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Your Global Investment Authority

Viewpoint

April 2015

An Open Letter to the Eurozone

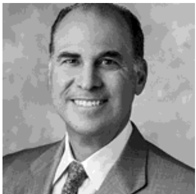
Dear public policy mavens:

As it has once again become fashionable to send an open letter to foreign dignitaries, now is certainly a propitious moment to help focus attention upon dissolving a perplexing financial impediment. For while limiting nuclear proliferation and reducing armed conflict are headline grabbers, the more mundane topic of cleansing the channels of global finance is in fact a public policy good that can create a positive social impact in real time. As such, I now respectfully offer my thoughts on ways to enhance the effectiveness of the current policy path.

Let's open with a parable. Consider the decision process of one Aron Ralston, as dramatized in the 2010 film "127 Hours". While canyoneering in a remote location, he tumbled into a ravine and accidentally wedged his arm under a massive boulder. As his limited supplies ran out and a dizzying dehydration focused his mind, he pulled out a pen knife so dull it could have passed through a TSA checkpoint. He soon freed himself (minus his right forearm) and survived to tell the story.

Mr. Ralston did not arise that morning, look out the window and exclaim what a fine day it would be to forsake his limb; rather, at that moment under the rock he realized that Plan B could only be worse.

And so too have the Fed and other central banks taken actions that at the time may have seemed hazardous, but in retrospect were rather brilliant as the Plan B of timid restraint would have led to an unpleasant denouement.



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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.

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The side door to monetary velocity

At the height of the financial crisis in 2008, the Federal Reserve recognized that the U.S. economy was over-indebted and the only avenue available to reduce this burden was to inflate (effectively a slow-motion default).

Reading from their textbooks, they knew:
M*V = P*Q = GDP

Unfortunately, a helicopter drop of $4 trillion (M) could not gain traction because declining velocity (V) more than offset the increasing money. (For the files, P and Q are prices and quantity of goods and services – elementary Milton Friedman.) Thus the importance of the combined power of the zero interest rate policy (ZIRP) + quantitative easing (QE) + Operation Twist: The Fed created a greased skid to force substitution from assets associated with safety for those imbued with "animal spirits" – that is, assets further out along the risk spectrum.

Relatively free U.S. capital markets facilitated the transmission of asset substitution to asset velocity to monetary velocity. The Fed purchased much of the free float of U.S. Treasuries and mortgage-backed securities (MBS) in its QE program from money managers. These managers soon substituted corporate bonds, both investment grade (IG) and high yield, in their portfolios for the "safer" debt sold to the Fed. In turn, many corporations soon issued new debt to satisfy this demand and used the proceeds to repurchase equity, sometimes with a dividend that was greater than the coupon. Separately, but inexorably linked, financial repression defused the worrisome "rollover" of the commercial real estate debt issued from 2003 to 2006. Lower capitalization rates decreased loan-to-value ratios (LTVs), which helped mitigate a brewing wave of defaults.

While little remarked, this policy prescription was executed in coordination with the U.S. Treasury and with the tacit approval of both the president and the Congress. In Japan a similar coordination of top policymakers has allowed Abenomics to be more effective than past efforts. Consensus was built and implemented to finally jolt the economy out of its twenty-year morass.

There are many market sages who fervently believe that a central bank cannot create inflation solely by its own hand, and point to Japan as proof. On the contrary, Japan is only proof that until recently the Bank of Japan (BOJ) did not try hard enough. Halfhearted attempts to reboot were frequently short-circuited by not fully implementing the stimulus or by a premature removal of such stimulus. Abenomics was a triple-barreled push to create inflation and devalue a debt overhang. In short order, the currency has devalued by 35%, the Nikkei is up over 80% in local terms and deflation is abating.

A key component was the coordination between the BOJ, the Ministry of Finance and the Government Pension Investment Fund, which agreed to alter their asset allocation enabling them to sell Japanese government bonds (JGBs) to the BOJ and then recycle the cash into both domestic and foreign equities.

In both the U.S. and Japan, the necessary condition that allowed asset substitution to accelerate monetary velocity was political and regulatory synergy to facilitate the flow of funds.

It is this synergistic coordination that is missing in the eurozone and must be resolved.

The European Central Bank takes the next step

The ECB is on a path to inject money into the financial system via its own version of QE. However, unlike in the U.S., where large pools of funds are attended to by private managers, in Europe most long-term assets are held by heavily regulated pensions and insurance companies. While one can appreciate the good intentions of regulators insisting that the maturity of assets should closely match that of their liabilities, the unintended consequence has been to encourage asset managers to buy fixed income securities as rates decline regardless of price, instead of transitioning to potentially superior long-run investment opportunities.

How can it occur that financial managers, whose liabilities

may cost well over 4%, may need to buy more bonds as rates decline from a 2%-handle to a 1%-handle? It is the byproduct of the geeky bond math known as convexity. Long-dated fixed coupon bonds have more convexity than shorter-dated bonds, and with rates already below their cost of capital, many managers have run a gap in their asset/liability management (or ALM – their assets might have an average maturity of 10 years while their liabilities could be 20 years.) Unfortunately, as interest rates declined in anticipation of QE, the ALM gap widened, and so as to not run afoul of various regulations, ever more bonds were purchased.

Thus have some pension and insurance regulations confounded the ECB's efforts. ECB President Mario Draghi wants portfolio managers to sell their sovereign bonds to the ECB and recycle those funds to other assets that will support economic growth. Instead, these hamstrung asset managers are effectively anticipating his policies and partially muting their effectiveness.

What would be helpful is policy coordination between the ECB, the European Insurance and Occupational Pensions Authority (EIOPA) and the Dutch National Bank (DNB), tempering the impact of Solvency II and other regulatory measures in the short to medium term; this would cover about 80% of euro-denominated pension and insurance and pension assets.

If not a partnership, at least a mutual goal

While it might seem daunting to ask an independent central bank to sip tea with a few independent regulators, the fact is a good deal of common ground could be found. The current regulatory hot button is limiting the gap between assets and liabilities. The worry is that if the gap becomes too wide, monetary stewards may have trouble fulfilling their obligations. However, if meeting this duration gap is done with little consideration of the ultimate return the assets generate, then one may suffer the "lipstick on a pig" conundrum – the duration may look pretty, but the underlying asset is still ugly. Buying assets that yield less than the cost of liabilities may satisfy current statutes, but it almost certainly assures an eventual shortfall.

Similar to our intrepid adventurer, the eurozone economy is presently wedged into a financial ravine that requires drastic action to escape. However, for the ECB's QE to be fully effective, macro policy coordination is needed. Without surrendering their independence, insurance supervisors and pension regulators could revise or temporarily suspend some of the more stringent reserve capital charges to allow for greater duration gap variability. In conjunction with the deferral of capital gains on the sale of premium bonds, this revision may well encourage diversified and broader holdings of equity investments.

Not only would this greater ALM flexibility potentially enable managers to earn a return closer to the true cost of their liabilities, it could also increase asset velocity to enable QE to be as effective in the eurozone as it has been in both the U.S. and Japan.

Respectfully,

Harley S. Bassman
PIMCO, 9 April 2015

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