JANUS CAPITAL Group

Investment Outlook

from Bill Gross

January 2015

"Ides"

A January Investment Outlook should normally be filled with recommended "do's and don'ts," "picks and pans" and December 31, 2015, forecasts for interest rates and risk assets. I shall do all of that as usual when I travel to New York City for the annual Barron's Roundtable in a few weeks' time. That is always an opportunity for me to engage in verbal jousting with Marc Faber, Mario Gabelli and the usual bearish forecast from the Gnome of Zurich, Felix Zulauf. So I'll leave the specific forecasting for a few weeks' time and sum it up in a few quick sentences for now: Beware the Ides of March, or the Ides of any month in 2015 for that matter. When the year is done, there will be minus signs in front of returns for many asset classes. The good times are over.

Timing the end of an asset bull market is nearly always an impossible task, and that is one reason why most market observers don't do it. The other reason is that most investors are optimists by historical experience or simply human nature, and it never serves their business interests to forecast a decline in the price of the product that they sell. Nevertheless, there comes a time when common sense must recognize that the king has no clothes, or at least that he is down to his Fruit of the Loom briefs, when it comes to future expectations for asset returns. Now is that time and hopefully the next 12 monthly "Ides" will provide some air cover for me in terms of an inflection point.

Manias can outlast any forecaster because they are driven not only by rational inputs, but by irrational human expressions of fear and greed. Knowing when the "crowd" has had enough is an often frustrating task, and it behooves an individual with a reputation at stake to stand clear. As you know, however, moving out of the way has never been my style so I will stake my claim with as much logic as possible and hope to persuade you to lower expectations for future returns over the next 12 months.

My investment template shares a lot in common with, and owes credit to, the similar templates of Martin Barnes of the Bank Credit Analyst and Ray Dalio of Bridgewater Associates. All three of us share a belief in a finance-driven economic cycle which over time moves to excess both on the upside and the downside. For the past few decades, the secular excess has been on the upside with rapid credit growth, lower interest rates and tighter risk spreads dominating the long-term trend. There have been dramatic reversals as with the Lehman Brothers collapse, the Asia/dot-com crisis around the turn of the century, and of course 1987's one-day crash, but each reversal was met with a new and increasingly innovative monetary policy initiative on the part of the central banks that kept the bull market in asset prices alive.

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Consistently looser regulatory policies contributed immensely as well. The Bank Credit Analyst labels this history as the "debt supercycle," which is as descriptive as it gets. Each downward spike in the economy and its related financial markets was met with additional credit expansion generated by lower interest rates, financial innovation and regulatory easing, or more recently, direct central bank purchasing of assets labeled "Quantitative Easing." The power of additional and cheaper credit to add to economic growth and financial asset bull markets has been underappreciated by investors since 1981. Even with the recognition of the Minsky Moment in 2008 and his commonsensical reflection that "stability ultimately leads to instability," investors have continued to assume that monetary (and at times fiscal) policy could contain the long-term business cycle and produce continuing prosperity for investors in a multitude of asset classes both domestically and externally in emerging markets.

There comes a time, however, when zero-based, and in some cases negative yields, fail to generate sufficient economic growth. While such yields almost automatically result in higher bond prices and escalating P/E ratios, their effect on real growth diminishes or in some cases, reverses. Corporate leaders, sensing structural changes in consumer demand, become willing borrowers, but primarily to reduce their own outstanding shares as opposed to investing in the real economy. Demographics, technology, and globalization reversals in turn have promoted a sense of "secular stagnation" as economist and former Treasury Secretary Larry Summers calls it and the "New Normal" as I labeled it as early as 2009. The Alice in Wonderland fact of the matter is that at the zero bound for interest rates, expected Returns on Investment (ROI) and Returns on Equity (ROE) are capped at increasingly low levels. The private sector becomes less willing to take a chance with their owners' money in a real economy that has a lack of aggregate demand as its dominant theme. Making money by borrowing at no cost for investment in the real economy sounds like a no-brainer. But, it comes with increasing risk in an environment of secular stagnation, demand uncertainty, and with the ROI closer to zero itself than an entrepreneur is willing to bear.

And so the miracle of the debt supercycle meets a logical end when yields, asset prices and the increasing amount of credit place an unreasonable burden on the balancing scale of risk and return. Too little return for too much risk. As the real economy of developed and developing nations sputter, so too eventually do financial markets. The timing – as mentioned previously – is never certain but the inevitable outcome is commonsensically sound. If real growth in most developed and highly levered economies cannot be normalized with monetary policy at the zero bound, then investors will ultimately seek alternative havens. Not immediately, but at the margin, credit and assets are exchanged for figurative and sometimes literal money in a mattress. As it does, the system delevers, as cash at the core or real assets at the exterior become the more desirable holding. The secular fertilization of credit creation and the wonders of the debt supercycle may cease to work as intended at the zero bound.

Comprehending (or proving) this can be as frustrating as understanding the differences between Newtonian and quantum physics and the possibility that the same object can be in two places at the same time. Central banks with their historical models do not yet comprehend the impotence of credit creation on the real economy at the zero bound. Increasingly, however, it is becoming obvious that as yields move closer and closer to zero, credit increasingly behaves like cash and loses its multiplicative power of monetary expansion for which the fractional reserve system was designed.

Finance – instead of functioning as a building block of the real economy – breaks it down. Investment is discouraged rather than encouraged due to declining ROIs and ROEs. In turn, financial economy asset class structures such as money market funds, banking, insurance, pensions, and even household balance sheets malfunction as the historical returns necessary to justify future liabilities become impossible to attain. Yields for savers become too low to meet liabilities. Both the real and the finance-based economies become threatened with the zero-based, nearly free money available for the taking. It's as if the rules of finance, like the quantum rules of particles, have reversed or at least negated what we historically believed to be true.

And so that is why – at some future date – at some future Ides of March or May or November 2015, asset returns in many categories may turn negative. What to consider in such a strange new world? High-quality assets with stable cash flows. Those would include Treasury and high-quality corporate bonds, as well as equities of lightly levered corporations with attractive dividends and diversified revenues both operationally and geographically. With moments of liquidity having already been experienced in recent months, 2015 may see a continuing round of musical chairs as riskier asset categories become less and less desirable.

Be cautious and content with low positive returns in 2015. The time for risk taking has passed.

Debt supercycles in the process of reversal are not favorable events for future investment returns. Father Time in 2015 is not the babe with a top hat in our opening cartoon. He is the grumpy old codger looking forward to his almost inevitable "Ides" sometime during the next 12 months. Be cautious and content with low positive returns in 2015. The time for risk taking has passed.

-William H. Gross

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