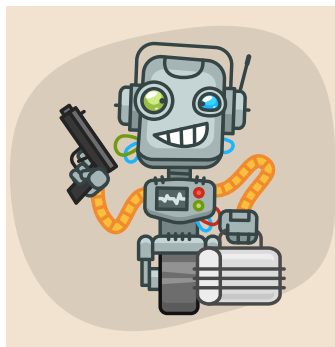




Investment Outlook

From Bill Gross



Killing Each Other

Some say humanity is making progress, and that civilization is becoming more “civilized”, but I wonder. Optimists would point to the global political focus on human rights and the slow, although sporadic, steps forward on racial and gender equality, but these are social morés generally unrelated to humankind’s tolerance for evil on a grander scale. “Thou shalt not kill” is a commandment on Moses’ tablet for a good reason, and yet our killing of each other in mass quantities continues unabated. Stalin and Hitler’s atrocities seem perhaps long ago to younger generations, but then

the “killing fields” of Pol Pot, the millions of lost souls in the Middle East, and the ongoing tribal carnage in parts of Africa testify to the “evildoing” of governments or religious factions in defense of Fascism, Communism and yes – Democracy. “God”, it seems, wears numerous hats, but almost always in defense of one particular ideology or another. “God Bless America”? Yes hopefully – but why not Cuba or the Congo? Chauvinistic mantras can be bonding but also destructive when used to kill masses of people for specious reasons. America – the self-proclaimed defender of freedom and equal rights – has proved vulnerable to those ideals in Vietnam, Iraq, and now Afghanistan and elsewhere.

Having participated in one of those wars, I suppose I should look inward and question my own behavior when I was the age of 22, or even now at 73. I often do. I guess in part, that is why I question humanity’s progress. If I was a willing killer then, how can I expect others and their governments to not do the same? I can’t, but it’s important for all of us to try to understand why humanity evolves slowly, if at all. For me, William Golding in his brilliant “Lord of the Flies” expressed it best. Searching for a murderous “beast” on a deserted island, a previously innocent group of young boys began to kill each other to ensure their own survival. “Maybe there is a beast”, said one child, “but then maybe it’s only us.” Maybe it is us. Maybe we haven’t evolved. Hopefully future robots can be programmed with a better understanding of Moses’ commandment, so that when they take over, we will have a more civilized society.

“ The bond market’s current “beast” is not so much a killer but a hibernating bear awakening from an extended secular bullish trend of lower inflation and excessive central bank accommodation.”

Both appear to be in reversal mode, but the reversal is gradual and relatively non-threatening to investors compared to historical examples. 10-year Treasuries, now nearly 150 basis points higher than their 2016 lows, should fluctuate around 3% for most of 2018. The Fed’s purported 3 to 4 hikes this year beginning in March are likely exaggerated. The U.S. and global economies are too highly leveraged to stand more than a 2% Fed Funds level in a 2% inflationary world. If more than 2%, a stronger dollar would affect emerging market growth and lead to perhaps premature tightening on the part of the ECB and other developed market central banks. When it comes to financial markets, (both bond and stock) the “beast” is really leverage, and while it’s hard to pinpoint when enough is really enough, the Great Recession really informed us that Hyman Minsky was right – “stability leads to instability” as good times and higher prices lead to a false sense of optimism. The Fed, under Jerome Powell, hopefully has learned that lesson, and should proceed cautiously, as must his counterparts around the globe.

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I write this – not in support of low interest rates and financial repression – indeed I have argued for the necessity of an eventual normal rebalancing if small savers and financial institutions such as pension funds and insurance companies are to continue to perform their critical capitalistic role. But I believe, as does Fed Governor Neel Kashkari, that our financial systems' excesses cannot be expunged quickly by "liquidating assets" à la Andrew Mellon in the 1930's, but by a mild and gradual re-entry back to privately influenced, as opposed to central bank suppressed, interest rates. 2% Fed Funds in a 2% inflationary world is the current limit in my opinion.

Investors should therefore look for 3% plus or minus on the 10-year for the balance of 2018. That level should ultimately force German Bunds and UK Gilts to higher yields, perhaps 1% on Bunds and 1.75% on Gilts. Still, in my mind, this is a hibernating global bear bond market, not a beast. That may come later, much like our programmable robots that may control future society.

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