



JANUS CAPITAL
Group

Investment Outlook

from Bill Gross

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Say A Little Prayer



I'm not what you would call a "prayerful" type of guy. Even at 30,000 feet, when the air gets rough, I never invoke the "God" word, settling instead for promising myself that if I ever get back to terra firma, I will never fly again, which I promptly forget days or even hours later. It's not that I'm a non-believer in prayer's ultimate destination, but more of a cynical take on why the Lord would hand out party favors to everyone that asked, or to those that asked most intently.

I do remember praying nightly as a child though, which might indicate that my mom and dad were better parents than I have given them credit for. I recited the Lord's Prayer, then followed it up with the standard "God Blesses" – in my case "God Bless Mommie, Daddie, Chip, Lyn, Mamie, Budgie, Brenda, Stinky

and everyone in the whole world." Stinky was my brother's cat, so named because she used the house as her personal litter box in the days before my parents could buy one at the local "five and dime". Brenda was the neighbor's bulldog but warranted a mention ahead of our own Stinky because – well – she didn't smell. Funny how we prioritize our prayerful moments.

Funny, too I think, about how I learned two different versions of the Lord's Prayer: one – the Protestant litany – spoke to "forgiving our debts as we forgive our debtors"; the other – maybe a more traditional Catholic influenced version – substituted "forgive our trespasses as we forgive those who trespass against us." The differences never much bothered me as I prayed less and sinned more into my teenage years, but later I got to thinking about it as I entered the bond market and began to contemplate the odds of paying and being paid, or trespassing and being trespassed against with other people's money. Given a chance, I thought I would infinitely prefer forgiving a trespasser as opposed to a debtor.

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Debtors didn't necessarily belong in a prison but then they didn't belong in a prayer either, where forgiveness was akin to abrogation, default, and not getting your good old fashioned money back! Over the following years then, my own kids got stuck with "trespasses" instead of "debts" even though I eventually realized – as do you, my more prayerful readers – that they are meant to convey one and the same thing. Still as I wound my way through my bond career, and the inevitable Penn Centrals, Continental Banks, and Lehman Brothers of this business, I had frequent moments of silence, if not teensy prayers, that gave thanks to the Lord for getting most of my (your) money back. Like bumpy air at 30,000 feet though, the next day I was flying again in the bond market but with a slightly firmer grip on the wheel. Life just seems to go that way.

Speaking of bumpy air, trespassing, and the forgiveness of debt, the Greek/German tragedy of midsummer seems to have landed on terra firma for at least a few months, although inevitably the weakness of the Eurozone with its common currency, but disparate fiscal philosophies spells renewed turbulence in financial asset markets. The Eurozone – and the Eurounion itself as Britain's 2017 referendum may eventually reveal – is a dysfunctional family and may always be. Examples: 1) Germany vs. France; 2) the Balkans; 3) Southern peripherals; and 4) the more stoic Nordic countries. They are all so different that a common purpose seems to be missing. Perhaps that purpose if summed in three words might be "Peace and Prosperity" but while the peace seems to be assured by German passivity and the military blanket of NATO, prosperity is a subject of conflicting views as to which policies lead to long term growth. Draghi's ECB and the Merkel controlled EZ ascribe to the old theory of "Feed a fever, starve a cold" – the "fever" in this case being financial bull markets fed with 0% credit, and the "cold" being fiscal austerity starved by balanced budgets. So far, the philosophy seems to be working well for Germany, miserably for Greece, and not so well for all other EZ countries in between.

But these conflicting views as to how to treat a fever or cure a cold are global in scope. Japan appears to be feeding both monetary and fiscal maladies with its persistent QE and substantial budget deficits, yet has little to show for it in terms of either inflation or real growth. China seems to resemble a desperate patient, changing doctors and proposed remedies every other month or so. First, it feeds the Shenzhen market fever, allowing it to "double bubble" in the first 6 months of 2015, then authorities starve it by "inactivating" two thirds of market listed shares, and then eventually create financial SOEs (state owned enterprises) to buy billions of stocks to bail out naïve first time investors and ultimately its own economy.

But, because it is the finance system's global locomotive, it is the United States where this debate seems to be most critical, and where it subtly seems to be changing. It is not the fiscal stance that appears to be morphing, however. Republican "tax cut" orthodoxy will likely dominate for at least another few years. It's monetary policy where the battleground for evolutionary ideas is taking place, as the Fed begins to recognize that zero percent interest rates increasingly have negative, as well as positive consequences. Historically, the Fed and almost all other central banks have comfortably relied on a model which assumes that lower and lower yields will stimulate not only asset prices but investment spending in the real economy. With financial assets, the logic is straightforward: higher bond prices and stock P/E's almost axiomatically elevate markets, although the assumed trickle-down effect leading to higher real wages has not followed suit. In the real economy, it seemed almost straightforward as well: if a central bank could lower the cost of debt and equity closer and closer to zero, then inevitably the

private sector would take the bait – investing in cheap plant + equipment, technology, innovation – you name it. “Money for nothing – get your clicks for free”, I suppose. But no. Not so. Corporate investment has been anemic. Structural reasons abound and I have tried to convey that ever since my well-advertised New Normal, in 2009, which introduced the probability of a future generation of low real growth due to aging demographics, tighter regulations, and advancing technology permanently displacing workers. But there are other negatives which seem to be directly the result of zero bound interest rates. 3 month Libor rates have rested near 30 basis points for 6 years now and high yield spreads have narrowed and narrowed again in the quest for higher investment returns. Because BB, B, and in some cases CCC rated companies have been able to borrow at less than 5%, a host of zombie and future zombie corporations now roam the real economy. Schumpeter’s “creative destruction” – the supposed heart of capitalistic progress – has been neutered. The old remains in place, and new investment is stifled. And too, because of low interest rates, high quality investment grade corporations have borrowed hundreds of billions of dollars, but instead of deploying the funds into the real economy, they have used the proceeds for stock buybacks. Corporate authorizations to buy back their own stock are running at an annual rate of \$1.02 trillion so far in 2015, 18% above 2007’s record total of \$863 billion.

But perhaps the recent annual report from the BIS – the Bank for International Settlements – says it best. The BIS is after all the central banks’ central banker, and if there be a shift in the “feed a fever” zero interest rate policy of the Fed and other central banks, perhaps it would be logically introduced here first. The BIS emphatically avers that there are substantial medium term costs of “persistent ultra-low interest rates”. Such rates they claim, “sap banks’ interest margins...cause pervasive mispricing in financial markets...threaten the solvency of insurance companies and pension funds...and as a result test technical, economic, legal and even political boundaries.” Greece is not specifically mentioned, nor the roller coaster ride of Chinese equity markets, nor the rising illiquidity of global high yield bond markets, nor the... well a reader should get the point. Low interest rates may not cure a fever – they may in fact raise a patient’s temperature to life threatening status. Yellen, Fisher, Dudley and company may not be in total agreement, but they assuredly are listening as this week’s Fed meeting will likely attest.

There is no statistical reason per se for the Fed to raise interest rates, yet absent a major global catastrophe we are likely to get one in September. But the reason will not be the risk of rising inflation, nor the continued downward push of unemployment to 5%. The reason will be that the central bankers that are charged with leading the global financial markets – the Fed and the BOE for now – are wising up; that the Taylor rule and any other standard signal of monetary policy must now be discarded into the trash bin of history. Low interest rates are not the cure – they are part of the problem. Say a little prayer that the BIS, yours truly, and a growing cast of contrarians, such as Jim Bianco and CNBC’s Rick Santelli, can convince the establishment that their world has changed.

-William H. Gross

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