. Buy cheap bonds!

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. Sovereign securities are generally backed by the issuing government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Corporate debt securities are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity.

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