Investment Outlook
September 2011
New-Fangled Love Songs

- Liquidity concerns may affect all European peripheral bond markets unless the European Central Bank counters the rush for the exits with an enlarged daily checkbook.
- In the U.S., discord between rich and poor has led to lower, not higher, Treasury yields as approaching recessionary winds force the Fed and private investors to favor bonds.
- We prefer investing in the "cleaner" dirty shirt countries of Canada, Australia, Mexico and Brazil, along with non-dollar currencies that have strong trade ties with the Asian continent.

Just an old-fashioned love song
Comin' down in three-part harmony.
Three Dog Night

In many ways the global economic crisis is like a marriage gone bad. As the Three Dog Night sang years ago, global economies have functioned harmoniously for many years, but suddenly the love songs have become strident and cacophonous, the policy coordination morphing into a war of the roses as opposed to a giving of them. Instead of three-part harmony we are now experiencing, at a minimum, tri-party <u>disharmony</u>, teetering on the brink of "divorce," which in economic parlance means a possible "developed economy" recession – a downturn from which reconciliation may be difficult due to a lack of policy options and cooperation. But I get ahead of myself. Let's first ring the wedding bells, then take you through an explanation of three separate global marriages and how each of the partners have grown apart.

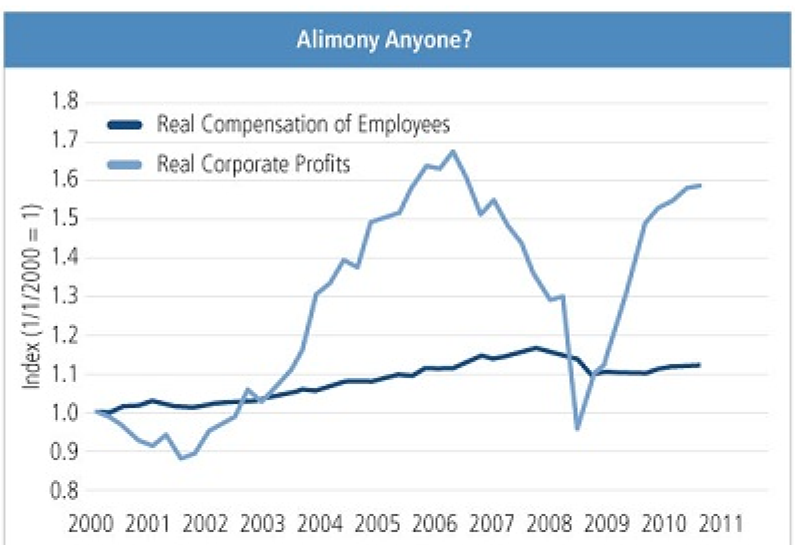
Europe Unites!
Oh those feisty Europeans! Always fighting like a dating couple and then finally resolving their differences by saying "I do" sometime in the 1950s with the creation of the Common Market and the European Economic Community (EEC). In doing so, France and Germany said "never again," and even though they didn't like each other (read "hate") they decided to make economic *lurv* in the hopes that they wouldn't destroy the continent again. It later turned into a formal union, a European Community (EC), where they invited lots of witnesses to the ceremony and created instant family members, if that's metaphorically possible. Twenty-seven of them, including Italy, Spain and the U.K. were now relatives despite some liking pasta and others preferring horrid cuisines featuring Shepherd's Pie or fish and chips. The marriage progressed to the point of a smaller monetary union sometime in 1999, but critically, without a common budget. Husband and Wife – Germany and Greece – decided to have a joint bank account, but with separate allowances and no oversight. Greece could issue bonds at nearly the same yield as could its Northern hard-working neighbors, but were free to spend it any way they chose. This was an economic version of an open marriage where one party gets to have all the fun and the other worked nine-to-five and came home too exhausted for whoopee. Well sometime last year, global lenders said enough is enough and soon the whole cheating European Union (EU) was at each other's throats, hiring lawyers and threatening to break up. Calmer heads prevailed when the ECB decided to make nice and use its checkbook. Last week Angela Merkel and France's

Sarkozy sort of got engaged for at least the second time, nixing expanded funding for their Southern neighbors and placing the burden even more on the ECB. **Who knows where it goes now, but let's put it this way – Germany and France are sleeping in a king-size bed while the rest of its EU family are sleeping in separate bedrooms. As a result Euroland faces economic contraction.**

California Dreamin'

This impending divorce in America is not about sex or sleeping around, but more about romancing the now stone-cold notion that anyone could be a millionaire in the good old U.S. of A. if only they worked hard enough. Our Statue of Liberty proclaimed "give us your tired, your poor…" and sent many of them West to build a little house on the prairie or strike it rich in the goldfields of Sacramento, California or Skagway, Alaska. Many of them did and a century later, the option-laden fields of Silicon Valley provided modern-day examples of rags to riches fairytales come true. But this odd couple marriage of rich (and poor hoping to be rich), now seems on rather shaky ground. Instead of boundless opportunity, the nursery rhyme describing Jack Sprat – who could eat no fat – and his wife – who could eat no lean – appears to be the starker of the two realities. There are the poor and there are the very rich, with the shrinking middle class resembling Mr. Sprat rather than his wife.

During this country's recent economic "recovery," real corporate profits increased by four times the amount of working wages in dollar terms, and, as the chart below shows, are 50% higher than at the turn of the century while wages remain relatively unchanged, something that has not occurred since this country's nuptials were concluded over three centuries ago. Is it any wonder that preliminary battlefield skirmishes in Wisconsin and Ohio between labor and capital promise to spread across every state of this land? (Not Texas!) **Is it any wonder that Republican orthodoxies favoring tax cuts for the rich and Democratic orthodoxies promoting entitlements for the poor threaten to hamstring any constructive efforts to reduce unemployment over the foreseeable future?** We are witnessing romantic love turning into a spiteful, bitter clash between partners in name only.



Source: National Income and Product Accounts, PIMCO

The Asian Miracle

Confucius say, "Can there be a love which does not make demands on its object?" While not a marriage, there has definitely been a love affair between Western consumers and their Chinese producer "objects" for several decades now. We loved them because they made cheap goods, but somehow they seemed to love us more as they slowly but surely put their people to work while ours were hitting the unemployment lines. Imperceptibly, the developed world's manufacturing base was gradually eroding and being replaced by securitized finance that destroyed itself and nearly its economies in 2008.

China, meanwhile, calmly played its cards with a decades-long plan centered around capitalistic mercantilism, a game the United States claimed to play best but somehow forgot most of the rules. Even when holding the trump card of a reserve currency, mercantilistic domination depends on making something the rest of the world wants. We don't and they do. The Chinese "object" has turned into an object lesson for developed economies that debt-financed consumerism is reaching an end. This affair then, which has sustained global growth during much of the 21st century, is vulnerable. Both parties still play kissy face and say "luv ya" (weak form for "I love you") but there is tension there. China questions our credit quality and the yields on their trillion dollars of Treasury bonds. The U.S. questions their exchange rate and claims currency manipulation behind closed doors. This couple claims to still be dating, but "hooking up" may be more like it. Even then, no one stays the night, claiming they left their toothbrush at home.

Judge Judy's Verdict

What to do when a love affair goes bad? How should you invest when Euroland is at each other's throat, when a thinly disguised battle between labor and capital freezes policy action in the United States, when a mercantilistic partnership between developed and developing nations produces more questions than answers, more losers than winners? Increase the odds for a divorce, we'd suggest, which in investment markets means focusing on the return of your capital as opposed to the return on your capital. Of the three rocky relationships, Euroland has the most immediacy. Mohamed El-Erian is increasingly of the persuasion that one or more of the outer periphery (Greece, Ireland and Portugal) may be forced to vacate the premises. If so, technically destabilizing liquidity concerns may affect all peripheral bond markets unless the ECB counters the rush for the exits with an enlarged daily checkbook.

In the U.S., strangely enough, matrimonial discord between rich and poor has led to lower, not higher, Treasury yields as approaching recessionary winds force the Fed and private investors to favor bonds. There are limits, however. Ten-year Treasuries at 2.25% are discounting a heap of trouble (none of it strangely enough due to its own credit standing), and neither investor nor borrower may emerge from this brouhaha unscathed. We prefer the "cleaner" dirty shirt countries of Canada, Australia, Mexico and Brazil, where higher yields and more pristine balance sheets prevail.

And what of China and its fling as mercantile dominatrix? Here to stay – get used to it, PIMCO would say, but at the same time a substantial currency revaluation would assist its image and economy in its new role as the global economy's economic locomotive. **Consider investing,**

therefore, in non-dollar currencies that have strong trade ties with the Asian continent. Global equities? They're cheap – dividend yields are higher than bonds in many cases – yet if growth falters there may be more downside to come.

A good relationship, as any adult knows, takes hard work and even then true love never runs smooth. We are into the "bumpy journey" phase of our New Normal where fear, lack of policy options and loss of control can dominate relationships. At a minimum, investors need to prepare for disharmony even with the hope of eventual reconciliation. Those old-fashioned love songs have become new-fangled freshly entangled ones from which an escape may be hard to envision.

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