

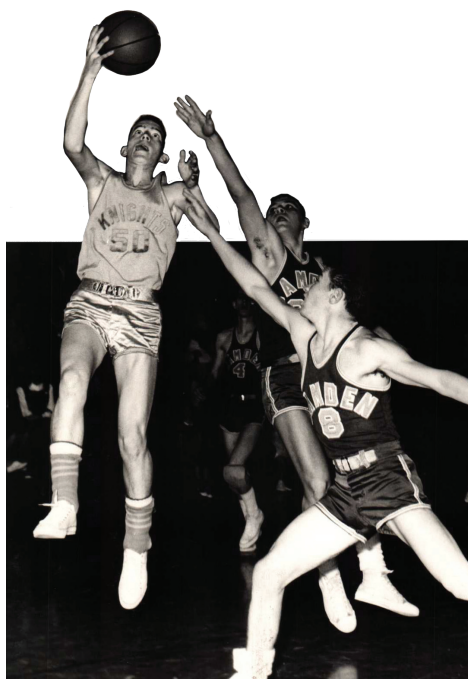


JANUS CAPITAL  
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# Investment Outlook

*from Bill Gross*

April 2015



## March Madness

Every year, March Madness reminds me of my own storied basketball career – with more emphasis on stories than a career I will admit, but what else would you expect from a 6 foot tall white guy whose best assets were that he could jump higher than most and whose legs looked good in short shorts. I did start as point guard on a championship team for three years running, but what I remember most was not a last second buzzer beater but the foxy cheerleaders yelling “Bill, Bill, he’s our man – if he can’t do it no one can.” Their cheers, however went silent outside of the gym. They never seemed to say hi in the halls which I found somewhat confusing but nevertheless precedent setting as I transitioned into college at Duke.

Being somewhat of a high school star, I decided to try out for the taxi squad on the freshman team. Duke that year was well stacked with three future All Americans and NBA players but they needed some competition in practice and I was a prospective servant for the greater cause – not Duke – but my chance to show off and eventually get a girl into the backseat of a car for the first time in my life. Neither came to pass as I was cut during the first tryout session and cut frequently as well on second and third dates in parking lots behind the sorority houses.

I found my chance to get even though, when 35 years later I came back to my alma mater on a philanthropic mission and was picked up at the airport by none other than Bucky Waters, the freshman coach who had so coldly and heartlessly cut me from the team. Recognizing Bucky but he not recognizing me I said, “Nice to see you again Buck.” “Did we ever meet?” he asked optimistically in hopes for a close personal connection and a bigger check. Once I said, “In 1962, the day you cut me from the freshman taxi squad.” “Ohooooo I’m so sorry”, he said. “I’m sorry too Buck”, I responded: “that’ll cost the university a few bucks!” We laughed and have been friends ever since.

But that’s not the end of my storied basketball career at Duke. Twelve years ago I attended a summer basketball camp for middle-aged guys at Cameron Indoor Stadium, the site of my humbling yet undeserved dismissal nearly forty years before. The one and only Coach K headed the three-day session and began with an inspirational talk followed by a friendly admonition to have fun, concluding by saying that no one who ever attended the camp for the past 15 years had ever gone home without making a basket. Never that is until Bill Gross signed up. Why my teammates never passed to me I’ll never know – perhaps it was my frequent air balls or the constant turnovers – go figure – but I remember during the last game Coach K called a special play – sort of like the one for that little runt Rudy, who was

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on the taxi squad for Notre Dame, in the movies. Coach even told the other team to sort of give me a wide berth to the hoop to keep the streak alive. Thirty seconds to go, I got the ball, my great looking legs now covered up by modern day shorts to the knee; lacking any youthful bounce that as a teenager could dunk a basketball; not hearing any sort of encouragement from foxy cheerleaders screaming my name from the sidelines; nevertheless, I dribbled the ball confidently to the hoop with no one in my way – I went up for the gimme layup – it rolled in and around and out. The streak had been broken. “That’ll cost you a few bucks, Coach K”, I disgustedly said as we shook hands after the buzzer. We laughed and commiserated about my unique contribution to Duke Basketball. Like I said, a storied career – full of stories but void of points not only in the parking lot of the Alpha Phi sorority but on the court at Cameron Indoor Stadium.

If there ever was an economic concept that currently is not a layup, it would be what the future average level of Fed Funds will be. No one really knows and unlike the gimme layup that Coach K provided for me, there are no “gimmes” when it comes to scoring a Fed Funds basket. As we all know, the neutral or natural rate of interest is not a new concept. Irving Fisher back in early 20th century hypothesized that while neutral nominal policy rates could go up or down depending on inflation and cyclical growth rates, that the real natural rate of interest was relatively constant. I think history has disproved this thesis, not only because central banks and govt. fiscal policies have suppressed (and sometimes elevated) that real rate but because of structural changes in real GDP growth rates, demographics, and the globalization of finance amongst others. Greenspan hinted at that with the “irrational exuberance” question that he never answered, and Bernanke got closer with his “global savings glut” but neither of them – nor Janet Yellen and her thousands of historically model driven staff have come very close since. They still believe in their 3¾% nominal blue dots which conflate to a 1¾% real rate of interest that has been in vogue for 30 years now. Yellen herself has admitted that the real neutral rate changes and that it depends on a variety of factors including fiscal and monetary policy, term premiums, equity prices and yield curves – so many as to be impossible to model. When Jim Cramer screamed “they know nothing, they know nothing”, he was being a little unfair but not by much. It was a 3% real rate of interest in the U.S. that broke the levered global economy back in 2006 / 2007; a rate that may have been appropriate 20 years before when credit as a % of GDP was 200% instead of 350%, but not in 2006, when the obvious micro example of a 1% short term teaser rate on a \$500,000 home in Modesto, California became a Libor + 3% loan shortly thereafter, and broke the back of the U.S. housing market.

Actually a few economists at the Fed have climbed on board the new neutral train, some as early as 2001 when a paper from Janet Yellen’s own San Francisco Fed authored by Thomas Laubach and John Williams showed the history of a changing U.S. real rate of interest from 4½% in 1965, to which it descended on a smoothing scale to a now (–.35%). Their model is updated quarterly by the way, and while I’m not a believer in historical models per se, I think it’s obvious that the real neutral has changed dramatically as evidenced by real time prices in the bond market. What the new neutral rate will be for the next 5-10 years is however, still up for grabs and of course is a central question of this Outlook.

Commonsensibly, and aside from statistical modeling, it would not be unusual for a new neutral to appear after the devastation of Lehman and The Great Recession. Reinhart and Rogoff in fact have measured dramatically different real policy rates during depressions and subsequent recoveries, acknowledging the obvious, that long periods of financial repression with Treasury yield caps, as well as inflation shattering changes in the global financial system such as Bretton Woods and its eventual transition to the Dollar standard in the early 1970’s, had a significant influence. But those policy changes indeed fit into my thesis. Rogoff and Reinhart’s average (–2%) real policy rates in advanced economies from 1940 to 1980 were a function of prior leverage and necessary delevering. Central bankers used policy rates as a hidden weapon until recovery was assured and Jim Grant’s dreaded inflation reappeared in the 1970’s. At that point it was appropriate for Paul Volcker to impose positive real rates – really positive real rates. The real rate, to my way of thinking while difficult to model, can subjectively and commonsensically be assumed to create superdebt cycles and asset bubbles, and then attempt to heal them in the aftermath of the popping. Such has been the experience over the past century of central banking in the U.S. and elsewhere.

I am not presenting anything revolutionary here worthy of a Nobel Prize, but reminding you and myself of why the new neutral real rate of interest may be much lower now and in the future than what it was from Volcker 1979 to Bernanke 2009, a number which Rogoff and Reinhart calculate to be +1.35% in advanced economies and +2.88% in emerging economies.

One can approach an estimated value for developed (and emerging) economy new neutrals from another direction. I think it's informative to measure the spread between policy rates and Nominal GDP growth rates for the post Lehman experience to get a handle on what rate has been necessary to stabilize certain large developed economies over that period of time. The complicating introduction of QE's around the globe will muddle that observation but only to the benefit of a more conservative conclusion. My commonsensical hypothesis is that nominal policy rates necessarily need to be lower than Nominal GDP. If annual GDP is the return on total outstanding credit and implied equity for a nation's economy, then the safest and most liquid asset must necessarily be priced lower than GDP in order to induce investment. That would be the policy rate. How much lower however, is the question. Let me summarize by saying that nominal policy rates in the U.S., UK, and Germany have been on average 350 basis points below Nominal GDP growth since 2010 and 150 basis points below inflation. And these numbers are for the 3 strongest developed economies! In order to stabilize the three developed titans, the real new neutral policy rate in these countries has been (-1.5%) for 5 years. It is not unreasonable to assume it might be 0% instead of the Fed's 1.75% even if these economies return to "normal". Other developed and developing economies need to reduce theirs in a similar fashion.

Importantly, lower new neutrals speak to portfolio durations and yield curve positions on the bond side, P/E ratios for equity portfolios, and long term cap rates for real estate amongst other valuations. Ultimately they lead us most importantly to the prospect for future asset returns, which if 0% real is the New Neutral in the U.S. and correspondingly lower elsewhere, speak to an inability of savers and investors to earn sufficient returns to satisfy presumed liabilities. If real rates continue to be so low, then discounted income streams are dependent solely on growth and/or inflation instead of capital gains, which in the prior three decades have been substantially influenced by the decline in real rates. The lower real rate / capital gains ocean liner has taken us into uncharted waters, but waters, which we must know, that are hostile to investors.

Knowing how to maximize return versus risk in these new waters will be key. There are at least several approaches, anyone of which may be the correct one. Dalio/Prince from Bridgewater cautiously advance the theme that if borrowing costs center around 0% real, then assets can be cautiously levered, being cognizant at the same time of the fat tails inherent in our new world of leverage and extreme monetary policy. Jeremy Grantham and fellow professionals at GMO hint at waiting it out in low returning cash under the assumption of a 7 year reversion to the mean, instead of a 20 year cycle hinted at by Rogoff and others. Grantham expects a stock market deluge in the near term future and he may be right, but if not, GMO may underperform while waiting. Then there is Warren Buffett, who has the benefit of a near perpetual closed-end fund purchasing stocks when fundamentally cheap. For most investors who don't have the benefit of a closed-end business structure, perhaps Jack Bogle is right. One can't be sure where markets are going, he consistently maintains, but one can be sure that the lower the fees the better.

Of the four approaches described above, unconstrained portfolios at Janus mimic most closely the strategic philosophy at Bridgewater. Cheap leverage is an alpha generating strategy as long as short rates stay low and mimic the 0% real new neutral. Of course if an investor borrows short term to invest longer and riskier, the potential alpha necessarily demands choosing the correct assets to lever. That is not easy these days since almost all assets are artificially priced. The challenge is to purchase the ones that might remain artificially priced over one's investment horizon. For me, credit spreads are too tight and therefore expensive. Duration is more neutral but there is little to be gained from it in the U.S., Euroland, and the

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UK unless the global economy inches towards recession. The most attractive opportunity to me rests with the notion that Draghi's 18 month QE, which roughly purchases 200% of sovereign net new issuance during that time, will keep yields low in Germany and therefore anchor U.S. Treasuries and UK Gilts in the process. I would not buy these clearly overvalued assets but sell "volatility" around them, such that much higher returns can be captured if say the German 10 year Bund at 20 basis points doesn't move to  $-.05\%$  or up to  $.50\%$  over three months' time. Draghi's QE should place a high probability on staying within that range, much like Kentucky has a high probability of winning March Madness in early April. We shall see.

Good luck to all of you in your office pools. I myself am not a betting man and cannot watch the Duke games for fear of an early heart attack. I didn't make the team but my heart's still with them. Wish I had made that layup though.

*-William H. Gross*



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