



No Country for Old Maids

There's a parlor card game most boomers know as "Old Maid." It could've just as easily been labeled "Crotchety Old Bachelor" I suppose, but then we all know why it wasn't – men owned the playing card companies and still do. But it was a fun game for Eisenhower generation kids to play and unlike "War," involved a surprising amount of skill and human interaction. If you had the "Maid" the object was to dump it on someone else, but doing that involved numerous deceptions not totally unlike today's shenanigans involving our capital markets and their imploding financial conduits. First of all, you had to pretend you didn't have it in your hand. A calm, "no problem" facial expression was a requisite, but then you still had to entice your opponent on your left to pull the old lady out of a handheld mini-stack of perhaps 6 or 7 of your remaining cards. Placing "the card" at either end was one tactic, but the most successful maneuver always seemed to be exposing one edge of a middle card just a little bit higher than all the rest – the bait. Once dumped, you could breathe a temporary sigh of relief until, until...well until it was your turn to

draw again from that all too suspicious player on your right.

Old Maid now has a second life mimicking our financial markets, and at PIMCO we've played it frequently in our Investment Committee over the past several months. "Who's got the 'Old Maid'?" we ask over and over again – not to make us feel good that we don't – but to make sure we won't draw it when its holder tries to pass it on. This shunned lady in asset form was originally identified as a subprime mortgage, aggregated into levered financial conduits which in turn were guaranteed to be AAA hotties either via their securitized structures or the solemn pledge of monoline insurance firms. No Old Maids in those hands, investors were assured; they were Babes with a stacked deck. Ah, but Father Time has a way of exposing plastic surgery and there have been implants aplenty in recent years. Most of the silicone to be sure involved mortgage-related assets – first the subprimes, then the Alt As, and now perhaps even levered primes. **Yet those that claim that the Old Maid necessarily resides in a deck composed**

of mortgage loans are missing the larger point. This parlor game is best defined by leverage and not the assets that have been dealt out to more than willing players over the past decade. That subprimes have garnered the headlines is only because they were the asset class that failed first. Now as the U.S. economy slows to what Alan Greenspan labels “stall speed,” levered structures holding commercial loans, and auto and credit card receivables are the new Babes in waiting – waiting to be exposed for what some of them could be: Old Maids with collagen carelessly injected by Moody’s and S&P.

That this topic as I’ve described it might seem to resemble a “LOL” *New Yorker Magazine* cartoon involving a most serious topic is hopefully forgivable. Sometimes you have to laugh at the human comedy in order to comprehend it. But let there be no mistake: this description of Old Maids and PIMCO’s Investment Committee’s attempt to avoid holding one is serious business and the game playing does involve some of the same skills that little kids learned by playing cards generations ago. Pretend that you don’t hold the Maid? Banks have been playing that game for nearly 12 months now and only recently have entered the confessional to expose some of their sins. Are the monolines showing any of their cards? No – just ask MBIA’s CEO – they’re doing just fine thank you. “But by the way,” he’ll say,

“take a card, one of these good ones on the end or maybe the one in the middle with the exposed edge.” Bank loans for sale by Wall Street at distressed prices? Nah, those Harrahs and Clear Channel loans are money good – “as a matter of fact all of the \$150 billion or so we have in inventory are great assets” the banks will say. We’ll just hold on to these maids – unless you pay 95 cents on the dollar that is. Don’t wanna take a loss you know.

And so the game goes on and on. **Its most recent twist involves an asset class known as Auction Rate Preferred Stock and the astounding revelation that its holders didn’t even know they were playing cards to begin with.** Holders of ARPS – mostly wealthy investors, but also the likes of Bristol-Meyers and other visible corporations – thought they were holding AAA assets with money market liquidity. In this case, most of the assets probably are AAA, but the liquidity has suddenly evaporated, transforming them from a 30-day to potentially a 30-year asset. The assets on these Maids it appears are real but they have come with a marriage license. Whoops! Another Old Maid in masquerade.

The investor’s task, however, is not to pillory or even desert the game, but to accomplish three primary tasks: 1) continue to ask “Who’s got the Old Maid?”, 2) understand and forecast the game’s

economic and policy consequences, and 3) formulate a portfolio (to paraphrase Will Rogers), that maximizes the return on capital as well as the return of capital.

To elaborate on #2, it seems obvious that players are getting tired of playing games and that a prolonged period of risk aversion and deleveraging of our global shadow banking system lies ahead. Tighter lending standards, reduced risk budgets, and increased regulatory scrutiny all promise to produce a reduction in the growth rate of lending. Mortgage credit, for instance, grew at 10%, then 11%, then 13%+ annualized rates during the shadow's heyday just a few years past. Now, despite the obvious rescue efforts of the Federal bureaucracy (much of which is aimed at preventing a contraction of mortgage credit), it promises to grow at tiny single-digit rates due to diminished housing starts and a buyer's strike of significant proportions. Similar trends lie ahead for consumer credit, and importantly, commercial lending which heretofore has held up the investment side of the GDP ledger.

Slow credit growth is a harbinger, however, for slow economic growth (if any) and that in turn leads to the necessity for low short-term interest rates for an extended period of time. I think Ben Bernanke knows that restarting the U.S. growth engine almost by definition requires nominal

GDP growth of 5%. He'd prefer that nominal rate be composed of 3% real and 2% inflation, but desperate times sometimes require compromise: 2% real and 3% inflation may be the best he can hope for in 2009 as soaring commodity prices and a declining dollar add to the equation's complexity. If so, a bond investor should expect a prolonged, several year period of low short-term rates (Fed Funds averaging 2½%) with vulnerability on the intermediate and long-term portions of the U.S. curve due to inflationary fears and the diminishing support of foreign central banks and SWFs. If, as a bond investor, I expected 3% inflation (2% in 2008 – higher in the out years), a 3% 5-year Treasury would not seem very appealing. Nor, I should add, would a 3.80% 10-year or a 4.65% 30-year bond.

This leads me to #3 on my list of action plans. What should an investor do – desperately trying to avoid the Old Maids, yet trapped with good Treasury cards at yields inappropriately low in a mildly inflationary future environment? The answer lies in managing a transition to riskier assets while being acutely aware, as my CIO partner Mohamed El-Erian is quick to point out, that such a transition will be characterized by technical purges of Old Maid and even higher quality assets that in many cases produce price levels significantly below what might at first seem reasonable. Minsky moments – the unwinding

of levered assets – produce as many surprises on the downside as do \$5 million dollar homes in Silicon Valley and NASDAQ 5,000 point stocks on the upside. Patience and cognizance of flows, El-Erian counsels, are as critical to the equation as is the recognition of the Old Maids in the first place.

Still, we would both agree that value is returning to many parts of the bond market. If an investor requires 5%+ yields to compensate for future inflation, then they can increasingly be found in authentic AAA assets – not disguised Old Maids. There’s not a hint of plastic surgery in agency-backed FNMA and FHLMC mortgages at 5¾%, although their actual ages (average lives) may be somewhat in doubt. Similarly, SBA government-guaranteed loans at LIBOR+ 125 basis point yields are beginning to entice, as are some of those bank loans when priced in the high 80s

as opposed to 95 cents on the dollar. If capitalism is a going enterprise – and we think it is – then investors will eventually return to play similar, perhaps more conservative games – much as they have in the past. **And if Washington gets off its high “moral hazard” horse and moves to support housing prices, investors will return in a rush.** PIMCO wants to sit at this more attractive return table – to provide an attractive return on your money (no matter what the asset class) as well as a return of your money. No Old Maids. No silicone AAA ratings. And ladies – no crotchety old bachelors either. The game, as well as the name of the game, is changing. It’s no country for Old Maids anymore.

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