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Investment Outlook

from Bill Gross

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Mr. Bleu



"It's a spectacle of excess at the highest level", quoted an art consultant to the N.Y. Times. Perhaps it was. Christie's, even not counting its archrival Sotheby's, had bagged \$1 billion in sales during its May auction week – rivaling even the frenzied bidding for Manhattan high rise condos. As with high flying stocks, the logic was that the money had to go somewhere and why not a wall instead of a monthly portfolio statement.

I've never been much of an art aficionado myself, having settled for framing some All American Rockwells neatly clipped from old Saturday Evening Post covers. There was a time though when a well-publicized Rockwell came to auction and Sue and I expressed some interest. Ever since, we've been on the art house's mailing lists and I must admit, it's fun to browse through the Picassos, Rothkos, and whatever else currently frenzies modern collectors. I'm no expert though, and if I begin to pretend that I am, Sue puts me in my place because she's the artist in the family. She likes to paint replicas of some of the famous pieces, using an overhead projector to copy the outlines and then just sort of fill in the spaces. "Why spend \$20 million?" she'd say – "I can paint that one for \$75", and I must admit that one fabulous Picasso with signature "Sue", heads the fireplace mantle in our bedroom.

My own artistic skills are severely limited – I even suspect I am missing the entire right half of my brain which drives fine motor skills and the ability to draw. Because of the auction catalogues we get in the mail though, I have determined that I am not unique in this regard – even famous artists it seems are lacking the right side of their brains. One of those is Yves Klein to which (1928-1962) follows his title on two spectacular pieces listed in a Christie's twentieth century art sales catalogue. The "1962" points out I guess that he's dead which is too bad, because it makes it harder to compare "right brain" notes with him.

Still, the similarity is obvious because this guy painted like I draw self-portraits, and he got paid for it too. I present to you the first of his two images for your perusal and careful discrimination:

This “tour de farce” was titled “IKB” and consisted of “pigment and synthetic resin laid down on panel”, as Christie’s described it. All blue. It was 8x7 inches, which is important in the art world but which in this case might otherwise be described as a tad “puny”. Nevertheless, it sold for \$35,000 because I assume Mr. Klein’s blues were the bluest of all possible blues – creativity and right side brain nevertheless lacking.



As further proof of his brain’s black hole, I present for you another of Mr. Klein’s creations; the better known (17x14) piece entitled “IKB 121”, priced at \$150,000 no less:



Well, if that’s not the clincher. This guy was truly a painter extraordinaire. Mr. Klein as it turns out, called himself “Yves le monochrome”, and I can surely see why. When you’ve got a niche, exploit it, Yves must have figured. I can’t speak French very well, but I recently tried to reach my kindred half brain spirit in a séance-like half dream. I addressed him as Mr. Blue out of respect. “Mr. Bleu, Mon Ami”, I said “where, oh where in the art world is my niche?” The following was his suggestion that I now lay before you for critical acclaim:



What I should have expected, I suppose. But as his ghostly voice faded out of my brain’s right side, I heard him say – “I got a monopoly on the blue, kid. Why don’t you try red.” Half brain. Some kindred spirit he was.

Well life imitates art or perhaps it’s vice versa, but let’s shift over to the left side of our brains for an analysis of current financial markets. On the bond side, my famous (infamous?) “Short of a lifetime” trade on the German Bund market was well timed but not necessarily well executed. Still, it was a prime example of opportunities hatched by the excess of global monetary policy – zero based policy rates and tag team match quantitative easing programs which continue to encourage malinvestment in financial assets as opposed to the real economy. Interestingly though, central banks and their respective economies seem to be on different time cycles. The ECB for instance, is still committed for over a year’s worth of 700 billion Euro asset purchases, while the U.S. Fed is chomping at the bit to raise policy rates in late 2015. Partially because of these differences, there remain significant disparities in global asset prices that potentially can be successfully arbitrated. 10 year Treasuries for instance still trade at a 175 basis point premium to 10 year Bunds versus a long term historical average of 25 basis or so. A purchase of Treasuries and a sale of Bunds allows for not only a potential capital gain if the spread narrows, but a yield pickup while the Rip Van Winkle investor potentially waits for a probable outcome.

It is the disparities in monetary / fiscal policies as well as the staggered implementation of them that allows for opportunities such as the above. Similar rich / cheap comparisons can be drawn in risk asset space where corporate and high yield bonds as well as some equity market valuations seem to be 2 or more std. deviations from historical averages. Still an investor cannot go too far with the assumption that global asset prices in any sector or location will inevitably revert to historical mean averages. My “New Normal” in 2009 and “New Natural Policy Rate” in 2014 were rather bold “it’s different this time” forecasts that argued for just the reverse. There would be slower U.S. and global growth based on high debt and other structural headwinds said the “New Normal”, and there would be substantially lower future policy rates because of it, stated the

“New Natural Policy Rate” thesis. Not only that, but the changes would be different in different countries! Wow, what a conundrum as Alan Greenspan might say!

My thesis of arbitragable opportunities may appear hopeless from the get go with so many variables and future assumptions in so many parts of the world. Aside from a near 0% 10 year Bund moment on April 20th 2015, how could an investor expect to make money off of this? “With care”, I suppose, would be my foremost declaration, because the variable inputs to a “new” Taylor-like rule, would necessarily be subjective. What’s the new neutral policy rate, what’s the Nominal GDP growth rate, what’s the yield of a 10 Treasury, Bund, Gilt or JGB based upon any or all of the above? An explorer looking for these answers, however, should not necessarily be setting sail to find absolute values, but relative values. The “relative” narrows the universe significantly under the assumption that “relative” growth rates in the developed world and “relative” new neutrals should be more amenable to mean reversion than absolute values. Although influenced by slow crawling demographic differences, productivity and therefore nominal growth rates in developed countries are more likely to mean revert to one another, than to an absolute historical mean. There should be no reason for a technology miracle to be confined to the U.S. or any other major developed country. Such inputs are transferable at warp speed over the Internet – itself an example of the transferability of high tech.

If so, then relative Nominal GDP growth rates, the primary determinant of yield and risk spreads, should allow an investor to arbitrage attractively priced disparities in asset prices. Quite simply, if future Nominal GDP growth rates revert to historical relative averages in major economies, then yield differentials should revert to average spreads as well, assuming no significant quality changes. A stickler of a reader would immediately retort that the timing of Nominal GDP reversion is itself a critical variable and I would agree, but that still shouldn't render an inquisitive investor helpless.

Let's proceed to a few conclusions. Although subjective themselves, I'll use a set of IMF structural Nominal GDP forecasts for various countries and economic zones, and then assume that these growth rates normalize in 3 years (2018). If they do, then 10 year relative yield spreads should normalize as well. The chart below, using the above inputs shows rich / cheap conclusions as of late May 2015.

Current valuations of 10 year yields relative to each other (5/15)

U.S.	+50 basis points too high
U.K.	-50 basis points too low
Germany	-100 basis points too low
Spain	-50 basis points too low
Japan	Flat
Australia	Flat

The above table is obviously just a rough guide to opportunities that may become even more attractive in the short term. Mario Draghi's recently announced acceleration of May / June purchases based on Euroland's seasonal summer siesta in August is just one example that can make an unattractive sovereign (Germany) even more unattractive in the short run. But even in this modern era of malinvestment in financial assets, investors should want to choose the least overvalued asset to hold, and the most overvalued asset to sell. For an unconstrained fund that can both buy and sell, the current opportunity is a rare one. I suspect even Mr. Bleu would agree. Buy the “Blue” he might say – sell the “Red”. It worked for him once, so why not again.

-William H. Gross

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