



## When I'm Sixty-Four

*Doing the garden, digging the weeds,  
who could ask for more?  
Will you still need me, will you still feed me,  
when I'm sixty-four.*

– *The Beatles*

Well who would have thunk it? Not Paul McCartney forty years ago and certainly not yours truly, but yes he has, and I am, about to turn 64. Unlike Paul's doleful dowager however, who pines for a companion to help him digging the weeds in a vegetable garden, life has offered up a more tossed and complicated salad for me to munch on. An authentic global financial crisis has led to sixteen-hour days and little time for gardening or the golf course for that matter. Still I'm not complaining – just explaining. As my wife Sue tells me every once in awhile, "You don't have to go to work, you know." Nor, I suppose, do I have to spend a Sunday afternoon writing *Investment Outlooks*, but here I am. Because, it only takes a second to realise how exciting this all is. The current crisis is like putting together the world's largest jigsaw puzzle and recognising you've completed the borders and a lot of the interior patterns. Can't stop now. Besides, 64 isn't old. The definition of old is "someone who is 15 years older than you are" and so I guess time must be on my side. Anyway, I hope I have a happy

64th and I'm glad that many of you still need me. The feeding, thank goodness, I can still do for myself.

There are so many important think pieces that have come up in recent PIMCO Investment Committee meetings that I thought I'd do a smorgasbord summary of four of them in order to let you know what we are keeping an eye on as we move ahead through 2008. They are as follows:

### **Credit Markets, Reregulation, and Home Prices**

In my opinion, the private credit markets have forfeited their privileged right to operate relatively autonomously because of incompetence, excessive greed, and in minor instances, fraudulent activities. As a result, the deflating private market's balance sheet is being re-nationalised – in some cases with increased regulation, in others with outright guarantees and agency lending. Ultimately government programs which support private credit market assets may be required in order to prevent an asset deflation of significant

proportions. Authorities must act quickly, with a shot of adrenalin straight to the heart of the problem: home prices. Since homes are the most highly levered and monetarily significant asset that American consumers own, if they decline much further they will drag the rest of the economy with them. Supporting home prices goes counter to the thinking of Republican orthodoxy. President Bush and Treasury Secretary Paulson argue that markets must “clear” in order to avoid similar mistakes made by Japanese authorities in the 1990s. Yet we may have passed the point of no return for “clearing” markets. Home price declines of 20% are in fact much more of a shock to the American economy than the popping of the Internet bubble and NASDAQ 5000, because the amount of homeowner leverage is so much greater. A 20% negative adjustment not only wipes out all ownership equity for millions of Americans, it turns their homes “upside down” – incentivising them to let their gardens grow weeds instead of lettuce. The decline needs to be stopped quickly in order to avert additional crises.

## **Bear Stearns and the Shadow Banking System**

The implosion of the Shadow Banking System claimed another victim in recent weeks with the forced sale of Bear Stearns to JPMorgan. The most likely conclusion to be drawn from the “Why Bear, Why Now?” question is that Bear Stearns was the most highly levered of the major investment banks and that it

was not well loved on the Street. The combination of the two led to increased haircuts and ultimately margin calls on the hundreds of billions of assets that were being financed by the intricate web of the Shadow.

Perhaps more significantly, the Fed’s near simultaneous provisions for discount window lending to investment banks was a major extension of Federal Reserve attitudes/authority that have seemed to typify past financial crises. The LTCM fiasco of 1998 led to an unofficial blessing of sizable hedge funds as “too big to liquidate” for instance, which led to the conclusion that the hedge fund industry had, to some extent, been validated. The Fed’s current invitation for investment banks to join the “discount window club” is a similar validation. It will however, come with a price tag. There seems no way that current reserve requirements for banks will not in some nearly uniform way be imposed on investment banks. Leverage and gearing ratios of securities firms therefore, will in a few years resemble those of commercial banks themselves resulting in reduced profitability for major houses such as Goldman, Lehman, and Merrill Lynch. Currently investment banks have only 50% of the capital base of standard commercial banks. If the two are to approximate each other either through regulation or moral suasion, these Shadow banks will likely be forced to raise expensive capital and/or reduce the bottom line footings of their balance

sheets. Either way, this need to have the Shadow Banking System more closely resemble the banks of Jimmy Stewart's "It's a Wonderful Life" will be costly, and bond spreads as well as stock prices should begin to reflect it.

Additionally, and importantly, because of this lender-of-last-resort operation, subsequent inflationary trends may have been fertilised because the debts that caused the crisis are now primarily in another private portfolio and not liquidated (the Fed having absorbed only 10% of the collateral). These debts have to be validated by policy makers through attempts to increase cash flows in the finance-based economy, which is another way of saying they are trying to reflate, which is another way of forecasting an increasing probability of higher inflation.

### **Asset-Backed Lending**

I've had a famous picture of J.P. Morgan on my office wall for 25 years. Even now, the old man seems to be staring at my back and taunting me with his famous quote written just below his vest with pocket watch in full view: "Lending is not based primarily on money or property. No sir, the first thing is character." For 20 of these 25 years I thought this idea was a relic of an outdated era. How could you judge the character of a CDO or an asset-backed security? Far better to lend on well collateralised property, I reasoned. But then it became increasingly apparent that credit, when issued against the collateral of assets, had

a capacity to multiply itself without restraint. The Shadow sanctioned and blessed increasing leverage under the assumption that "property" (houses) could only go up in value. "Character" had no place in such a modern-day financed-based economy. Liar loans, fraudulent appraisals, or even just the origination and resale of mortgage loans and asset-backed securities themselves proved that character was out, and property securitisation was in.

Thank you JP. While it's improbable that we can ever go back to your "know the customer" model of lending, we will likely pull back from our rating service blessed confidence in asset-backed securities. In its place will likely come the increasing reliance on government/agency guarantees as well as the explicit use of the government's balance sheet to support and then assimilate egregious loans of the past decade. As well, because of the retreat of securitisation, risk spreads – from corporate bonds to equities, to commercial and residential real estate – will settle at permanently higher levels. The US asset-based economy will morph into a more expensive hybrid that will reign supreme for years to come.

### **No Bailouts?**

Politicians – especially those on the Republican side of the aisle – are adamant about not using taxpayers' funds to bailout Wall Street or housing speculators, or whoever the current devil

may be. The public seems to nod in agreement while at the same time not noticing that their watch is being lifted or their pocket being picked. Let's see: Twelve months ago the yield on your money market fund was 5%+ but your next statement will probably feature something closer to 2%. Did your money market fund (which in aggregate approaches 3 trillion dollars) experience any capital gains in the process? Absolutely not. So it looks like your (the taxpayer's) contribution to the bailout of banks, or Florida condominium speculators can at least be quantified: 3% foregone interest per year on whatever you own. In addition, as pointed out in a previous section, the reflationary (inflationary) implications of all this suggest your contribution to the bailout will be even greater, since you'll likely wind up paying higher prices for many of the things you'll buy.

Ah, government sometimes works in mysterious ways. There's more than one way to have taxpayers bailout Wall Street!

Well, that's enough liberal, populist, straight-talking think pieces for one

*Investment Outlook.* Over the past few pages I've suggested: 1) home price declines have to be halted in order to revive the US economy, 2) the Bear Stearns crisis and its solution will lead to increased government regulation and a higher probability of inflation, 3) J.P. Morgan (the old man) was right – character, not assets, should form the foundation for lending, although a reversion to this old-fashioned model is not likely anytime soon, and 4) whether you know it or not – whether you like it or not – you are bailing out Wall Street.

And with that, let me put on my Mad Hatter hat from Alice in Wonderland and say, "A very merry un-birthday to you, to you." I'm the one, I guess, who's sixty-four.

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