



Two-Bits, Four-Bits Six-Bits, a Dollar

The Gross family legend is rather full of Paul Bunyan tall tales passed down over the years but none perhaps more self-revealing than “The Day When I Gave the Waitress a Negative Tip.” Admittedly I was young and full of testosterone but the service was terribly sloooww and I was in a big hurrrrryyy! Finally presented with a \$2.00 bill, I took two bucks and wrote the following on a nearby napkin: “Thanks for the sh...ty service, negative tip – you owe me 25 cents.” I didn’t stick around to see the reaction, but I’m sure it was a unique experience for the young lady. I was, of course, like any 21-year-old, in the business of establishing a repertoire of “unique” experiences and this was but one notch on my Paul Bunyan Axe.

These days, my negative two-bit tip would hardly leave a dent in the estimated \$25 billion annual pool of tips left at American restaurants. No matter. What was revealing at the moment back in 1965 was what it said about me: impatient, willing to disappoint people (at least strangers) and a little inconsiderate of some people. Maybe a little imaginative too. In any case, social scientists have recently confirmed that tipping does send a message and that it is more about the man or the woman in the mirror than the quality of the service. The primary reason for tipping appears to be social approval. Theoretically it is a power

tool, a financial weapon that commands “treat or trick,” but studies since the 1940s have shown that most people do not have the requisite nerve to stiff a waitress even for unreasonable service. And too, William Grimes, in *The New York Times*, pointed out a decade ago that a waitress who touched her customers when asking if the meal was OK, raised her tip from 11 to 14% of the tab. Waiters’ personal introductions, as well as crouching at the table when taking an order, also worked famously. And here’s an interesting tidbit: Solo diners leave an average tip of 19.7% while a five-some drops all the way to 13.2%. Evidently, the size of the tip is a factor, and a reason why restaurants charge 16%+ for groups of six or more. That surely would have enraged Leo Crespi, who at the turn of the 20th century proposed the formation of a National Anti-Tipping League. While ahead of his time, he would likely play second fiddle to yours truly 65 years later who invented the “negative tip.” Recently my 22-year-old son, Nick, carved a notch on his own Paul Bunyan Axe with a negative \$1.00 tip adjusted for 45 years of inflation. Tip off the old block, I’d say!

Speaking of investment tips, no clue or outright signal could have been any clearer than the one given in December 2008, labeled “Quantitative Easing.” While the term was new, the intent was obvious:

(1) pump public money into the financial system to replace private credit that was being destroyed in the process of deleveraging; (2) lower interest rates on intermediate and long-term mortgages/Treasury bonds and in the process flush money into risk assets – most visibly the stock market; and (3) forecast publically then hope that higher stock prices would lead to a wealth effect, and in turn generate new private sector lending, job creation and a virtuous circle of economic expansion that would heal the near-fatal wounds of Lehman and its aftermath. If that was the game plan, then so far, so good, I'd say. Interest rates are artificially low, stocks have nearly doubled since QE I's first announcement in December of 2008, and the U.S. economy will likely expand by 4% this year, although a \$1.5 trillion budget deficit must share QE's Oscar for most stimulative government policy of 2009/2010.

Many critics, though, including yours truly, would wonder whether Quantitative Easing policies actually heal, as opposed to cover up, symptoms of an unhealthy economy. They might at the same time ask simplistically whether it is possible to cure a debt crisis with more debt. As I have discussed in numerous *Investment Outlooks*, the odds of an ultimate QE success seem critically dependent on several criteria: (1) initial sovereign debt levels that are relatively low. Reinhart and Rogoff in their book "This Time Is Different" have suggested an 80–90% of GDP limit to sovereign debt levels before they become counterproductive; (2) the ability of a

country to print globally acceptable scrip – especially enhanced if that nation has the reserve currency status now ascribed to the U.S.; and (3) the willingness of creditors to believe in future real growth as a rebalancing solution to current excessive deficits and debt levels.

Most observers would agree with us at PIMCO that QE I and II programs were initiated and employed under the favorable conditions of (1) and (2). The third criterion (3), however, is more problematic. A successful handoff from public to private credit creation has yet to be accomplished, and it is that handoff that ultimately will determine the outlook for real growth and the potential reversal in our astronomical deficits and escalating debt levels. If on June 30, 2011 (the assumed termination date of QE II), the private sector cannot stand on its own two legs – issuing debt at low yields and narrow credit spreads, creating the jobs necessary to reduce unemployment and instilling global confidence in the sanctity and stability of the U.S. dollar – then the QEs will have been a colossal flop. If so, there will be no 15%+ tip for the American economy and its citizen waiters. An inflation-adjusted "negative buck" might be more likely.

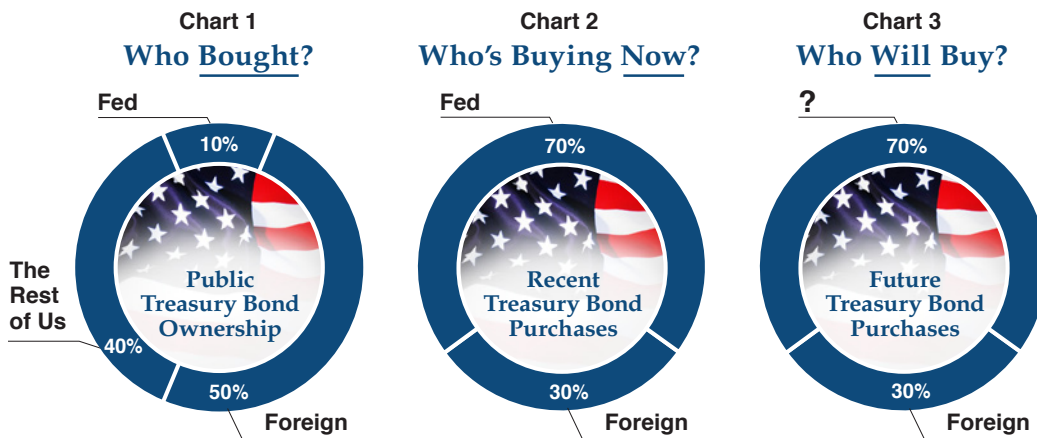
Washington, Main Street – and importantly from an investment perspective – Wall Street await the outcome. Because QE has affected not only interest rates but stock prices and all risk spreads, the withdrawal of nearly \$1.5 trillion in annualized check writing may have dramatic consequences in the reverse direction. To visualize the

gaping hole that the Fed's void might have, PIMCO has produced a set of three pie charts that attempt to point out (1) who owns what percentage of the existing stock of Treasuries, (2) who has been buying the annual supply (which closely parallels the Federal deficit) and (3) who might step up to the plate if and when the Fed and its QE bat are retired. The sequential charts 1, 2 and 3 are illuminating, but not necessarily comforting.

What an unbiased observer must admit is that most of the publically issued \$9 trillion of Treasury notes and bonds are now in the hands of foreign sovereigns and the Fed (60%) while private market investors such as bond funds, insurance companies and banks are in the (40%) minority. More striking, however, is the evidence in Chart 2 which points out that nearly 70% of the annualized issuance since the beginning of QE II has been purchased by the Fed, with the balance absorbed by those old standbys – the Chinese, Japanese and other reserve surplus sovereigns. Basically, the recent game plan is as simple as the Ohio State

Buckeyes' "three yards and a cloud of dust" in the 1960s. When applied to the Treasury market it translates to this: The Treasury issues bonds and the Fed buys them. What could be simpler, and who's to worry? This Sammy Scheme as I've described it in recent *Outlooks* is as foolproof as Ponzi and Madoff until... until... well, until it isn't. Because like at the end of a typical chain letter, the legitimate corollary question is – **Who will buy Treasuries when the Fed doesn't?**

I don't know. Reserve surplus sovereigns are likely good for their standard \$500 billion annually but the banks are now making loans instead of buying Treasuries, and bond funds are not receiving generous inflows like they were as late as November of 2010. Who's left? Well, let me not go too far. Temporary voids in demand are not exactly a buyers' strike. Someone will buy them, and we at PIMCO may even be among them. The question really is at what yield and what are the price repercussions if the adjustments are significant. Fed Vice Chairman Janet Yellen in a speech just last week confirmed the theoretical rationale



Source: Federal Reserve, PIMCO estimates

that Treasury yields are directly linked to the outstanding quantity of longer-term assets in the hands of the public. If that quantity is suddenly increased in one year as the charts imply, what are the yield consequences? **What I would point out is that Treasury yields are perhaps 150 basis points or 1½% too low when viewed on a historical context and when compared with expected nominal GDP growth of 5%.** This conclusion can be validated with numerous examples: (1) 10-year Treasury yields, while volatile, typically mimic nominal GDP growth and by that standard are 150 basis points too low, (2) real 5-year Treasury interest rates over a century's time have averaged 1½% and now rest at a negative 0.15%! (3) Fed funds policy rates for the past 40 years have averaged 75 basis points less than nominal GDP and now rest at 475 basis points under that historical waterline.

As a counter, one would argue (and I would partially agree) **that the U.S. and indeed developed global economies must keep yields artificially low for some time if post Lehman healing is to take place. But that of course is the point. By eliminating QE II, the Fed would be ripping a Band-Aid off a partially healed scab. Ouch!**

25 basis point policy rates for an “extended period of time” may not be enough to entice arbitrage Treasury buyers, nor bond fund asset allocators to reenter a Treasury market at today’s artificially low yields. Yields may have to go higher, maybe even much higher to attract buying interest.

Investors should view June 30th, 2011 not as political historians view November 11th, 1918 (Armistice Day – a day of reconciliation and healing) but more like June 6th, 1944 (D-Day – a day fraught with hope for victory, but fueled with immediate uncertainty and fear as to what would happen in the short term). Bond yields and stock prices are resting on an artificial foundation of QE II credit that may or may not lead to a successful private market hand-off and stability in currency and financial markets. 15% gratuities may lie ahead, but more than likely there is a negative two-bit or even eight-bit tip lying on the investment table. Like I did 45 years ago, PIMCO’s not sticking around to see the waitress’s reaction.

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