THE FED DECIDES… FOR NOW

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"When you're underperforming the index, you go home at night and cry in your beer."

So said Bill Gross a few weeks ago in response to the recent underperformance of the $244bn Total Return Fund he manages for Pimco. Performance fell short primarily because earlier this year Gross not only sold all of the fund's US Treasury holdings, but also used derivatives to enhance what was essentially a bet against the credibility of the US government. The tactical pivot was, in his words, a "mistake." But was his mea culpa premature?

Technically speaking, no. As Gross frankly admits, his recent returns compare poorly relative to his competition. It must be painful for one who has for so long been astonishingly adroit in maneuvering the financial equivalent of a supertanker. In many respects he set a standard that even he was destined to disappoint (hence the tears). But the reality is that over the investment short-term no one – including Gross – can distinguish being *early* from being *wrong,* And hindsight may yet prove his pessimism justified. More concerning to the rest of us, his confession has all the earmarks of a classic capitulation. It's when the last skeptic finally throws in the towel that the market is prone to abrupt, violent reversals.

QE2, QE3, Operation Twist (in the wind?) – taken as a whole or individually, they all represent the Federal Reserve's attempt (abetted by the US Treasury) to force investors burdened with cash to assume more risk than current interest rates compensate them for.

But the more the Fed manipulates rates, the more the yield curve starts to look like a ladder with all of the middle rungs ripped out. With short- and medium-term rates offering almost no yield (1.8% for the 10-year), investors seeking only modest returns are forced to stretch further out in duration, exposing themselves to long-term inflation precisely when "Helicopter Ben" Bernanke is doing everything he can to create it.

There's a motive to Bernanke's madness. Inflation may be toxic, but *de*flation – the cancer it preempts – is potentially lethal. Low rates help banks as well as borrowers repair their devastated balance sheets. But they're a plague to the investors effectively doing the lending, particularly income-dependent retirees. The speculators get saved, and the savers get crucified. If this is what a lifetime of thrift earns us, perhaps Keynes was misquoted – in the long run, we'll all *want to* be dead.

Indeed, with every opening of the monetary spigot, the Fed's "accommodative policy" looks more and more like *return-free risk* for investors. It's incredible, really – the more indebted America becomes, the lower our cost of borrowing falls! Japan has pulled this off, but only because their government forces a captive national savings system to buy most of the debt they issue. It will be interesting to see what happens when that tap finally runs dry. You can be sure they're watching America's monetary mambo very closely.

At present the Fed is in the driver's seat, unilaterally dictating the terms at which the nation borrows. They're able to do so only because the capital seeking refuge is of such magnitude that it has no alternative but the vast ocean of American IOUs. It says something profoundly disturbing about the depth of Europe's difficulties that the sheer size of America's indebtedness constitutes a virtue. For now…

On the first night of the doomed journey described in Joseph Conrad's *Heart of Darkness*, the narrator Marlow reminds his audience that brute force is nothing to boast of, "since your strength is just an accident arising from the weakness of others." Let's hope that America's attractions ultimately reside in something more than the perverse relative appeal of its vast, spiraling debt versus the slow-motion economic collapse of Europe and surreal, suspect resilience of Japan. Because if Bill's original instinct proves correct, we'll be the ones crying in our beer.

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