

**Tuesday Never Comes**

**PIMCO**

**By Bill Gross**

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The global economy is floating on an ocean of credit, and a good thing too as our cartoon friend Wimpy reminds us. Without it, he would be a hungry puppy by next Tuesday and nearly seven billion world citizens would be worse off if barter, and not credit, was the oil that lubricated trade. Unlike Wimpy, early societies functioned without an exchange (money) or the promise to pay it back in the future (credit). Growth was limited, however, because savings or investment could not be incented properly. Those that wanted to save for a rainy day had no means to express that caution; better to consume a banana or a hamburger today than to watch it rot and become worthless on Tuesday. But money changed all of that and the ability to borrow and exchange it for repayment at some future date was the economic elixir of the ages. Shakespeare, with his admonition to “neither a borrower nor a lender be,” might have won a 17th century Pulitzer, but definitely not a Nobel Prize for economics.



Still, the use of credit never really kicked into high gear until the discovery of fractional reserve banking and the ultimate formation of central

banks to facilitate and protect its disbursement. Picture a Wild, Wild West Bank in Yuma, Arizona back in 1901. It had a big safe where miners left their gold nuggets for safe keeping, but in order to become more than a depository, the bank needed to issue notes and letters of credit in an amount greater than the gold in its vault. Theoretically there was some of the owner's gold dust in there too, but who was counting as long as gold came in and gold went out and Yuma's citizens thought that the bank's notes were backed by tangible evidence of wealth. Fractional reserve banking was aborning in the 20th century, sharpshooters and all.

Problem was that many of those local banks with their individual currencies and drafts went out of business, leading to panics and mild depressions throughout the growing states, and so in 1913 the dollar became our single currency, and the Federal Reserve our official central bank. The Fed, with a certain amount of gold certificates, would then extend credit to its member banks, which would then extend credit to businesses, which would magically promote savings, investment and economic growth. No leftover hamburgers on Tuesday for Wimpy – his tummy was grumbling and by god, or by Fed, he was gonna get it NOW.

**This process of credit and its creation powered global economies for the next century. It benefited not only consumers who wanted their burgers now, but lenders and investors who were willing to go hungry on Friday for the benefit of getting their money back with interest on Tuesday.** Both sides experienced a win/win exchange as the real economy charged ahead, creating jobs, technological advances and the eradication of disease. What was not to like about credit? Nothing really, except much as the absence of it hindered ancient societies, the excess of it now hobbles modern economies. Credit is the foundation of the wealth creation process, but it can also be the cause of financial instability and potential wealth destruction. Like nuclear energy, "atomic" credit or debt must be controlled if it is to benefit, as opposed to destroy.

**And so the job of modern-day central bankers – Bernanke, King, Draghi and their global counterparts – is to decide how to control a beneficial chain reaction without it getting out of hand. In many ways they are like their Wild, Wild West counterparts, trying to convince skeptical depositors that the gold will always be there.** Yet, since 1971, when Nixon cratered Bretton Woods, there has been no explicit or even implicit gold backing. The U.S. and therefore the world's finance-based economies have been backed by an increasing amount of IOUs, which are simply paper promises to create more paper when there is an old-fashioned 20th century run on the banks, or incredibly enough – even when there is not. Lacking a disciplined parental example, the banks, investment banks, money managers and hedge funds piled paper on top of paper as well, creating derivatives and seemingly endless chains of repos and rehypothecation of repos to amass a total amount of credit that literally cannot be counted. Estimates suggest global credit in the financial sector exceeds \$200 trillion, with developed economies' central banks holding only \$15 trillion in reserves or figurative "gold dust." If so, then the global banking system is levered at least thirteen times. These numbers don't even count the amount of side bets or credit default swaps, which can't be used as burger payments, but which total \$700–\$800 trillion alone. Wimpy has financed so many Whoppers that Tuesday can never come. Judgment day must always be around the corner or after the next weekend. Wimpy cannot pay the tab, except with more and more credit creation, as Euroland countries are discovering first hand.

Yet how much credit is too much credit and how is a dedicated central banker to know? Part of the problem is in clearly defining what does or doesn't fit the definition. There are the families of M's – M1, M2 and the disbanded M3 in the U.S. – the former two of which the Fed now loosely uses to monitor a growth rate so as not to bring credit creation to a boil. 21st century privateers, however, proved there can be no accurate gauge of credit growth as long as banks and the shadow banks can create their own money at will. CDOs, CLOs and securitized lending that managed to skirt regulatory standards for bank loans by applying 1%, 2% and 5% "haircuts" to securitized assets made a mockery of sound banking and ultimately created great risk for central bankers and their ability to temper the excess of credit creation. In 2008, central bankers never really knew how much debt was out there, and to be honest, they don't know now.

Austrian school economists might say "no matter, forget the counting – all a central banker has to do is observe the interest rate, the price of credit, to know whether things have gotten out of hand." And they may have had a point – even after 1971 and up to the mid-1990s, but then economies and the credit that was driving them morphed into a universe that the conservative Austrians would not have recognized. With the dotcoms, the subprimes and now thereflexive delevering of our financial system, it is practically impossible to know what interest rate is applicable. With the QEs and LTROs reducing real yields far below absolute zero, a central banker must wander aimlessly in policy space, wondering how much credit to create, how many Treasuries to buy, and how firm a twist to give the yield curve in order to allow Wimpy the chance for another burger and a side order of fries.

**What they should know – and what the following chart, provided by the always observant Jim Bianco, shows – is that when QEI and QEII lapsed in recent years, stock prices declined by 10%–15% until magically they came back to live another day. The same stunting**

effect can be observed in the bond market when measured by real as opposed to nominal interest rates. They go down with QEs and up in their absence.

Admittedly, Chart 1 shows only two real data points, which are difficult for a Fed Chairman or his staff to rely on, but common sense underlies the historical observation as well. With the Fed buying nearly 70% of all five- to 30-year Treasuries during Operation Twist, and similarly large percentage amounts of Treasury and Agency mortgage-backed issuance since the beginning of QE1 in December 2008, who will buy them now, if the Fed doesn't?

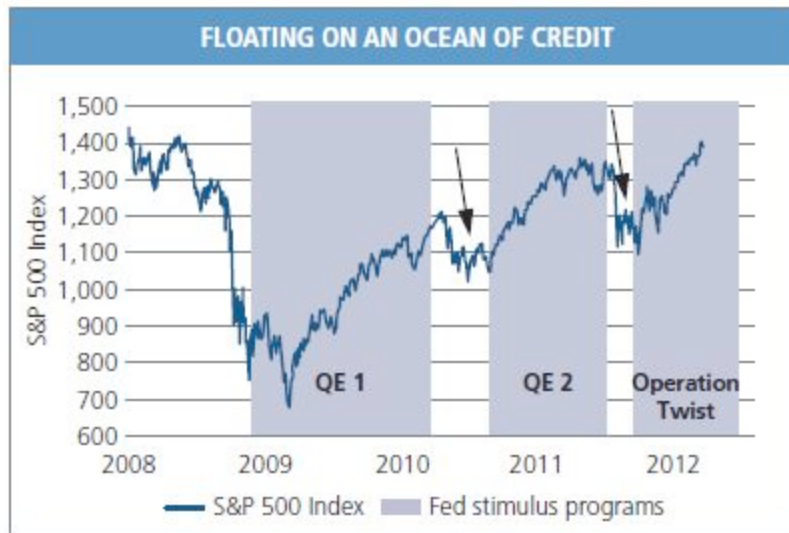


Chart 1

Source: LPI Financial, Bloomberg data. As of 23 March 2012.  
(Shaded areas represent Fed programs from the date of announcement until termination.)

**The Fed appears to have a theory that is somewhat incomprehensible to me, stressing the “stock” of Treasuries as opposed to the “flow.”** Future flows and annual supplies of \$1 trillion and more, the theory argues, will be gobbled up by the market even without the Fed’s help, at current artificially suppressed yields because the private market’s “stock” of Treasuries has been depleted. Much like a wine cellar, I suppose, that is now nearly empty because policymakers have been drinking the rare vintages, wine lovers will now be forced to restock their cellars to get a historically comfortable inventory. Hmmm, being a beer drinker myself, I might otherwise assume that appetites might switch due to higher prices (and lower yields). And if wine or bonds were mandated to fill the cellar, then why not a foreign wine or a foreign bond? And too, I’m sure the Chinese in addition to PIMCO clients would be willing at the margin to change their preferences to real as opposed to financial assets. More conservative investors might migrate to cash as the preferred alternative, because the price of bonds or burgers was too high. Wimpy, in other words, might just go vegan if burgers aren’t cooked to taste.

Because of QEs, the associated Twist, and similar check writing by the BOE, BOJ and ECB, several trillion dollars of what is academically referred to as “base money,” and what Main Street citizens would recognize as “gold dust,” has been added to global central bank vaults. Rather than dug out of the ground, this credit has been created at the stroke of a pen or a touch of the keyboard in today’s electronic monetary system. How that is done is a topic for another day, but since the early 1900s, and especially since 1971, it has been done so often that prices of goods and services are 400% of what they were when President Nixon decided to propel central banking to another orbit. “We are all Keynesians now,” he said back then, but he should have replaced Mr. Keynes with Mr. Burns, Miller, Volcker, Greenspan and Bernanke. We are all central bankers now, at least from the standpoint of endorsing stimulative policies that permit Wimpy and his seven billion counterparts to keep on eating burgers, and their lenders, by the way, to keep on coining profits.

Part productive, but increasingly destructive, the current acceleration of credit via central bank policies will likely produce a positive rate of real economic growth this year for most developed countries, but the structural distortions brought about by zero bound interest rates will limit that growth as argued in previous *Outlooks*, and induce serious risks in future years. **In addition, inflation should creep higher. Do not be**

mellowed by the affirmation of a 2% target rate of inflation here in the U.S. or as targeted in six of the G-7 nations. Not suddenly, but over time, gradually higher rates of inflation should be the result of QE policies and zero bound yields that were initiated in late 2008 and which will likely continue for years to come. We are hooked on cheap credit just as Wimpy was hooked on Friday's burgers. As I highlighted last month in "The Great Escape," bond and equity investors should focus on securities with shorter durations – bonds with maturities in the five-year range and stocks paying dividends that offer 3%–4% yields. In addition, real assets/commodities should occupy an increasing percentage of portfolios. Wimpy would not be pleased by this change of diet nor by the cost and risk of burgers for delivery next Tuesday. But for him, and for central bankers, the hope is that Tuesday never comes.

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