02 07 2009 Bill Gross Dividend Stocks and Bonds Make Most Sense Now

In PIMCO Managing Director Bill Gross's monthly market commentary for July 2009, the Bond King comments on structural changes in the US economy that investors would do well to respond to in their portfolios:

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If long-term economic growth declines by 1½%, then profit growth will as well. This, after settling at perhaps half of absolute peak profit levels of 2007, because of the rise of savings rates from 0 to 8% or higher... What do trillion-dollar deficits and the recent reinitiation of PAYGO government programs tell you about the future of corporate tax rates? They're headed higher. Do you really think that a national health care program can be paid for with cost-cutting as opposed to tax hikes at insurance companies and benefit-paying corporations throughout all sectors of the American economy? The new normal will not be investor-friendly unless your forecasting dial is turned to "Pollyanna" or your intelligence quotient is significantly less than 100.

Investors who stuffed themselves on a constant diet of asset appreciation for the past quarter-century will now be enclosed in a cage featuring government-mandated, consumer-oriented fasting. "Non Appétit," not Bon Appétit, will become the apt description for the American consumer, and significant parts of the global economy, including the U.S. Because this is so, short-term policy rates will be kept low for longer than cyclical norms, and the outlook for risk assets – stocks, high yield bonds, and commercial and residential real estate will involve just that – risk. Investors should stress secure income offered by bonds and stable dividend-paying equities. Consumer Cuisinart consumption is a relic of the past.

"Kill the umpire," the fan cried to open the 1996 baseball season in Cincinnati, and eight pitches later, the man behind the plate, John McSherry, was dead, all 320 pounds of him screaming for more and more oxygen to feed his spastic heart. He'd been killed by a billion molecules of sink-clogging, Drano-resistant cholesterol that fed on his coronary artery and sucked up his life's blood like a vampire in the heat of the night. The next day Howard Stern had characteristically railed that the antidote was obvious. It was the same for all fat people: "DON'T EAT," he howled. As if the ump hadn't known. The fact was, he couldn't stop. He loved the taste of food – every sugary, fat-ladened, carbohydrated morsel. The first bite was a special ecstasy, as was the last, and everything in between. The man, it seemed, was a Cuisinart with four limbs.

Franz Kafka wove a tale 100 years earlier that was a mirror image of McSherry's tragedy. His "A Hunger Artist" described a professional faster – a sideshow freak in 19th century Europe who attracted attention and spare coins by withering away inside a wooden cage. The gapers marveled at his shriveled skeleton, stuck their hands through the bars to nudge his boney ribs, and awed at his resolve to starve himself to the precipice of self-extinction. "I always wanted you to admire my fasting," confessed the hunger artist, "but you shouldn't have. The fact is, I have to fast, I can't help it. I couldn't find the food I liked. If I had found it, believe me, I would have made no fuss and stuffed myself like you or anyone else."

The juxtaposition: one man who couldn't stop and another one who couldn't start – eating, that is. Their stories, though, are really not about food, but life itself – what compels us to do what we do, what forces us to act or not to act, what makes us who we are: is personal behavior really beyond our control? Shakespeare would retort that the fault lies not in our stars, but in ourselves. On the other hand, who are we other than this amorphous, gelatinous blob of moving flesh and bone molded primarily without our input, first by DNA, and then by environment into the living person we know as ourselves? Are we all just walking Cuisinarts, or better yet, mobile computers with a consciousness? Modern science has progressed to the point of asking, "Can machines think?" and if they can, it might well ask the corollary, "Are people machines?" The fact is that sophisticated modern machines can do just about anything a human being can do. The difference between "us" and "them" may only be our consciousness. We are "aware" whereas they are not. But if true, who wants to be a machine that simply knows it's a machine? Who wants to walk the Earth as a preprogrammed robot with no input or free will? **Unless the John McSherrys of the world can stop eating and the hunger artists can start, we might as well just turn out the lights.**

Our economy's lights, if not switched off in a rehash of the 1930s Depression, have certainly been dimmed in a 21st century version likely to be labeled the Great Recession. Much like John McSherry, U.S. and many global consumers gorged themselves on Big Macs of all varieties: burgers to be sure, but also McHouses, McHummers, and McFlatscreens, all financed with excessive amounts of McCredit created under the mistaken assumption that the asset prices securitizing

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them could never go down. What a colossal McStake that turned out to be. Now, however, with financial markets seemingly calmed and an inventory-based recovery in store for the balance of 2009, there is a developing optimism that we can go back to the lifestyle of yesteryear. PIMCO's driving thesis however, if not a juxtaposition, is succinctly described as a "new normal" where growth is slower, profit margins are narrower, and asset returns are smaller than in decades past based upon the delevering and reregulating of the global economy, which in turn should substantially inhibit the "gorging" of goods and services that we grew used to in decades past.

Forecasts based on econometric models inevitably miss these secular/structural breaks in historical patterns because it is impossible to quantify human behavior, and long-term trends involving risk-taking and in turn derisking are decidedly human in their origin. Bell-shaped curves with Gaussian/random distributions fail to anticipate that human beings do not make decisions by chance or independently of each other, but in many cases in reaction to one another. Humanity's personal and social computers appear to be programmed that way. And so, instead of "normal" distributions, economists and investors must learn to be on the lookout for "black swans," and if not, then certainly "fat tails," which differ from the measurement of natural phenomena accepted in science. "New normals," flatter-shaped bell curves, and structural shifts in previously accepted standards become not only possible, but probable as human nature reacts to itself and its prior behavior. The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking.

PIMCO and yours truly are not masters of the antithesis, a subjective approach which might derisively be called "crystal ball gazing," but we try to focus on what might be legitimate changes in the way economies and financial markets are affected by seemingly irrational or "non-normal" behavior and events. **The supersizing of financial leverage and consumer spending in concert with the politicizing of deregulation** describes in fifteen words our most recent brush with irrational behavior and inefficient markets. Greed will come again. But for now, the trend is the other way and it promises to persist for a generation at a minimum. The fact is that American consumers have suffered a collapse in wealth of at least $15 trillion since early 2007. Global estimates are less reliable, but certainly in multiples of that figure. And when potential spenders feel less rich by that much, the only model one can use to forecast the future is a commonsensical one that predicts higher savings, lower consumption, and an economic growth rate that staggers forward at a new normal closer to 2 as opposed to 3½%. There's no magic in that number, and no model to back it up, just a lot of commonsense that says this is how people and economic societies behave when stressed and stretched to a near breaking point.

I was impressed this weekend by an article in the Op-Ed section of ***The New York Times*** by staff writer Bob Herbert. "No Recovery in Sight" was the heading and his opening sentence asked, "How do you put together a consumer economy that works when the consumers are out of work?" That is really all one needs to ask when divining our economy's future fortune. Unless an optimist can prescribe how to put Humpty Dumpty back together again and shuffle him/her back to work then there can be no return to an "old normal." As unemployment approaches 10%, what is less well publicized is that the number of "underutilized" workers in the U.S. has increased dramatically from 15 to 30 million. Those without jobs, as well as those individuals who only work part-time and have become discouraged and stopped looking, total 30 MILLION people. The number is staggering. Commonsensically, one has to know that many or most of these are untrained for the demands of a green-oriented, goods-producing future economy. Imagine a welding rod in the hands of an investment banker or mortgage broker and you'll understand the implications quicker than any economist using an econometric model.

What this all means to you as an investor is near obvious as well. Unsurprisingly, what still can be modeled is the direct correlation of real profit growth to real economic growth, assuming a constant division of the "pie" between profits, labor and government. If long-term economic growth declines by 1½% then profit growth will as well. This, after settling at perhaps half of absolute peak profit levels of 2007, because of the rise of savings rates from 0 to 8% or higher. But to add to the woes of the investor class, one has only to observe that their share of the pie is shrinking. What does the General Motors example tell us all about the rebalancing of power between the investor class and the proletariat? What do trillion-dollar deficits and the recent reinitiation of PAYGO government programs tell you about the future of corporate tax rates? They're headed higher. Do you really think that a national health care program can be paid for with cost-cutting as opposed to tax hikes at insurance companies and benefit-paying corporations throughout all sectors of the American economy? The new normal will not be investor-friendly unless your forecasting dial is turned to "Pollyanna" or your intelligence quotient is significantly less than 100.Investors who stuffed themselves on a constant diet of asset appreciation for the past quarter-century will now be enclosed in a cage featuring government-mandated, consumer-oriented fasting. "Non Appétit," not Bon Appétit, will become the apt description for the American consumer, and significant parts of the global economy, including the U.S. Because this is so, short-term policy rates will be kept low for longer than cyclical norms, and the outlook for risk assets – stocks, high yield bonds, and commercial and residential real estate will involve just that – risk. Investors should stress secure income offered by bonds and stable dividend-paying equities. Consumer Cuisinart consumption is a relic of the past.

William H. Gross Managing Director

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