JANUS CAPITAL Group

Investment Outlook

from Bill Gross

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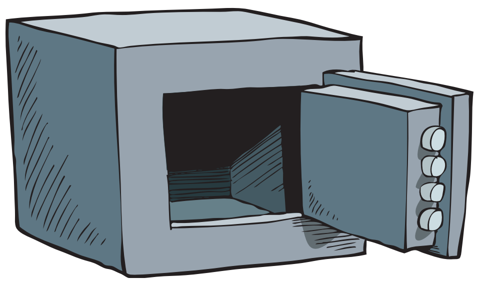


Show Me The Money

"School days" inexorably continue at the Gross household, not just because of grandchildren, but because of the necessity to teach my own kids the complexities and pitfalls of investing. As I get older, I fear I may unduly introduce them to a 1930s Will Rogers warning about losing money: "I'm not so much concerned about the return <u>on</u> my money," he wrote, "but the return <u>of</u> my money." <u>"Don't lose it"</u> is my first and most important conceptual lesson for them despite the Trump bull market and the current "animal spirits" that encourage risk, as opposed to the preservation of capital.

Recently I also explored with them the concept of financial leverage – specifically that of fractional reserve banking, which has been the basis of credit and real economic growth since the system was blessed by central banks over a century ago. "It still mystifies me," I told them, "how a banking system can create money out of thin air, but it does." By rough estimates, banks and their shadows have turned $3 trillion of "base" credit into $65 trillion + of "unreserved" credit in the United States alone – Treasuries, munis, bank loans, mortgages and stocks too, although equities are not officially "credit" they are still dependent on the cash flow that supports the system.

But I jump ahead of myself. "Pretend," I told the "fam" huddled around the kitchen table, that there is only one dollar and that you own it and have it on deposit with the Bank of USA – the only bank in the country. <u>The bank owes you a buck any time you want to withdraw it.</u> But the bank says to itself, "she probably won't need this buck for a while, so I'll lend it to Joe who wants to start a pizza store." Joe borrows the buck and pays for flour, pepperoni and a pizza oven from Sally's Pizza Supplies, who then deposits it back in the same bank in their checking account. Your one and only buck has now turned into two. You have a bank account with one buck and Sally's Pizza has a checking account with one buck. Both parties have confidence that their buck is actually theirs, even though there's really only one buck in the bank's vault.

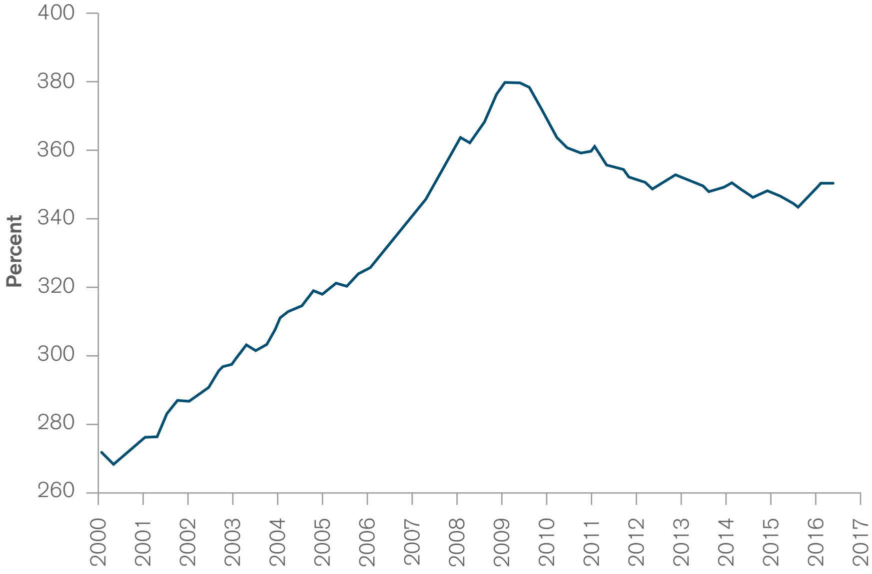
The bank itself has doubled its assets and liabilities. Its assets are the one buck in its vault and the loan to Joe; its liabilities are the buck it owes to you – the original depositor – and the buck it owes to Sally's Pizza. The cycle goes on of course, lending and relending the simple solitary dollar bill (with regulatory reserve requirements) until like a magician with a wand and a black hat, the fractional reserve system pulls five or six rabbits out of a single top hat. There still is only one dollar bill but fractional reserve banking has turned it into five or six dollars of credit and engineered a capitalistic miracle of growth and job creation. And importantly, all lenders of credit believe that they can sell or liquidate their assets and receive the single solitary buck that rests in the bank's vault. Well . . . not really.

"And so," my oldest son, Jeff, said as he stroked his beardless chin like a scientist just discovering the mystery of black holes. "That sounds like a good thing. The problem I'll bet comes when there are too many pizza stores (think subprime mortgages) and the interest on all of the loans couldn't be paid and everyone wants the dollar back that they think is theirs. Sounds like 2008 to me – something like Lehman Brothers." "Yep," I said, as I got up to get a Coke from the refrigerator. "Something like Lehman Brothers."

In the U.S., credit of $65 trillion is roughly 350% of annual GDP and the ratio is rising. In China, the ratio has more than doubled in the past decade to nearly 300%.

My lesson continued but the crux of it was that in 2017, the global economy has created more credit relative to GDP than that at the beginning of 2008's disaster. In the U.S., credit of $65 trillion is roughly 350% of annual GDP and the ratio is rising. In China, the ratio has more than doubled in the past decade to nearly 300%. Since 2007, China has added $24 trillion worth of debt to its collective balance sheet. Over the same period, the U.S. and Europe only added $12 trillion each. Capitalism, with its adopted fractional reserve banking system, depends on credit expansion and the printing of additional reserves by central banks, which in turn are re-lent by private banks to create pizza stores, cell phones and a myriad of other products and business enterprises. But the credit creation has limits and the cost of credit (interest rates) must be carefully monitored so that borrowers (think subprime) can pay back the monthly servicing costs. If rates are too high (and credit as a % of GDP too high as well), then potential Lehman black swans can occur. On the other hand, if rates are too low (and credit as a % of GDP declines), then the system breaks down, as savers, pension funds and insurance companies become unable to earn a rate of return high enough to match and service their liabilities.

U.S. Total Credit Market Debt as a Percent of GDP



Source: http://www.Economagic.com/

Central banks attempt to walk this fine line – generating mild credit growth that matches nominal GDP growth – and keeping the cost of the credit at a yield that is not too high, nor too low, but just right. Janet Yellen is a modern day Goldilocks.

How is she doing? So far, so good, I suppose. While the recovery has been weak by historical standards, banks and corporations have recapitalized, job growth has been steady and importantly – at least to the Fed – markets are in record territory, suggesting happier days ahead. But our highly levered financial system is like a truckload of nitro glycerin on a bumpy road. One mistake can set off a credit implosion where holders of stocks, high yield bonds, and yes, subprime mortgages all rush to the bank to claim its one and only dollar in the vault. It happened in 2008, and central banks were in a position to drastically lower yields and buy trillions of dollars via Quantitative Easing (QE) to prevent a run on the system. Today, central bank flexibility is not what it was back then. Yields globally are near zero and in many cases, negative. Continuing QE programs by central banks are approaching limits as they buy up more and more existing debt, threatening repo markets and the day to day functioning of financial commerce.

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I'm with Will Rogers. Don't be allured by the Trump mirage of 3-4% growth and the magical benefits of tax cuts and deregulation. The U.S. and indeed the global economy is walking a fine line due to increasing leverage and the potential for too high (or too low) interest rates to wreak havoc on an increasingly stressed financial system. Be more concerned about the return of your money than the return on your money in 2017 and beyond.

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Janus has been helping fixed income investors reach their financial goals for more than 25 years. Our team of investment experts is committed to delivering the stability our clients expect, with an unwavering focus on risk-adjusted returns and capital preservation. Today, we serve investors across a variety of markets by offering a diverse suite of fixed income strategies with highly complementary and distinctly separate investment approaches: a bottom-up, fundamental suite of strategies, and a top-down, global macro process.

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