



Seventh Inning Stretch

They say that reality is whatever you wish it to be and I suppose that could be true. Just wish it, as Jiminy Cricket used to say, and it will come true. Reality's relativity came to mind the other day as I was opening a box of Cracker Jacks for an afternoon snack. That's right – I said Cracker Jacks! I can't count the number of people who have told me during the seventh inning stretch at a baseball game to make sure I sing Cracker Jack (without the S) because that's what the song says. I care not. No one ever says buy me some "potato chip" or some "peanut." How about a burger and some "french fry?" In all cases, the "s" just makes it flow better. My reality is a box of Cracker Jacks, and I think little sailor Jack on the outside of the box would be nodding his approval if he could ever come to life, which maybe he can if the stars are aligned and reality is whatever we wish it to be.



Having mentioned Jack and the game of baseball, let me give you some opinions that come close to being hard cold facts, not wishes. First of all, baseball is the most boring game in the world next to cricket. I don't know how to play cricket, which is the only reason I rank it second. CNN Sports did an actual survey of how much time during an average two hour and 39 minute game that baseball players are actually moving – you know, swinging a bat or running to first base. Five minutes and 13 seconds! The rest of the time the boys of summer are actually just standing around, scratching you know where, and spitting tobacco juice onto the nice green grass. Most disgusting, I'd say. And why, I wonder, does a baseball "season" consist of 162 individually boring games? In football you only need 16 or so to declare a champion, in boxing sometimes three minutes or less.

Now for some controversy: steroids, HGH and juicin'? I say, why not. They can't be cheating if they're all cheating together. And as a matter of fact, management and owners "cheat" all the time. If they have a lineup heavy with left-handed hitters, they will shorten the right field fence. The Yankees and now the Dodgers

just “buy” championships with money from the game’s most gargantuan TV rights (who’s watching?). That’s playing by the rules? If your counterpoint on drugs is that it’s unnatural and harmful to the body, I wonder what’s so healthy about the way they conduct spring training or do their pregame warm-ups. Two or three half-hearted sprints in the outfield and they’re done. If baseball was concerned about health or addiction, they’d be testing for lip cancer or diabetes. Modern day relief pitchers, who now “exercise” for two innings or less on the mound, have pot bellies that would make a sumo wrestler proud. Why, the Babe was so fat he could hardly waddle back around to home plate 60 times in one season.

Last point, because I know you’re dying to hear my opinion on Pete Rose and the Hall of Fame. I say anyone as ugly as Pete deserves a free pass to Cooperstown or any town for that matter, maybe the same free pass that you’d have to give me to go to a baseball game again. Take me anywhere, but don’t take me out to the ball game and make me stretch during the seventh inning while I’m eating my Cracker Jacks. Reality can smack you in the face sometimes, like it did Pete Rose, but if I’m gonna be smacked it’ll have to be on the gridiron or the hardwood, not Yankee Stadium.

Life’s ballgame ended several decades ago for Hyman Minsky, author of *“Stabilizing an Unstable Economy”* and proponent of the notion that capitalism is inherently unstable, in part because of the short term financing of long term capital assets such as bonds, buildings, plant and equipment. His stabilizing solution was for Big Bank and Big Government to intercede with monetary and fiscal pump priming, confident in the notion that if the priming was large enough and the pumping fast enough, that stability could at least be temporarily achieved. Yet Minsky played ball in another era, before steroids and corked bats. He legitimately could not foresee the time when what he labeled “Big Bank” and “Big Government” became so large and stimulation so excessive that even temporary stability of a closed or an evolving global economy would be difficult to attain.

Over these five post-Lehman years, financial markets have grown leery of the medicine Dr. Minsky recommended to calm the symptoms, if not the disease, of capitalistic excess. During a crisis, Minsky’s solution was for Big Government to generate substantial fiscal deficits which in turn would stabilize corporate profits, financial asset prices and ultimately the real economy. In turn, and concurrently, he advocated the growth of Big Bank, by

which he meant the ability of a central bank to lower interest rates and reserve requirements in order to stimulate private lending via the monetary channel. In combination, and if large enough, the two could stabilize asset prices and eventually produce an “old normal” 3–4% real growth rate in developed and presumably developing economies too. We have lived in a Minsky-based policy world for some time now, but unfortunately in a “New Normal” world of lower economic growth.

What perhaps Minsky couldn’t conceive of was the point at which debt, deficits and interest rates would go to such extremes that the creation of credit itself, which was and remains the heart of capitalism, would be threatened. No longer might the seventh inning stretch lead to a Coke, some “Cracker Jacks” and the resumption of the old ballgame. Instead, zero-bound interest rates and debt/GDP ratios in a majority of capitalistic economies would begin to threaten, not heal, the nature of finance and investment in the real economy. Investors, leery of not only overleveraged investment banks such as Lehman Brothers, but overextended countries such as Greece, Cyprus and a host of Euroland lookalikes would derisk as opposed to rerisk as per the Minsky model. As well, with interest rates close to the zero bound, investors in intermediate and long term bonds would become dependent on Big Bank to do their bidding. When that QE buying power became jeopardized via tapering and the eventual ninth inning conclusion of asset purchases, then the process of maturity extension and the terming out of historically modeled corporate lending was prematurely threatened.

In short, and in too-abbreviated summation, debt-laden economies with near-zero-bound interest rates became victims of their own excess, a condition that was more difficult to stabilize cyclically because Big Government and Big Bank had reached limits, and private market investors with huge portfolios of their own began to leave the ballpark early. Why stick around if your team is down by seven runs with only a few innings left? Why invest in financial or real assets if bond prices could only go down, and/or stock prices could no longer be pumped up via the artificial steroids of QE?

The rush for the exits seems to have been hastened recently not only by the increasingly obvious limitations of Big Government and Big Bank but by the additional knock-on effects of Big Investor and Big Regulation. The regulatory aspect is not hard to

see. Having threatened the global economy with endogenously generated financial leverage, banks are under the government thumb to recapitalize and derisk from a multitude of directions including Basel III, SEC fines and criminal investigations, as well potential transaction taxes in Euroland, to name a few. While this response would have been typical in an historical Minsky model of normal economic recoveries, it is now no doubt excessively so, if only because of the enormity of the Great Recession itself. Whatever the cause, the duration of regulatory restraint, while long term beneficial, has been short to intermediate term negative for “stabilizing an already unstable economy.”

An analysis of “Big Investor” is a little more complicated, if only because there are a multitude of “structural” investors with varied and in many cases dissimilar interests. Our “unstable global economy” for instance has produced a number of developing (China, Brazil, India, South Africa to name a few) and developed economies (Japan to name one) that run substantial trade deficits or surpluses that give rise to the artificial pricing of currencies and/or government debt. As these imbalances raise concerns domestically or amongst international investors, the quickened pace of bond purchases or liquidation creates an unstable as opposed to a stable financial foundation. Minsky, I fear, would be appalled, if only because Big Government and Big Bank cannot now be coordinated in an open global as opposed to a closed domestic economy. “Technical” considerations involving trillions of dollars of financial flows are now dominating fundamentals in many markets.

But Big Investor is now influenced not just by public and sovereign entities but by an enormously expanded private market with liquid alternatives and choices. Call it pension-related or institutional severance monies. Call it retail, call it Mom & Pop with their 401(k)s, but they all have a host of choices at today’s ballpark snack bar. Bonds, stocks, cash – emerging/developed – euros, dollars, pesos. Sounds like a good game to play, does it not? The problem is that as Big Government, Big Bank and Big Regulation begin to tighten their purse strings and the risk budgets of their constituent vassals, then the liquidity to choose amongst a varied menu of assets becomes more limited. At the extreme, Mom & Pop have only themselves to buy from or sell to. When policymakers say so long to QE, and investment banks are no longer able to inventory large blocks of stocks and bonds, then historical liquidity is challenged. ETFs and mutual funds, once energized by

excessively generous fiscal and monetary policies, have only themselves to sell to. At the extreme, the new game is now played in a Pogo ballpark, with the enemy, the opponent, the buyer of last resort being “us” as opposed to “them.” Minsky’s hoped-for stability, if only temporary, falls short because Big Government and Big Bank are now much smaller than historical proportions in an economy dominated by private funds or individual country flows.

So what to do here, folks? For those of you who are still fans of the old American pastime – in this case capitalism and the making of money as opposed to baseball – how do you play on this rather unstable field of our own making? Which pitch do you swing at? Well, commonsensically, in an unstable global economy that is increasingly difficult to stabilize, an investor should seek out the most stable of assets. At the extreme, that would be cash in the world’s most stable currency. But whether dollars, euros, or pounds be your first choice (ours being dollars), cash or overnight deposits in any of them yield next to nothing. So say you want something but don’t want to lose your money either; a modern day Will Rogers. More concerned about the return of your money than on your money but still a little greedy (or perhaps just needy) too. Well, some say stocks – the only game in town. But I don’t know. When the Fed stops the QE game, it seems that stocks might be at risk. After all, haven’t they more than doubled in price since 2009 in part because of it? Without Big Government deficits and Big Bank check writing and with the advancing risks posed by Big Regulation and the technical whimsy of Big Investor, the safest pitch to swing at may not be stocks but the asset that will soon be the nearly sole focus of central banks. Instead of QE, central bankers are shifting to “forward guidance” which, if reliable, allows financial markets and real economies to plan several years forward in terms of financing rates and investment returns. If unemployment and inflation rates can be at least closely guesstimated, then front-end yields become the most reliable bet in the ballpark, Pete Rose notwithstanding. While low, they can at least form the basis for curve rolldown and volatility strategies that have higher return/risk ratios than alternative carry options such as duration, credit or currency. With Big Investor unsure or perhaps unable to catch stock, long bond or currency fly balls in today’s afternoon sun, it’s perhaps best to field boring slow-rolling grounders based on policy rate stability for “an extended period of time.” Recall as well that the result of Minsky’s “Big Government” and “Big

Bank” policies has always been accelerating inflation at some future time. We recommend longer-dated TIPS as insurance against just such an outcome.

Baseball’s old saw pleads to “buy me some peanuts and Cracker Jack, I don’t care if I never get back.” Jack or Jacks aside, getting back to the old normal Minsky world of stabilization via Big Government and Big Bank is now being challenged, as are the investment choices and future returns dependent on them. Grab for the prize at Jack’s bottom if you will, but the safer and perhaps most rewarding treat lies at the top with those front-end yields and inflation-protected securities based on our evolving age of central bank “forward guidance.” I have a hunch that even Pete Rose would bet on this one.

Seventh Inning Speed Read

- 1) Hyman Minsky’s hoped-for “Stability in an Unstable Economy” must be updated for the exhaustion of Big Government and Big Bank
- 2) Private market technicals can temporarily overwhelm fundamental considerations
- 3) Bond investors should focus on “safer” front-end positions in Treasuries or credit space because of the Fed’s shift to forward guidance
- 4) Don’t bet on baseball games. Bookies take too much, plus it’s boring!

William H. Gross
Managing Director

Treasury Inflation-Protected Securities (TIPS) are Inflation-linked bonds issued by the U.S. government. TIPS are perceived similarly to insurance as they are generally purchased to protect or hedge against inflation. Inflation-linked bonds are designed to help protect investors from the negative impact of inflation by contractually linking the bonds’ principal and interest payments to a nationally recognized inflation measure such as the Consumer Price Index in the U.S.; However, TIPS, unlike insurance are a security and may lose value. ILBs decline in value when real interest rates rise.

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. 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. **Currency rates** may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **Sovereign securities** are generally backed by the issuing government. Portfolios that invest in such securities are not guaranteed and will fluctuate in value. Inflation-linked bonds (ILBs) issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. **Treasury Inflation-Protected Securities (TIPS)** are ILBs issued by the U.S. government.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

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. PIMCO and YOUR GLOBAL INVESTMENT AUTHORITY are trademarks or registered trademarks of Allianz Asset Management of America L.P. and Pacific Investment Management Company LLC, respectively, in the United States and throughout the world. ©2013, PIMCO.

PIMCO Investments LLC, distributor, 1633 Broadway, New York, NY, 10019 is a company of PIMCO.

IO podcast

To download Bill Gross’s IO podcast, check pimco.com or iTunes.com.

Mobile app

Download the PIMCO app for iPhone and iPad.

twitter

Follow PIMCO on twitter.
Search “@PIMCO.”

LinkedIn

Follow PIMCO on LinkedIn.
Search “PIMCO.”

YouTube

Watch PIMCO on YouTube.
Search “PIMCOtv.”

Newport Beach

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

Amsterdam

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com/investments