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Viewpoint

November 2014

The Tortoise and the ECB

Aesop relays the tale of a hare who ridicules a slow-moving tortoise, who then challenges the hare to a race. The hare soon leaves the tortoise far behind and, confident of winning, takes a nap midway through the race. When the hare awakes, however, he finds that his competitor, crawling slowly but steadily, has crossed the finish line before him.

Investors may wonder how long the European Central Bank (ECB) will slumber after taking an early lead in the race to expand its balance sheet to facilitate growth across the eurozone – the world's second-largest economy.

We could call it an economic fable…

Harley Bassman
Executive Vice President
Portfolio Manager

Mr. Bassman is an executive vice president and portfolio manager in the Newport Beach office, focusing on convexity products. Prior to joining PIMCO in 2014, he was a senior member of Credit Suisse's global rates business. Prior to that, he was with Merrill Lynch for 26 years in a variety of senior roles, including creating, marketing and trading a wide range of derivative and structured products. Mr. Bassman helped create the trademarked OPOSSMS and PRESERV mortgage risk management products and helped design the MOVE Index, the benchmark interest rate volatility gauge. Subsequently, he managed the firm's North American mortgage-backed securities and structured finance trading group and helped build the RateLab, the firm's full-spectrum U.S. rates trading desk strategy group. He has 31 years of investment experience and holds an MBA from the University of Chicago and a bachelor's degree in management science from the University of California, San Diego.

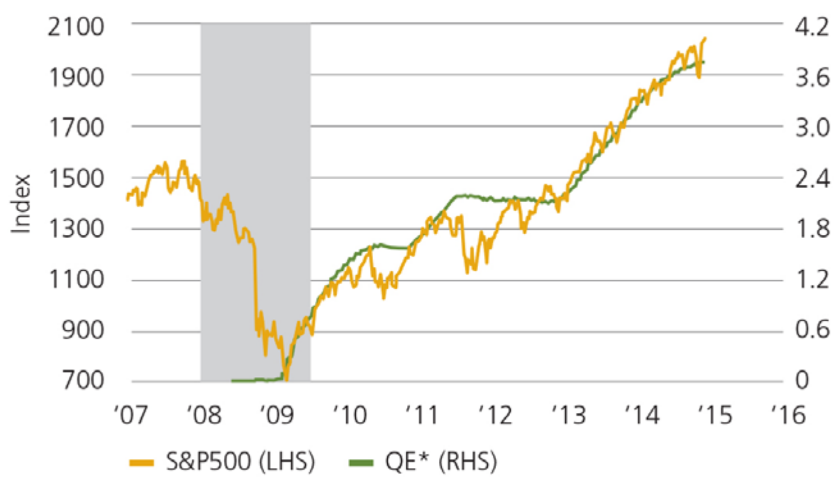
It has come to pass that the first- and third-largest economies on the planet – the U.S. and Japan, respectively, and the tortoises of our tale – have engaged in massive quantitative easing (QE) programs as a means to spur monetary velocity (via increased asset velocity – that is, the rate at which assets circulate). Yet some analysts insist the eurozone may not follow suit.

Quantitative easing in practice

While the philosophical merits of QE are questioned and debated, no one can doubt the results. To quote former Federal Reserve Chair and "dear leader" Ben Bernanke: "The problem with QE is that it works in practice, but it doesn't work in theory." Indeed, since the financial crisis, the Fed has implemented a grand scheme to increase monetary velocity via financial repression (the hovering-near-zero interest rate policy, or ZIRP, along with asset substitution) to create inflation, depreciate nominal debt, and delever both the public and private economies of the U.S.

Thus have we witnessed massive wealth creation via rising equity share prices (see Figure 1), with the steadily expanding Fed balance sheet *(**harlequin line**)* seemingly leading the S&P 500 *(**saffron line**)* to new heights. While one could certainly argue that corporate share repurchase programs have been the critical impetus for a rising equity market, all I can say is "tut-tut." Of course this is the dynamic of how QE would push stocks higher. That it was corporations instead of other investors effectuating the asset swap is irrelevant. Asset substitution was the entire purpose of QE; it just turns out that the credit channel for corporations is not as gummed up as the mortgage refinance process is for individuals.

FIGURE 1: QUANTITATIVE EASING HELPS DRIVE EQUITY MARKET GAINS



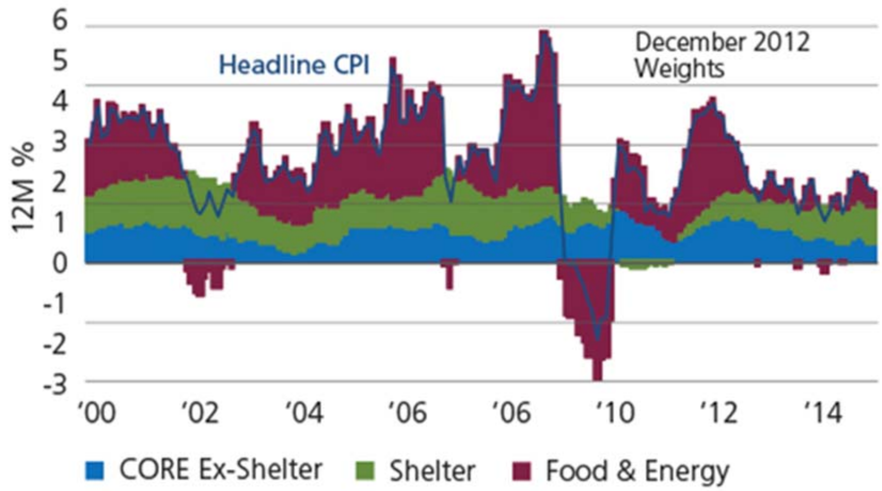
* Change from August 2008 in Fed holdings of Treasuries, MBS, GSE paper

Source: Minack Advisors, Federal Reserve, National Bureau of Economic Research, Bloomberg as of 31 October 2014.

There are many who are troubled by the Fed's actions since the funding markets decided that Lehman should "sleep with the fishes," but I have no such qualms. Maybe James Grant is right and we should have followed a similar hands-off policy as President Harding did during the depression of 1920–1921, or maybe Paul Krugman is correct and the $800 billion fiscal stimulus of 2009 was completely inadequate for the size of the problem. But I would retort that the Fed had recognized the checks and balances of our political system made it difficult to execute a prompt fiscal solution, and therefore the Fed needed to take the public policy reins.

And so it did. The Fed's unique abilities to directly affect funding markets quickly cut short the risk of a deflationary spiral in 2009 (see Figure 2). Away from the pampered 1%, most homes are purchased via a mortgage; as such, the retail mortgage rate will have a greater impact on the price of a house than any other input vector. Notice the ***fern shading*** that represents the housing component of CPI: It quickly changed direction as the dual liquidity measures of ZIRP and QE coursed through the market. The stabilization of housing prices may well have been the most important result of QE∞ (QE "infinity").

FIGURE 2: FED QE ANSWERS THE RAPID PLUNGE IN INFLATION DURING THE GLOBAL FINANCIAL CRISIS



Source: Minack Advisors, Bureau of Labor Statistics, National Bureau of Economic Research as of 30 September 2014

The lessons of Federal Reserve quantitative easing

This lesson has not been lost on policymakers in Japan, where residential housing has been in decline for over a decade. The inability of Bank of Japan (BOJ) to break its decade-long deflation is *not* proof that a central bank does not have the necessary tools to create inflation, but rather a demonstration that the BOJ had yet to try hard enough.

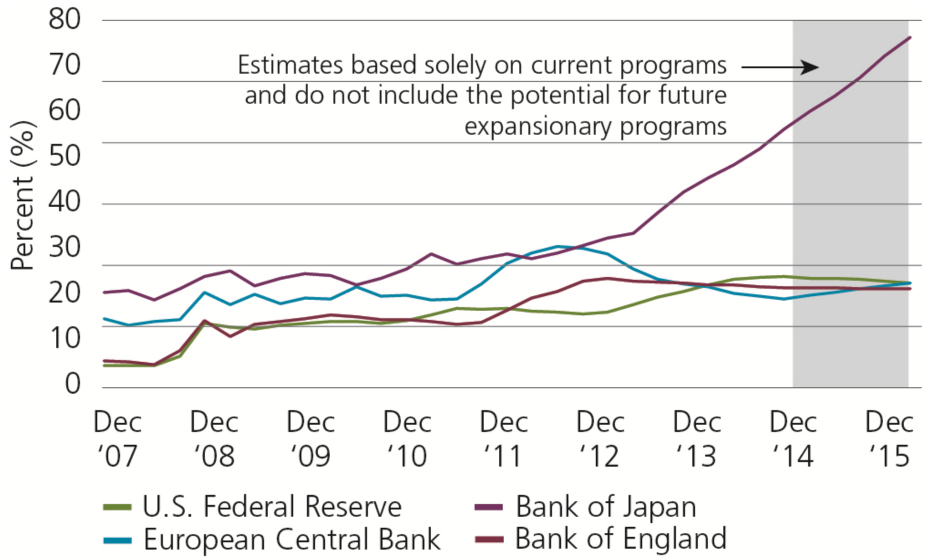
This was the entire point of Abenomics, to jolt the market into appreciating that there would soon be "all hands on deck" coordination between the Ministry of Finance (MOF) and the BOJ to direct the twin barrels of fiscal and monetary policy at deflationary expectations. As shown via the ***Nippon line*** in Figure 3, the yen depreciated by over 25% in the four months after the policy change in November 2012, and to emphasize how Japanese officials encourage asset velocity as a means to create monetary velocity, the Government Pension Investment Fund (GPIF) will soon adjust its asset allocations and redirect investment activities to increase its equity holdings while reducing Japanese government bond (JGB) holdings. One might call this investment "leadership by example."

FIGURE 3: PUBLIC POLICY IN JAPAN DEPRECIATES YEN AS PART OF THE BATTLE AGAINST DEFLATION

Source: Credit Suisse LOCUS data as of 20 November 2014

Not to place too fine a point on the fervency of Japan's determination to defeat deflation, Figure 4 shows projected total central bank assets as a percentage of GDP for the major developed markets (DMs), including the expanded parameters of Japan's version of QE∞.

FIGURE 4: EUROPEAN CENTRAL BANK ASSETS HAVE DECLINED



Source: Bloomberg, Financial Times as of 31 October 2014

Next move for the ECB

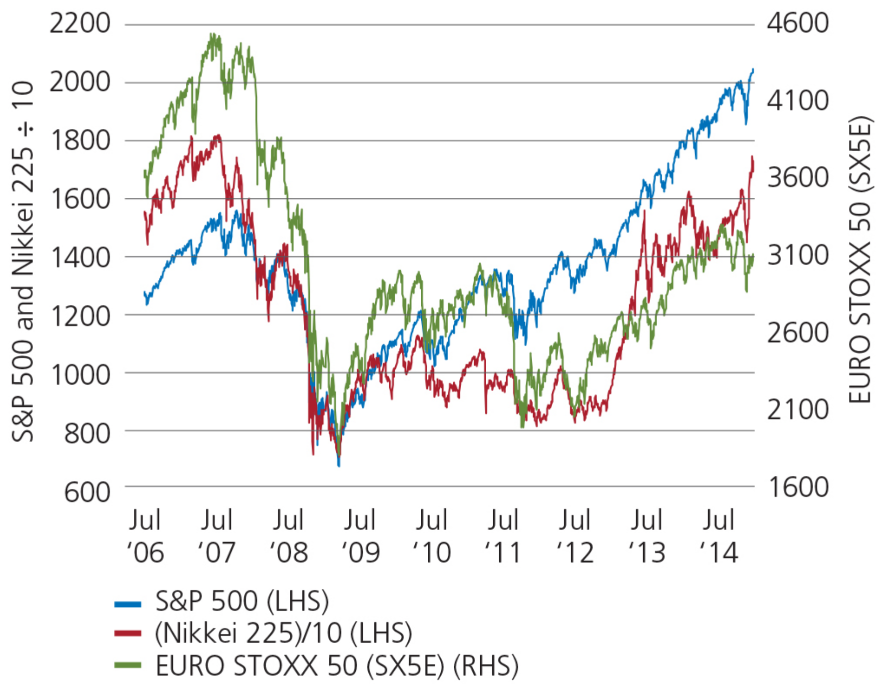
A small detail lost in the scale of Figure 4 is the ***picton line*** representing the central bank assets for the ECB. Notice it has been declining consistently for nearly two years. Napping, let us say.

What, then, is Europe's strategy? Expansive fiscal policy often works *internally* within a country's economy. Its primary goal is Keynesian pump priming as enhanced short-term government spending substitutes for a local dip in private spending. The primary goal of aggressive monetary policy is to devalue the country's currency to make its economy more competitive *externally* relative to its trading partners.

This "beggar thy neighbor" policy is not completely independent as it can only be effective to the extent that other countries do not respond in kind. So it is curious that the ECB continues to slumber while the eurozone's trading partners move steadily ahead.

Relative price changes in the three main DM equity indexes (see Figure 5) since they all bottomed in March 2009 show the ***cobalt line*** S&P 500 is up nearly 200% since its low while the ***pepper line*** Nikkei 225 is up 140%. The laggard has been the ***asparagus line*** EURO STOXX 50 (or SX5E), up barely 70%. Since the beginning of 2014, the S&P is up 10.3% and the Nikkei is up 6.7%, yet the SX5E is actually down 0.6%.

FIGURE 5: WHY IS THE RECOVERY IN EUROPEAN EQUITIES LAGGING THE U.S. AND JAPAN?



Source: Credit Suisse LOCUS data as of 19 November 2014.

Note how almost all of the European stock market's gains came soon after ECB President Mario Draghi's 2012 commitment to do "whatever it takes." Markets reacted in similar fashion to the balance sheet expansions of the Fed and the BOJ. So we have to wonder, "How long will Europeans effectively subsidize the U.S. and Japan via relatively weak policies?" We would suggest the answer is "not too long," and that investors should consider preparing for a stronger ECB policy by gaining exposure to the asset class that is most sensitive to an expanding balance sheet, namely European equities.

A dash forward at last?

Recall that asset velocity is not a goal but rather a path to accelerating monetary velocity. Other paths include increasing total wealth to stimulate spending or reducing risk aversion to invigorate animal spirits, both of which would occur under an explicit QE∞ program. Thus does encouraging (or, more correctly, bludgeoning) investors to trade into riskier assets at the expense of safer government-related ones fit into the master plan.

Consider this example: On 13 September 2012, before the Fed initiated its version of QE∞, the dividend yield of the S&P towered 100 basis points (bps) over the 10-year swap rate (2.60% versus 1.60%); at the same time, the S&P sported a calculated equity risk premium of 465 bps (i.e., inverse P/E ratio of 6.25% minus swap rate of 1.60%). In either case, the disparity over swap rates is rather amazing when one considers that bonds (when held to maturity) can only return a fixed principal denominated in fiat currency, while equities tend to offer some "real return" potential.

A sharp poke of QE∞ was enough to send the S&P up 45% through November 17. The S&P dividend yield has flipped to 60 bps below the 10-year swap rate, and the equity risk premium has been cut nearly in half. Similarly in Japan, Abenomics has coincided with a compression of the dividend to rate spread from +180 bps to +70 bps.

Relative to the U.S. and Japan, the European equity market is a rally waiting for ignition. The SX5E sports a 3.75% dividend yield versus a 1.05% swap rate: a +265 bps rate differential. Plus it sports a wide +360 bps equity risk premium. It would only take a slight push by the ECB to motivate European stocks to follow the other developed markets. And within equity markets, active stock pickers may find unique or overlooked opportunities.

While not a certainty, it seems highly unlikely that the ECB will indefinitely allow its main trading partners to competitively devalue versus the euro. And since there is no reason to reinvent the wheel, Europe's policymakers will likely unveil a familiar-looking and expansive QE policy designed to accelerate asset velocity and, in turn, reflate their equity market.

Unlike our fabled rabbit, investors should be awake, alert and positioned to see potential profit when the ECB arises from its slumber.

As such, all we can say is: "Run, rabbit, run."

Past performance is not a guarantee or a reliable indicator of future results. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Equities** may decline in value due to both real and perceived general market, economic and industry conditions. **Derivatives** may involve certain costs and risks, such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested.

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The **Dow Jones EURO STOXX 50 Index** is a capitalization-weighted index of 50 European blue-chip stocks from those countries participating in the EMU. Objective is to provide a blue-chip representation of supersector leaders in the Eurozone. The **Nikkei Stock Average** is an index of 225 leading stocks traded on the Tokyo Stock Exchange. Similar to the Dow Jones Industrial Average, it is composed of representative "blue chip" companies (termed first-section companies in Japan) and is a price-weighted index, whereby the movement of each stock, in yen or dollars respectively, is weighed equally regardless of its market capitalization. The **S&P 500 Index** is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the Large-Cap segment of the U.S. equities market. It is not possible to invest directly in an unmanaged index.

Newport Beach Headquarters
650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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Newport Beach, CA 92660
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