PIMCO

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Investment Outlook

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ACHOO !

There's nothing like a good sneeze; maybe a hot shower or an ice cream sandwich, but no – nothing else even comes close. A sneeze is, to be candid, sort of half erotic, a release of pressure that feels oh so good either before or just after the Achoo! The air, along with 100,000 germs, comes shooting out of your nose faster than a race car at the Indy 500. It feels sooooo good that people used to sneeze on purpose. They'd use snuff and stick it up their nose; the tobacco high and the resultant nasal explosion being the fashion of the times. Healthier than some of the stuff people stick up their nose these days I suppose, but then that's a generational thing. My generation is closer to the snuff than that other stuff.

One of the problems with sneezing though is that there can be an embarrassing aftermath. People in the old days used to carry around handkerchiefs for just that purpose, but now nobody carries a handkerchief. As a substitute you could walk around all day with toilet paper in your pocket, but then you'd stand accused of being a bumpkin and people would probably be right. So usually sneezers just let it rip, cover with their hand, and pray there's nothing visible behind it. If there is, there might be a pocket to wipe away the evidence, at least for guys like me. Ladies? Their outfits are obviously less sneeze proof. So they need to pray harder.

Speaking of praying, there's just no stopping people from saying "God bless you" or "bless you" for short. If you're in a crowded room with more than 50, the "God bless you's" sort of create a rather constant cacophony like the communion line at a Catholic church. The shorter and more frequently used "bless you" though, may take the religion out of it somewhat and make it ok for atheists to sneeze and still get noticed. Actually, way back when, there was a legitimate purpose for the "God bless you" part. Lots of people died from influenza and associated epidemics and God's blessing would certainly have come in handy. My wife Sue though, is just a "bless you" person like many of you readers. I am not, which I hope is ok, except that it sort of makes it awkward when we both sneeze at the same time. I get blessed and she doesn't. Not quite fair I suppose, so sometimes I play along and squeeze her hand after the Achoo and tell her I'm blessed to have her – sneeze or no sneeze. Don't even need a pinch of snuff to know that's a good move.

The old saying goes that when the U.S. economy sneezes, the world catches cold. That still seems to be true enough, although Chinese influenza is gaining in importance. If both sneezed at the same time then instead of "God bless you" perhaps someone would cry out "God have mercy." We're not there yet, **although in this period of high leverage it's important to realize that the price of money and the servicing cost of that leverage are critical for a healthy economy**. The Great Recession occurred significantly as a result of central banks raising the price of credit too high in the face of households and levered speculators who eventually could not afford to pay the increasing interest rate tab. As defaults on U.S. subprime mortgages and high yield bonds began to mount, lenders not only refused to lend more but were forced to liquidate levered holdings, producing a literal run on the "Bank of Credit" which in the U.S. now totals an estimated 75-85 trillion dollars.

As the Fed raised short-term rates to 5¼% in 2004/2006 they were following a historically standard model that followed the thesis of flattening the yield curve, making credit more expensive, and slowing the economy in order to moderate inflation. The 5¼% destination was in part determined by what was and still is known as the Taylor Rule as well as a rather practical assumption that short-term rates approaching the rate of nominal GDP growth had usually been the ultimate destination in a tightening cycle. What the Fed failed to factor in was the increasing amount of leverage in the system that could no longer tolerate standard Taylor/nominal GDP rules of monetary policy.

I bring up this history to illustrate the problem that not only the Fed but all central banks face in this new epoch of high leverage. High debt levels don't necessarily change the rules of finance (you gotta pay to play), but the models upon which they are based. **Interest rates have to be lower in a levered economy so that debtors can survive, debt can be reduced as a % of GDP, and economies can avoid recessions/depressions!** In a levered landscape, what is the magical "neutral" policy rate that can do all of that? Hard to know. No wonder the Fed and other central banks stumble along with QEs and Twists, extended periods of time, magical blue dots, and other potions and elixirs to try and produce a favorable outcome.

Despite the uncertainty and the recent importance of historical models using unemployment as a practical guide, there has been research that might point to a proximate neutral fed funds rate. Thomas Laubach and John Williams working for the Fed Board of governors wrote an early 2003 piece titled "Measuring the Natural Rate of Interest." Their updated model from the San Francisco Fed website suggests the **"neutral nominal fed funds rate" might be as low as 50 basis points currently and 150 basis points assuming 2% PCE inflation in the future.** Others, such as Bill Dudley, President of the New York Fed, gave an important speech in May of 2012 suggesting a "neutral real rate" close to 0% which would imply a 200-basis-point nominal rate if the Fed's inflation target was hit. PIMCO's Saumil Parikh in a March 2013 "Asset Allocation Focus" concluded that a 100-basis-point or a 1% nominal fed funds rate was long-term neutral – stabilizing inflation at 2% and nominal GDP growth close to 5%.

These estimates are just that – approximations of a neutral policy rate in a New Normal economy burdened by high debt leverage and other structural headwinds such as globalization, aging demographic influences, and technology. But I suspect these estimates which average less than 2%, are much closer to financial reality than the average, 4% "blue dot" estimates of Fed "participants," dismissed somewhat by

Fed Chair Janet Yellen herself last month. Why is this academic "Fed Fight" important to markets? **Well, if a bond investor knew whether 4% or 2% was the long term neutral policy rate, he/she would literally have the key to the kingdom.** Forward markets now anticipate a 4% nominal policy rate sometime out in 2020. **If the neutral policy rate was 2% instead of 4% then bonds instead of being artificially priced, would be attractively priced.** Instead of facing a nearly 100% certain bear market currently forecast by market mavens, bond investors could draw some comfort from a low returning yet less volatile future. Bonds would shed the "certificates of confiscation" label for yet another decade or so, as this 2% neutral policy rate delevered the economy without igniting inflationary fears.

At PIMCO, we believe that this focus on the future "neutral" policy rate is the critical key to unlocking value in all asset markets. If future cash returns are 2% (our belief) instead of 4%, then other assets such as stocks and real estate must be assumed to be more fairly priced as well. Current fears of asset bubbles would be unfounded. A 2% neutral policy rate, however, is not a "win/win" for investors. It comes at a price – the cost being a financial future where asset returns are much lower than historical levels. When you think about it, savers would much prefer to receive a 4% yield on their savings than a 2% rate. No-brainer there. But the journey to 4% would be much bumpier and "bear market" would be an apt description of the next half-decade. That is what the Fed is trying to avoid, but in the process they "financially repress" markets, offering a "Yellen put" but distributing low asset returns as a result. Potentially 2% instead of 4% for cash; maybe 3% instead of 5% yields for 10-year Treasury bonds; 4% returns instead of 5–7% for stocks; financial repression ultimately is not an investor's friend, because it lowers returns on cash and all other financial assets.

So you say you need more? Join the club. Most pension funds assume 7–8% total returns in order to fund future retirement liabilities. Investors want their "cake," priced at current market prices, but they want to "eat" future returns of near double-digits. That won't happen with a 2% neutral policy rate. Still there are ways to fight back – most of which involve taking different risks than you may be commonly used to taking: alternative assets, hedge funds, levered closed-end funds, a higher proportion of stocks vs. bonds in a personal portfolio. Portfolio managers at PIMCO who understand this can also transform a total return bond portfolio into a higher returning asset. All of these alternatives are potentially higher returning assets in a world of 2% policy rates where cash is a poor performing asset, but likewise a cheap liability that can be borrowed to an investor's advantage. Look to PIMCO for your common cold solution. If you sneeze, we'll just squeeze your hand and tell you we are blessed to have you. Hopefully vice versa. Don't need a pinch of snuff to know that.

Achoo Speed Read

1) Future "neutral" policy rate is critical for all asset values.
2) Current Fed "participants" believe 4% is the neutral rate.
3) PIMCO believes 2% neutral is closer to the mark.
4) If so, asset markets are not bubbly, just low returning.
5) Look to different areas of risk taking if you need higher returns.
6) Bring a handkerchief in any case.

Achooooooo!

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