December 2017

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Investment Outlook

From Bill Gross

Investment Potpourri

1. Prior market tops (1987, 2000, 2007, etc.) allowed asset managers to partially "insure" their risk assets by purchasing Treasuries that could appreciate in price as the Fed lowered policy rates. Today, that "insurance" is limited with interest rates so low. Risk assets, therefore, have a less "insurable" left tail that should be priced into higher risk premiums. Should a crisis arise because of policy mistakes, geopolitical crises, or other currently unforeseen risks, the ability to protect principal will be impaired relative to history. That in turn argues for a more cautious and easier Fed than otherwise assumed.

2. Economists prior to Keynes viewed "modeled" as well as "real time" economies as self-balancing, but subject to imbalances from external shocks like oil prices. Rarely did theory incorporate finance and credit as one of those potential earthquakes. It took Hyman Minsky to change how economists view the world by introducing the concept of financial stability that leads to leverage and ultimate instability. He alerted economists to the fact that an economy is a delicate balance between production and finance. Both must be balanced internally and then the interplay between them balanced as well.

3. Credit creation begins at the central bank level, but in reality is predominantly expanded via fractional reserve banking and near zero reserved shadow banks. This model allows substantial leverage and can overprice AAA assets at the core then expand outward until it reaches the periphery of financial markets. At that point or even before, credit usually leaks out into the real economy via purchases of real assets, plant and equipment, commodities and other factors of production. It is this process that has become the operating model for 20th and 21st century capitalism – a system which ultimately depends on asset prices for its eventual success. This model, however, is leverage dependent and – 1) debt levels, 2) the availability, and 3) cost of that leverage are critical variables upon which its success depends. When one or more of these factors deteriorates, the probability of the model's success and stability go down.

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4. Our entire financed-based system – anchored and captained by banks – is based upon carry and the ability to earn it. When credit is priced such that carry can no longer be profitable (or at least grow profits) at an acceptable amount of leverage/risk, then the system will stall or perhaps even tip. Until that point, however (or soon before), investors should stress an acceptable level of carry over and above their index bogies. The carry may not necessarily be credit based – it could be duration, curve, volatility, equity, or even currency related. But it must out carry its bogey until the system itself breaks down. Timing that exit is obviously difficult and perilous, but critical for surviving in a new epoch. We may be approaching such a turning point, so invest more cautiously.
5. Money/cash is different than credit. High-quality credit can at times take the place of money when its liquidity, perceived return, and safety of principal allow for its substitution. When the possibility of default increases and/or the real return on credit or liquidity decreases and persuades creditors to hold classical "money" (cash, gold, bitcoin), then the financial system as we know it can be at risk (insurance companies, banks, mutual funds, etc.) as credit shrinks and "money" increases, creating liquidity concerns.
6. Someone asked me recently what would happen if the Fed could just tell the Treasury that they ripped up their $4 trillion dollars of T-bonds and mortgages. Just Fugetaboutit! I responded that that is what they are effectively doing. "Just pay us the interest", the Fed says, "and oh, by the way, we'll remit all of that interest to you at the end of the year". Money for nothing – The Treasury issuing debt for free. No need to pay down debt unless it creates inflation. For now, it is not. Probably later.

Have a great December.

Be careful in 2018.

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