



Pennies from Heaven

Ranking right up there with the myths about Santa Claus and the tooth fairy is the legend that pennies fall from heaven. This can't be true, a priori, because God wouldn't save pennies – nobody does! I know this for a fact because every weekend when Sue and I walk the neighborhood there is a fresh supply just waiting to be picked up on the blacktop. Here a penny, there a penny, everywhere a penny penny. Perhaps, I figure, it rained copper last night instead of H₂O but no, they're just on the street, lying there like a bunch of cigarette butts that someone obviously didn't want to bother with. I will. As a matter of fact Sue and I compete for them. "Just think," she said after beating me to the first on a three penny walk the other day, "there might be twenty or thirty thousand of these just lying around the street in this country right now. Think of all the good luck someone could be having." And that of course is why someone should believe in pennies instead of the tooth fairy. They bring good luck: more than horseshoes, four-leaf clovers, or even betting on birthdates when you're playing Lotto. Very, very lucky!

There's a theory that your luck depends on whether the penny is found heads or tails up. I've never been able to actually correlate that statistically. The competition is so fierce between Sue and I that the position of the penny goes unobserved as we push each other out of the way to be the official finder and therefore dispenser of the day's good luck. When Sue gets there first she rather smugly hands the penny to me for safe keeping – her shorts having no pockets and all. I accept it reluctantly, all the while scouring the area for what might have been a "shower" of copperheads from some nonbeliever the night before.

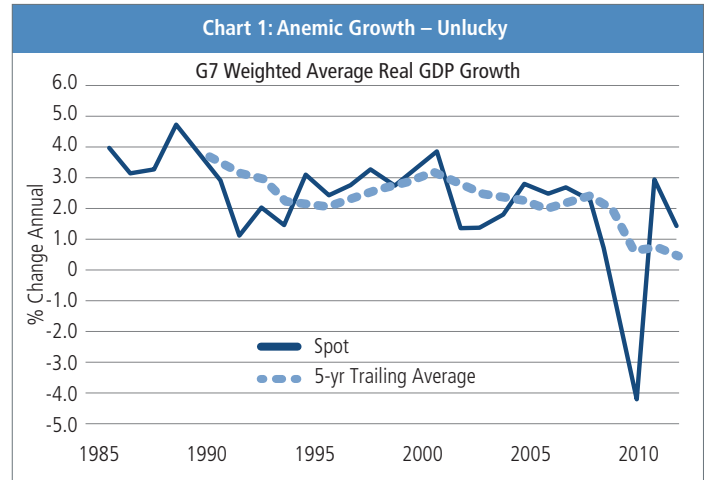
This brings up an interesting question. If someone throws away a penny, is it bad luck? I'm not sure but I'm not risking it in any case. Those "Give a Penny, Take a Penny" containers near your local merchant's cash register should be totally avoided. Giving a penny comes so close to throwing away a penny on the street that it ranks right up there with black cats, cracked mirrors and

walking under ladders. In addition to pennies, I have advice on nickels, dimes and quarters that you might find lying along the road. Don't touch 'em. First and foremost, they don't bring you any luck, and second of all they have billions of germs all over them. I've never been keen on cooties in any form or fashion. I might risk it for pennies, but I'm not about to pick up quarters no matter how profitable. Besides, how could any of you think that silver coated coins would be lying in the street in the first place? According to the efficient market theory, someone must already have picked them up. Find and save pennies. Very... very lucky!

Speaking of luck, the investment question du jour should be "can you solve a debt crisis with more debt?" Penny or no penny. Policymakers have been striving to answer it in the affirmative ever since Lehman 2008 with an assorted array of bazookas and popguns: 0% interest rates, sequential QEs with a twist, and of course now the EU grand plan with its various initiatives involving debt write-offs for Greece, bank recapitalizations for Euroland depositories and the leveraging of their rather unique "EFSF" which requires 17 separate votes each and every time an amendment is required. What a way to run a railroad. Still, investors hold to the premise that once a grand plan is in place in Euroland and for as long as the U.S., U.K. and Japan can play scrabble with the 10-point "Q" letter, then the markets are their oyster. Not being one to cast pearls before swine or little Euroland PIGS for that matter, I would tentatively agree with one huge qualifier: As long as these policies generate growth.

Growth is the elixir that seems to make every ache, pain or serious ailment go away. Sovereign debt too high? Just grow your way out of it. Unemployment rates hitting historical peaks? Growth produces jobs. Stock markets depressed? Nothing a lot of growth wouldn't cure. But growth is the commodity that the world is short of at the moment, as shown in Chart 1. No country has enough of it – not even China – and many of the developed countries (specifically in Euroland) seem to be shrinking into recession.

The lack of growth, as explained in prior Outlooks over the past few years, is structural as opposed to cyclical, and therefore relatively immune to interest rate or consumption



Source: International Monetary Fund

stimulative fiscal policies. 1) Globalization, 2) technological innovation, and 3) an aging global demographic have all combined to dampen policy adjustment post Lehman and will inexorably continue to work their black magic going forward. To defeat this misunderstood structural voodoo, countries would have to mint pennies by the billions, pretend to lose them, and then incredibly find them strewn all across their city streets like some global Easter egg hunt. Not gonna happen.

The situation, of course, is compounded now by high debt levels and government spending that always used to restart capitalism's private engine. However, as economists Rogoff & Reinhart have shown in their historic text, *This Time Is Different*, sovereign debt at 80-90% of GDP acts as a barrier to growth. Because debt service and interest rate spreads start to rise at these debt levels, a greater and greater percentage of a nation's output must necessarily be diverted to creditors who in turn become leery of reinvesting in a slowing economy. The virtuous circle becomes vicious in its reflexive counter reaction, spiraling into a debt/liquidity trap à la Japan's lost decades if not stopped in time.

Halting the downward maelstrom is what current monetary policy is attempting to accomplish. With fiscal policy in most developed countries incredibly restrictive instead of stimulative, central banks have assumed the helm on their own – but it has been a long and relatively futile watch.

Structural growth problems in developed economies cannot be solved by a magic penny or a magic trillion dollar bill, for that matter. **If (1) globalization is precluding the hiring of domestic labor due to cheaper alternatives in developing countries, then rock-bottom yields can do little to change the minds of corporate decision makers. If (2) technological innovation is destroying retail book and record stores, as well as theaters and retail shopping centers nationwide due to online retailers, then what do low cap rates matter to Macy's or Walmart in terms of future store expansion? If (3) U.S. and Euroland boomers are beginning to retire or at least plan more seriously for retirement, why will lower interest rates cause them to spend more?** As a matter of fact, savers will have to save more just to replicate their expected retirement income from bank CDs or Treasuries that used to yield 5% and now offer something close to nothing.

My original question – “Can you solve a debt crisis by creating more debt?” – must continue to be answered in the negative, because that debt – low yielding as it is – is not creating growth. Instead, we are seeing: minimal job creation, historically low investment, consumption turning into savings and GDP growth at less than New Normal levels. The Rogoff/Reinhart biblical parallel of seven years of fat followed by seven years of lean is not likely to be disproven in this cycle. The only missing input to the equation would seem to be how many years of fat did we actually experience? More than seven, I would suggest.

The investment implications are numerous although far from certain. Equity markets should be dominated by dividend yields and the return of capital via share buybacks, as opposed to growth. A market P/E ratio of 15X is actually a 6.5% earnings yield – not a bad return compared to 2% 10-year Treasuries, but actually a little bit short when placed against Baa and High Yield corporate bonds, which represent a senior claim against earnings in a rather uncertain global economic environment.

Despite 2% 10-year Treasuries, low economic growth rates are usually supportive of high quality sovereign debt and they may likely continue to be as long as QEs continue. Investors

should be mindful of the global bond market's most recent historical example of sovereign debt returns in a slow/no growth environment – Japanese JGBs. Even after yields reached relative rock bottom by 2003, bond returns managed to outpace inflation as holders of 5–10 year maturities “rolled down”¹ a relatively steep yield curve and added capital gains to a relatively paltry interest coupon. The same strategy can be conceptualized in the United States. A seemingly anorexic 1.00% 5-year Treasury yield would be turned into a 2% annual return by allowing it to “age” for 12 months and become a .75% 4-year with an assumed attendant 1% upward price movement. Sort of like finding a lucky penny – but dependent of course on a Fed policy that shows no sign of moving off the 25 basis point goal line.

One should not stray too far, however into Japanese la-la bond land. Developed economies – the U.S. included – have experienced 3%+ inflation in the midst of a New Normal economy where expectations 12 months ago would have been for far less. Sovereign monetary and fiscal policies, while generating undersized real growth, have managed to produce disproportionately large inflation. While “output gaps” represented by high unemployment might normally contain the rise, it has not done so to date. The answer might be found in the narrow output gap in developing economies and the transmittal of their inflation back into the U.S., U.K. and Euroland.

My point on the bond side is not to discourage the ownership of fixed income assets despite the relatively low expected returns, but to suggest that portfolios should avoid longer dated issues where inflation premiums dominate performance. Despite the Fed's twist program, which promises to absorb almost all 20-30 year supply over the next 6 months, future QE programs hinted at by Yellen and Dudley – two of the three Fed Musketeers – are likely to push long-term yields higher because their policy objective is 2%+ inflation. Investors should consider migrating to the relatively safe haven of 1–10 year maturities offering “roll-down” total returns of 2–3% with far less duration risk. In addition, Agency mortgages are back on the Fed's menu and may be a featured “special” in months to come.

In sum, with both earnings and bond yields near historic lows as a result of a lack of real growth in developed economies, investors will need to find lots of pennies to produce asset returns much above 5% in bonds or equities. Pension funds, Washington politicians, and indeed Main Street investors are likely expecting much more. One of the big problems of an asset-based economy is that once interest rates inch close to zero and discounted future cash flows are elevated in price, it's difficult to generate much more if economic growth doesn't follow. Such appears to be the case today. Unlucky...very, very unlucky.

William H. Gross
Managing Director

¹ Roll return can occur when a yield curve is steeply sloped. In the absence of any changes in the curve, as a security is held over time its maturity will decrease and the yield (as read off the curve) will change. If the slope is positive, the yield will decrease and the security's price will increase.

A word about risk:

Past performance is not a guarantee or a reliable indicator of future results. All investments contain risk and may lose value. Certain U.S. Government securities are backed by the full faith of the 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. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. 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. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not.

This material contains the current opinions of the author but not necessarily those of PIMCO and such opinions are subject to change without notice. This material has been distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission. ©2011, PIMCO.

PIMCO advised funds are distributed by PIMCO Investments LLC.
Investment Products

Not FDIC Insured | May Lose Value | Not Bank Guaranteed

Newport Beach Headquarters
840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Amsterdam

Hong Kong

London

Munich

New York

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com/investments

P I M C O