



Investment Outlook From Bill Gross

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Curveball

"Kill the Umpire", the fan cried to open the 1996 baseball season in Cincinnati, and 7 pitches later, the man behind the plate, John McSherry, was dead, all 320 pounds of him screaming for more oxygen to feed his struggling heart. He'd been killed by his poor health, by a billion molecules of sink-clogging cholesterol that fed on his coronary artery and sucked up his life's blood like a vampire at midnight. The next day Howard Stern had characteristically railed that the antidote was obvious. It was the same for all fat people: "DON'T EAT", he howled. As if the ump hadn't known. The fact was he couldn't stop. He loved the taste of food – every sugary, starchy, carbohydrate morsel. The first bite was an ecstasy, as was the last, and everything in between. The man, it seemed, was a Cuisinart with 4 limbs.

Franz Kafka wove a tale 100 years earlier that was a mirror image of McSherry's tragedy. His "A Hunger Artist" described a professional faster – a sideshow freak in 19th century Europe who attracted attention and spare coins by withering away inside a wooden cage. The gapers marveled at his shriveled skeleton – stuck their hands through the bars to nudge his bony ribs – and awed at his resolve to starve himself to the precipice of self-extinction. "I always wanted you to admire my fasting", said the hunger artist, "but you shouldn't have. (The fact is) I have to fast, I can't help it. I couldn't find the food I liked. If I had found it, believe me, I would have made no fuss and stuffed myself like you or anyone else."

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Well, well – one man who couldn't stop and another one who couldn't start – eating, that is. Their stories, though, are really not about food, but life itself – what compels us to do what we do, what forces us to act or not act, what makes us who we are. Is personal behavior, though, really beyond our control? Shakespeare would retort that the fault lies not in our stars, but in ourselves, and I applaud that – strong-willed 175-pound guy that I am. But, on the other hand, who are we other than a morphous, gelatinous blob of moving flesh and bone that's been molded primarily without our input, first by genes, and then by environment into the living person we know as ourselves? Are we all just walking Cuisinarts, or better yet, mobile computers with consciousness?

A TIME Magazine cover story once asked, "Can machines think?" and if they can, it might well have asked the corollary, "Are people machines?" The fact is that sophisticated modern machines can do just about anything a human being can do. TIME suggested that the difference between "us" and "them" was a human being's consciousness. We are "aware" whereas they are not. But even if that is true, to me it's not enough. Who wants to be a machine that simply knows it's a machine? Who wants to walk the Earth as a preprogrammed robot with no input as to his or her final fate? To my mind, free will is the key to our unique position among life's animals. Without it, this business of living is reduced to a meaningless game. Unless the John McSherrys of the world can stop eating and the hunger artists can start, we might as well just turn out the lights.

Monetary policy in the post-Lehman era has resembled the gluttony of long departed umpire John McSherry – they can't seem to stop buying bonds, although as compulsive eaters and drinkers frequently promise, sobriety is just around the corner. To date, since the start of global Quantitative Easing, over \$15 trillion of sovereign debt and equities now overstuff central bank balance sheets in a desperate effort to keep global economies afloat.

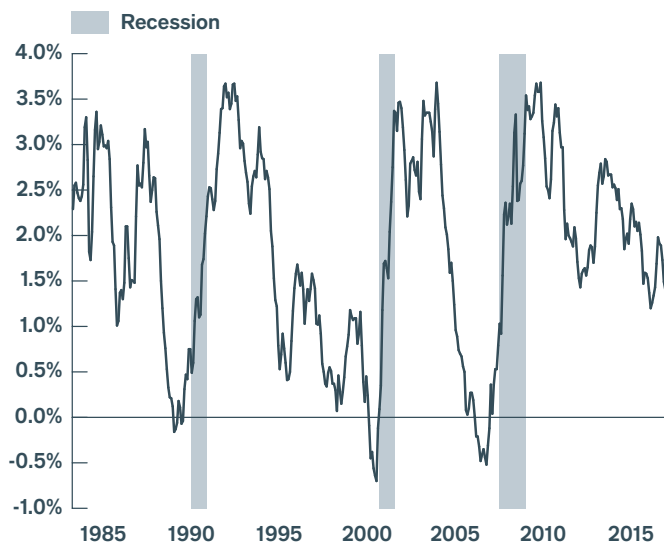
At the same time, over \$5 trillion of investment grade bonds trade at negative interest rates in what can only be called an unsuccessful effort to renormalize real and nominal GDP growth rates. The adherence of Yellen, Bernanke, Draghi, and Kuroda, among others, to standard historical models such as the Taylor Rule and the Phillips curve has distorted capitalism as we once knew it, with unknown consequences lurking in the shadows of future years.

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Similarly, private economists adhere to historical models, which attempt to “prove” that recessions are the result of negative yield curves, as seen in Chart 1. Over the past 25 years, the three U.S. recessions in 1991, 2000, and 2007-2009 coincided nicely with a flat yield curve between three-month Treasury Bills and 10-year Treasuries. Since the current spread of 80 basis points is far from the “triggering” spread of 0, economists and some Fed officials as well, believe a recession can be nowhere in sight.

When the Yield Curve Rolls Over

Interest rate on 10-year Treasury note minus that of three-month Treasury bill (average monthly)



Source: Federal Reserve Bank of St. Louis, 30 September 1983 to 30 June 2017.

Perhaps. But the reliance on historical models in an era of extraordinary monetary policy should suggest caution. Logically, (a concept seemingly foreign to central bank staffs) in a domestic and global economy that is increasingly higher and higher levered, the cost of short term finance should not have to rise to the level of a 10-year Treasury note to produce recession. Most destructive leverage – as witnessed with the pre-Lehman subprime mortgages – occurs at the short end of the yield curve as the cost of monthly interest payments increase significantly to debt holders. While governments and the U.S. Treasury can afford the additional expense, levered corporations and individuals in many cases cannot. Such was the case during each of the three recessions shown in Chart 1. But since the Great Recession, more highly levered corporations, and in many cases, indebted individuals with floating rate student loans now exceeding \$1 trillion, cannot cover the increased expense, resulting in reduced investment, consumption and ultimate default. Commonsensically, a more highly levered economy is more growth sensitive to using short term interest rates and a flat yield curve, which historically has coincided with the onset of a recession.

Just as logically, there should be some “proportionality” to yield curve tightening. While today’s yield curve would require only an 85 basis increase in 3-month Treasuries to “flatten” the yield curve shown in Chart 1, an 85 basis point increase in today’s interest rate would represent a near doubling of the cost of short term finance. The same increase prior to the 1991, 2000 and 2007-2009 recessions would have produced only a 10-20% rise in short rates. The relative “proportionality” in today’s near zero interest rate environment therefore, argues for much less of an increase in short rates and ergo – a much steeper and therefore “less flat” curve to signal the beginning of a possible economic reversal.

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How flat? I don’t know – but at least my analysis shows me that the current curve has flattened by nearly 300 basis points since the peak of Fed easing in 2011/2012. Today’s highly levered domestic and global economies which have “feasted” on the easy monetary policies of recent years can likely not stand anywhere close to the flat yield curves witnessed in prior decades. Central bankers and indeed investors should view additional tightening and “normalizing” of short term rates with caution.

** The introduction to this month’s Outlook was modified from an Investment Outlook originally constructed more than a decade ago.

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