PIMCO

Your Global Investment Authority

Investment Outlook

August 2014

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Goodnight Vietnam

It was a matter of happenstance I suppose – certainly not serendipity. Our meeting may have been an inevitable coming together, but it was certainly not initially welcomed by me. Happenstance is the better word. Fateful happenstance.

Serendipity rarely happens in a cab and it was in a San Francisco cab – not an Uber – where I confronted my ancient past. Sue and I were headed back to the Four Seasons after a brief glimpse of the city at dusk from the "Top of the Mark." The driver appeared to be Vietnamese, and having had a margarita or two, I unfortunately stumbled into the emotional jungles of Vietnam to which I had come, and from which I had safely departed nearly a half century ago. "You're Vietnamese," I said, "how old are you?" "53," he said. "I grew up in Da Nang and escaped when I was 8 with my mother, after my father and older brother were killed." I subtracted 8 from 53 and quickly placed him in Vietnam at the same time I had been, in 1969. "Have you ever been there?" he queried. "Well yes," I stuttered, "about the time you left, but I was in the Navy" – an excuse that supposedly cleared me of direct involvement, but in reality was not the case. An awkward silence followed. I wanted to say, "I'm sorry for what we did. I/we shouldn't have been there." I desperately wanted to say that. But I didn't. I missed my moment of atonement and we continued on to the hotel. Getting out I gave him a $20 bill for an $8 fare – a weak apology to be sure, and he knew it. "No," he said, "that is too much, take back 5 dollars." I did – apology accepted – flawed as it was. He and his mother had survived and moved on. Perhaps I have too. "Goodnight," I said. Goodnight Vietnam ….

Don't say "goodnight," but say "good evening" to the prospect of future capital gains in asset markets. Investors won't be getting much of them. Financial markets have had nearly a half century of peaceful (sometimes volatile) asset appreciation fueled particularly by the decline in real and nominal interest rates from 1981 onward. We know that bond prices go up when interest rates go down, but somehow have to be reminded of a similar effect on stocks, real estate and commodities. Almost all commonsensical and historical financial models tell us interest rates are a key asset price driver.

But now – and since 2012 – we have reached the beginning of the end just as I did in 1969 – the dusk of asset appreciation – because it has lost its primary interest rate driver. And after nearly 5 years of U.S. near-zero percent policy rates and global quantitative easing, which have seen the Fed's balance sheet – to name one – expand by nearly 4 trillion dollars, and those of the BOJ and the BOE increase proportionately more, the global economy is left to depend on economic growth for further advances, and it is growth that is now and has recently been historically deficient. At PIMCO, Paul McCulley recently reminded us that **structural global growth rates have come down due to a yawning gap of aggregate demand relative to aggregate supply. Economist speak, I suppose (and he's a good one), for not enough willing or able consumers: 1) they have too much debt, 2) Boomers are getting older, 3) workers are outdated and outjobbed by technology, and 4) labor is overwhelmed by corporations with the power to contain wages at a lower rate than topline increases. Demand is deficient because consumers are experiencing their own Vietnam from a multitude of directions**.

So as yields have bottomed and are now expected by the markets to gradually rise, it's down to growth, and growth is a question mark. The U.S. for sure is near the top of the "more certain" list, but 2% real growth since the Great Recession is nothing to brag about. It would have been a bare minimum expectation back in 2010. Elsewhere, an investor not only has to wonder, but perhaps retreat from the lack of growth sunshine. South America is in virtual recession with its big three – Brazil, Argentina, and Venezuela – approaching lockjaw conditions of one sort or another. Euroland is above water, but floating on water wings with peripheral country unemployment (Spain, Portugal, Italy) averaging close to 20% – unprecedented except for the 1930s. Russia is retreating for geopolitical reasons. And Japan/China are supported only by credit creation of a magnitude that reminds one of Minsky, or Ponzi, or Potemkin with his mythical villages of growth due to paper, not productivity. Where is the growth? The world as McCulley correctly analyzes it, is demand deficient and supply rich.

Asset price growth therefore – capital gains in market speak – will be harder to come by. Without the tailwind of declining interest rates which have increased profit margins as well as decreased cap rates, they will instead face structural headwinds**. Let me be clearer though – clearer than I was to my Vietnamese friend. PIMCO is not saying that asset prices will go down – they just won't go up as much as many expect. And income – not capital gains – will be the dominant driver of future returns. "Good evening," capital gains. "Good morning," more dependable income – even in this age of artificially low interest rates.**

Our reasoning for the continuation of an artificially priced global asset market that may be neither bear nor bull rests with our New Neutral interest rate template. If global policy rates eventually rise, but go up less than currently expected, then asset prices and P/Es can be better supported. **PIMCO believes "Old Neutral" policy rates of 2% real and 4% nominal are out. The New Neutral policy rates (U.S.) of 0% real and 2% nominal are likely to be in. The Taylor Rule – is out. PIMCO's Clarida (Rich) Rule – is in. How so? Because a levered global economy can only stand so much. Because a demand deficient global economy requires an extended period of low interest rates in order to maintain minimum levels of consumption. Because a low growth global economy in many cases is closer to deflation than inflation. Because, because, because.**

What to do as an investor? First of all, reduce expectations. Second of all, do not reach for assets outside of your risk universe. Most of all, recognize that alpha generation in a capital gains deficient, income-oriented, low total return environment is more critical than ever. 100 basis points of excess return with near similar Sharpe/information ratios is all the more valuable in a 4–5% low-returning asset world. This is where PIMCO shines. Look to our bottom-up credit analysis. Check out our selected income diversifiers in strategic asset categories. Follow our top-down macro template à la McCulley/Clarida/and our revitalized PIMCO

Investment Committee. Not a promise, but a decent bet. We've done it for 40 years, and we're doing it in 2014. Just check the numbers, not the headlines.

As to specific strategies, we believe high quality Treasury and corporate bonds are fairly priced, but not cheap. Our typical durations are at index levels. We believe the yield curve will gradually flatten, but not in historical cyclical proportions. We believe credit spreads are tight, but may stay there. We still believe the Fed will be on hold until mid-2015 and will hike only gradually to our New Neutral 2% by 2017. We think investors should own bonds, and an average proportion of stocks too.

As we exited our cab at the Four Seasons, my Vietnamese friend seemed to want our conversation to go on and on. "How is it that we have come to this place 45 years on," he seemed to be asking? "Why is it that we are now at peace, instead of war? And why did you come in the first place?" Happenstance, I suppose, not serendipity. I never responded to the quizzical look on his face; a missed opportunity. Ours was not necessarily a happy goodbye nor was the extra tip an appropriate apology. But there seemed to be an acceptance and a mutual hope for a peaceful future. A new epoch, just like the one for global investment markets.

Goodnight Vietnam Speed Read

1) Global growth rates will stay low due to a lack of aggregate demand and a continuing surfeit of supply.

2) Capital gains from almost all asset classes are approaching dusk. Low but relatively dependable income will be the market's future driver.

3) PIMCO currently has indexed durations, a belief in a flattening but still historically steeper global curve, and credit positions that are mildly overweight.

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