



## The Tipping Point

I've spun a few yarns in recent years about my days as a naval officer; not, thank goodness, tales told by dead men, but certainly echoes from the depths of Davy Jones' Locker.



A few years ago I wrote about the time that our ship (on my watch) was almost cut in half by an auto-piloted tanker at midnight, but never have I divulged the day that the USS Diachenko came within one degree of heeling over during a typhoon in the South China Sea. "Engage emergency ballast," the Captain roared at yours truly – the one and only chief engineer. Little did he know that Ensign Gross had slept through his classes at Philadelphia's damage control school and had no idea what he was talking about. I could hardly find the oil dipstick on my car back in San Diego, let alone conceive of emergency ballast procedures in 50 foot seas. And so...the ship rolled to starboard, the ship rolled to port, the ship heeled at the extreme to 36 degrees (within 1 degree, as I later read in the ship's manual, of the ultimate tipping point). One hundred sailors at risk, because of one twenty-three-year-old mechanically challenged officer, and a Captain who should have known better than to trust him.

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We survived, and a year later I exited – the Diachenko and the Navy for good – theirs and mine. I think I heard a sigh of relief as I saluted the Captain for the last time, but in memory of those nearly tragic moments, let me reprint an article posted on wikiHow, outlining exactly how to go about abandoning ship should you ever venture into the South China Sea or anywhere close to Davy's infamous locker. The article is a bona fide and serious attempt to

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instruct would be passengers in a Titanic-like disaster. I found it, however, as comical as yours truly pretending to be a chief engineer in 1969. Judge for yourself...

*wikiHow: the how to manual you can edit*

### **How to Escape a Sinking Ship**

#### **The Basics: Before Setting Sail**

1. Understand the mechanics of a sinking ship. Water usually enters the lowest point of a ship first, the bilge area.
2. As more and more water enters the ship, it will start to heel significantly. From this point on, sinking will occur quickly. Abandon ship.

#### **If Sinking is Imminent**

1. Think about your sense of etiquette. What will you do if push comes to shove?
2. If you're in charge of the sinking ship learn how to send a Mayday. Read "How to call Mayday from a marine vessel" on the attached internet link.
3. Stay calm and don't panic.
4. If you see someone with fear, yell at them.
5. While still on deck, watch for catapulting objects coming your way. Large items can kill you.

#### **Abandoning Ship**

6. Find a lifeboat. The best scenario is to enter a lifeboat without getting wet.
7. If jumping off the ship, always look first.
8. If you survive, be ready for the reality that others may have perished. Seek counseling.

Counseling indeed! If only I knew then what I know now: wikiHow, not experience or damage control school, is the best teacher. So, should bond investors abandon ship? And who to believe? The captain of the Fed, the co-captains of the USS PIMCO, or just trust your instincts? Well there is no

wikiHow moment to guide you in this case, although it's true that yours truly, PIMCO, and the bond market have sailed some rough seas over the past few years. So has Chairman Bernanke. We're all in this one together it seems.

**Immediate analysis of the past 6 weeks' market action would argue that in late April, both the Fed and PIMCO observed that bond markets were approaching a tipping point.** Yields were too low, prices too high, both for investors' and the economy's own good. The Fed's Jeremy Stein had written a research paper outlining the risk. I, in fact, had written a March *Investment Outlook* outlining [Governor Stein's paper](#), and to be fair, PIMCO had been warning of high seas for what seems like an eternity. "Never," I tweeted, "have investors reached so high for so little return. Never have investors stooped so low for so much risk." True enough, history will likely record.

**It will also record however, that the risk was not only in narrow credit spreads and emerging market debt/equity markets but at the heart of the credit system itself: U.S. Treasuries.** What supposedly old salts like yours truly didn't suspect was that all bonds, and yes, equities too were at risk of heeling over based upon a rather perfect storm, one that forecasters everywhere found difficult to fathom.

The forecast for bad weather as I've mentioned was becoming more rational with every increase in asset prices. If all markets were being artificially supported as PIMCO claimed and the Fed confirmed, then [someday](#), [someday](#) that support via quantitative easing would have to be withdrawn. But the dark clouds seemed to be far off on the horizon. Investors worldwide piled on the leverage – not just in high yield or equity space – but in Treasuries as well. If the Fed (and BOJ) were going to keep writing checks at one trillion per year, then these two central banks alone might be buying 70-80% of all developed market future supply. The fear was that there might not be enough for others, not that there was too much leverage.

Well, that started to change with the May 22<sup>nd</sup> taper talk and, of course, with the Fed's June 19<sup>th</sup> statement and Chairman

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Bernanke's press conference. In trying to be specific about which conditions would prompt a tapering of QE, the Fed tilted *overrisked* investors to one side of an *overloaded* and *overlevered* boat. Everyone was looking for lifeboats on the starboard side of the ship, and selling began more selling, even in Treasuries. While the Fed's move may ultimately be better understood or even praised, it no doubt induced market panic. Without the presence of a "Bernanke Put" or the promise of a continuing program of QE check writing, investors found the lifeboats dysfunctional. They could only sell to themselves and almost all of them had too much risk. A band somewhere on the upper deck began to play "Nearer, My God, to Thee."

Well I go too far in my sinking ship metaphor, but you get the point, I hope. The U.S. economy is not sinking, nor are the majority of global economies. Their markets just had too much risk, and in PIMCO's opinion, too much hope for a constant QE and for the growth that it would produce. In effect, the ship was top heavy with too little ballast. Guess I should have known, huh?

Well where does the ship go from here? Should you as a bond investor jump overboard and risk the cold money market Atlantic Ocean at near zero degrees? We don't think so – and not because we want to keep you on board – we just don't think so. Why not?

- 1) **The Fed's forecast of the economy which prompted tapering panic is far too optimistic.** If 7% unemployment is tapering's final port of call, we simply think that we're much further away than the Fed's compass would suggest. We argue for structural headwinds – demographic, globalization, and technology influences – that have had and will continue to have dampening effects on domestic and global growth. The Fed, we would argue, is too cyclically oriented, focusing substantially on housing prices and car sales. And speaking of housing, since mortgage rates have risen by 1½% in the last six months and the average monthly check for a new home buyer is up by 20–25% as well, then as I tweeted several weeks ago,

"Mr. Chairman are you serious?" Growth will be negatively influenced.

- 2) **Inflation, according to the Fed's own statistics is running close to a 1% pace.** The Fed has told us that they "target," "target" 2% and for the next 1–2 years are willing to accept even 2½% until they reverse engines. Fed Governor Bullard of the St. Louis Fed was in our opinion correct where he dissented from the majority decision several weeks ago, citing the distant shores of 2%+ inflation and the seeming inability to even move in that direction.
- 3) **Yields have adjusted by too much.** While T.V. and the press focus on 10-year Treasuries at 2.55% as their guiding star, subjective stabs by yours truly or anyone else are difficult day to day. The technicals, as Mohamed has written, can dominate while the fundamentals are flushed to second page priorities. When analyzing the fundamentals though, I like to point to a "North Star" that is as permanent as possible within the context of current market instability. Tapering aside, if the Fed has consistently informed the market that its policy rate – Fed Funds at 25 basis points – will stay there for a substantial period of time even after the end of QE, then to my eye, Fed Funds will not increase until at least mid-2015 and even then subject to a consistently strong economy that produces 2%+ inflation. I wonder if we can get there in this decade to tell you the truth. But the beauty of this North Star Fed Funds sextant is that it can be rather directly observed in futures markets, either for Fed Funds or for Eurodollars, which are a close companion. Right now, Fed Funds futures markets are predicting a 75 basis point yield in 2015, and Eurodollars validating a similar conclusion. That would suggest a mispricing, despite the obvious caveat of professional observers that some of the 75 is a surcharge for potential volatility. **In any case, if frontend curves are up to 50 basis points cheap, then intermediate curves – the 10-year Treasury – may be as much as 35 basis points too cheap. They belong in our opinion at 2.20% instead of 2.55%.**

So there you have it, fellow passengers and paying clients. Don't jump ship now. **We may have reached an inflection point of low Treasury, mortgage and corporate yields in late April, but this is overdone.** Will there be smooth sailing tomorrow? "Red sky at night, sailors delight?" Hardly. Will you be able to replicate annualized returns in bonds and stocks for the past 20–30 years? Hardly. Expect 3–5% for both. But sailors, don't panic. And like wikiHow suggests, if you see someone that's afraid, "yell at them!" Yell, "This ship's going to make it to port," Fed, PIMCO, and PIMCO co-captains willing. Those icy Atlantic money market waters are likely to be with us for a long, long time. Have a cocktail, tell the band to stop playing dirges, because you're gonna be just fine with PIMCO at the helm.

### **Tipping Point Speed Read**

- 1) Yields and risk spreads were far too low two months ago.
- 2) Global markets were too levered and now they are derisking.
- 3) The bond market ship is not sinking. Expect low but positive returns in future years.
- 4) Don't panic. Yell at someone!

William H. Gross  
Managing Director

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