There Will Be Haircuts

“Good as Money,” proclaimed the ad for Twenty Grand Vodka infused with Cognac. Being a beer drinker, and never having cashed in a Budweiser to pay for a fill-up at the local gas station, I said to myself “Man, that must be really good stuff!” Even in a financial meltdown I thought, you could use it in place of cash, diamonds, gold or Bitcoins! And if the Mongol hordes descend upon us during a future revolution, who wouldn’t prefer a few belts of Twenty Grand on the way out, instead of some shiny rocks and a slingshot?

Well, not being inebriated at that moment I immediately shifted focus to a more serious topic. What IS money? A medium of exchange and a store of value is a rather succinct definition, but we generally think of it as cash or perhaps checks that reflect some balance of “ready” cash at a friendly bank. Yet as technology and financial innovation have progressed over the past few decades, and as central banks have tenuously validated the liquidity and price of various forms of credit, it seems that the definition of money has been extended; not perhaps to a bottle of Twenty Grand Vodka, but at least to some other rather liquid forms of near currency such as money market funds, institutional “repo” and short-term Treasuries “guaranteed” by the Fed to trade at par over the next few years.

All of the above are close to serving as a “medium of exchange” because they presumably can be converted overnight at the holder’s whim without
loss and then transferred to a savings or checking account. It has been the objective of the Fed over the past few years to make even more innovative forms of money by supporting stock and bond prices at cost on an ever ascending scale, thereby assuring holders via a “Bernanke put” that they might just as well own stocks as the cash in their purses. Gosh, a decade or so ago a house almost became a money substitute. MEW – or mortgage equity withdrawal – could be liquefied instantaneously based on a “never go down” housing market. You could equitize your home and go sailing off into the sunset on a new 28-foot skiff on any day but Sunday.

So as long as liquid assets can hold par/cost with an option to increase in price, then these new forms of credit or equity might be considered “money” or something better! They might therefore represent a “store of value” in addition to serving as a convertible medium of exchange. But then, that phrase “Good as Money” on the vodka bottle kept coming back to haunt me. Is all this newfangled money actually “money good?” Technology and Fed liquidity may have allowed them to serve as modern “mediums of exchange,” but are they legitimate “stores of value?” Well, the past decade has proved that houses were merely homes and not ATM machines. They were not “good as money.” Likewise, the Fed’s modern day liquid wealth creations such as bonds and stocks may suffer a similar fate at a future bubbled price whether it be 1.50% for a 10-year Treasury or Dow 16,000.

But let’s not go there and speak of a bubble popping. Let’s perhaps more immediately speak about current and future haircuts when we question the “goodness of money.”

Carmen Reinhart has said with historical observation that we are in an environment where politicians and central bankers are reluctant to allow write-offs: limited entitlement cuts fiscally, no asset price sink holes monetarily. Yet if there are no spending cuts or asset price write-offs, then it’s hard to see how deficits and outstanding debt as a percentage of GDP can ever be reduced. Granted, the ability of central banks to avoid a debt deflation in recent years has been critical to stabilizing global economies. And too, there have been write-offs, in home mortgages in the U.S., for example, and sovereign debt in Greece. But the cost of these strategies, which avoid what I simplistically call “haircuts,” has been high, and their ability to reduce overall debt/GDP ratios is questionable. Chairman Bernanke has admitted that the cost of zero-bound interest rates, for instance, extracts a toll on pension funds and individual savers. Some of his Fed colleagues have spoken out about the negative aspects of QE and future difficulties of exit strategies should they ever take place. (They won’t!) So current policies come with a cost even as they act to magically float asset prices higher, making many of them to appear “good as money” – shots of vodka notwithstanding.

But the point of this Outlook is that even IF... even IF QEs and near zero-bound yields are able to refloat global economies and generate a semblance of old normal real growth, they will do so utilizing historically tried and true “haircuts” that rather surreptitiously “trim” an asset holder’s money without them really knowing they had entered a barbershop. These haircuts are hidden forms of taxes that reduce an investor’s purchasing power as
manipulated interest rates lag inflation. In the process, governments and their central banks theoretically reduce real debt levels as well as the excessive liabilities of levered corporations and households. But they represent a hidden wealth transfer that belies the vaunted phrase “good as money.”

Before drinking up, let's examine these haircuts to see why they do not represent an authentic store of value even if their bubbly prices never pop. I will give each haircut a symbolic name – I welcome your suggestions as well via e-mail reply: outlook@pimco.com

(1) **Negative Real Interest Rates – “Trimming the Bangs”**

During and after World War II most countries with high debt overloads resorted to artificially capping interest rates below the rate of inflation. They forced savers to accept negative real interest rates which lowered the cost of government debt but prevented savers from keeping up with the cost of living. Long Treasuries, for instance, were capped at 2½% while inflation was soaring towards double-digits. The resulting negative real rates together with an accelerating economy allowed the U.S. economy to lower its Depression-era debt/GDP from 250% to a number almost half as much years later, but at a cost of capital market distortions.

Today, central banks are doing the same thing with near zero-bound yields and effective caps on higher rates via quantitative easing. The Treasury's average cost of money is steadily grinding lower than 2%. If current policies continue to be enforced in future years it will eventually be less than 1% because of the inclusion of T-bill and short maturity financing. **The government’s gain, however, is the saver’s loss. Investors are being haircutted by at least 200 basis points judged by historical standards, which in the past offered no QE and priced Fed Funds close to the level of inflation.** Large holders of U.S. government bonds, including China and Japan, will be repaid, but in the interim they will be implicitly defaulted on or haircutted via negative real interest rates.

Are Treasuries money good? Yes. But are they good money? Most assuredly not, when current and future haircuts are considered. These rather innocuous seeming (-1%) and (-2%) real rate haircuts are not a bob or a mullet in hairstyle parlance. More like a “trimming of the bangs.” But at the cut’s conclusion, there’s a lot of hair left on the floor.
(2) Inflation / Currency Devaluation – the “Don Draper”

Inflation’s sort of like your everyday “Mad Men – Don Draper” type of haircut. It’s been around for a long time and we don’t really give it a second thought except when it’s on top of a handsome head like Jon Hamm’s. 2% ± a year – some say more – but what the heck, inflation’s just like breathing air … you just gotta have it for a modern-day levered economy to survive. Sometimes, though, it gets out of control, and when it is unexpected, a decent size hit to your bond and stock portfolio is a possibility. If our TV idol Don Draper lives another decade or so on the airwaves, he’ll find out in the inflationary 70s. Such was the example as well in the Weimar Republic in the 1920s and in modern day Zimbabwe with its One Hundred Trillion Dollar bill shown below. As central banks surreptitiously inflate, they also devalue their currency and purchasing power relative to other “hard money” countries. Either way – historical bouts of inflation or currency devaluation suggest that your investment portfolio may not be “good as the money” you might be banking on.

(3) Capital Controls – the “Uncle Sam Cut”

Uncle Sam with his rather dapper white hair and trimmed beard serves as a good example for this type of haircut, if only to show that even the U.S. can latch on to your money or capital. Back in the 1930s, FDR instituted a rather blatant form of expropriation shown above. All private ownership of gold was forbidden (and subject to a $10,000 fine and 10 years in prison!) if it wasn’t turned into the government. Today we have less obvious but similar forms of capital controls – currency pegging (China and many others), taxes on incoming capital (Brazil) and outright taxation/embargos.
of bank deposits (Cyprus). Governments use these methods to keep money out or to keep money in, the net result of which is a haircut on your capital or your potential return on capital. Future haircuts might even include a wealth tax. Are gold and/or AA+ sovereign bonds good as money? Usually, but capital controls can clip you if you’re not careful.

(4) Outright Default – the “Dobbins”
Ah, here’s my favorite haircut, and I’ve named it the “Dobbins” in honor of this 5-year bond issued in the 1920s with a beautiful gold seal and payable, in dollars or machine guns! Bond holders got neither and so it represents the historical example of the ultimate haircut – the buzz, the shaved head, the “Dobbins.” As suggested earlier, the objective of central banks is to prevent your portfolio from resembling a “Dobbins.” I have tweeted in the past that the Fed is where all bad bonds go to die. That is half figurative and half literal, because central banks are typically limited from purchasing bonds payable in machine guns or subprime mortgages (there have been exceptions and Bloomberg reported that nearly 25% of global central banks are now buying stocks believe it or not)! But by purchasing Treasuries and Agency mortgages they have rather successfully incented the private sector to do their bidding. This behavior reflects the admission that modern-day developed economies are asset-priced supported. Unless prices can continuously be floated upward, defaults and debt deflation may emerge. Don’t buy a Dobbins bond or a Dobbins-like asset or a bond from a country whose central bank is buying stocks. They probably aren’t “good as money!”

Investment Strategy
So it seems as if the barber has you cornered, doesn’t it? Sort of like Sweeney Todd! Let’s acknowledge that possibility, along with the observation that all of these haircuts imply lower-than-average future returns for bonds, stocks, and other financial assets. If so, the rather mixed metaphor of “money’s goodness” and “avoiding haircuts” is still the question of our modern investment age. The easiest answer to the question of what to buy is to simply take your ball and go home. If the rules aren’t fair, don’t play. That endgame however, results in a Treasury bill rate of 10 basis points or a negative yield in Germany, France and Northern
EU markets. So a bond and equity investor can choose to play with historically high risk to principal or quit the game and earn nothing. PIMCO’s advice is to continue to participate in an obviously central-bank-generated bubble but to gradually reduce risk positions in 2013 and perhaps beyond. While this Outlook has indeed claimed that Treasuries are money good but not “good money,” they are better than the alternative (cash) as long as central banks and dollar reserve countries (China, Japan) continue to participate.

The same conclusion applies to credit risk alternatives such as corporate bonds and stocks. Granted, this sounds a little like Chuck Prince and his dance floor metaphor does it not? His example proved that dancing, and full heads of hair are not forever. So give your own portfolio a trim as the year goes on. In doing so, you will give up some higher returns upfront in order to avoid the swift hand of Sweeney Todd. There will be haircuts. Make sure your head doesn’t go with it.

**Quick Read**

1) Central banks and policymakers are acting like barbers. They **haircut** your investments.

2) Negative real interest rates, inflation, currency devaluation, capital controls and outright default are the barber’s scissors.

3) Gradually reduce duration, risk positions and “carry” as the year proceeds.

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