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Investment Outlook

Bill Gross | June 2009

Staying Rich in the New Normal

*"Behind every great fortune lies a great crime."
Balzac*

Balzac was on to something 200 years ago, but to be fair to modern day multi-millionaires, the only real way to accumulate wealth prior to the 18th century was to steal it, or tax it, I suppose, as was the case with kings and their royal courts. It was only with the advent of capitalism and annual productivity gains that entrepreneurs, investors, and risk-takers with luck or pinpoint-timing could jump to the head of the pack and accumulate what came to be recognized as a fortune. Still, the negative connotations persist. I remember a cocktail party in the early 80s where a somewhat inebriated guest engaged me in a debate about the merits of capitalism. "You're filthy rich," he said, which struck me as most unfair from a number of angles. First of all, he hadn't seen anything yet, I thought, and second, I wasn't quite sure where the "filthy" came from. Resentment that he'd missed out on my presumed good deal, I suppose, and in the process using a hackneyed phrase that was bitter and biting, yet had some context of historical sociological relativity. Still, he might have been on to something there – not about me, hopefully, because I've always felt that while PIMCO has prospered, it's only because its clients have benefitted even more so – but about the developing sense of one-sided, perhaps off-sided wealth generation that was to dominate the next several decades. Granted, we had Bill Gates and Steve Jobs and other true capitalistic dynamos who benefitted society immeasurably. But growing percentages of fortunes were being made by those who could borrow or aggregate other people's money. Because our economy was still in a relatively early stage of leveraging, those who borrowed money and used it to invest in higher-risk yet higher-return financial or real assets didn't require a lot of skill, they just needed to be able to convince a bank or an insurance company to lend them some money. After that, the secular wave of leverage would be enough to multiply their meager equity many times over and carry them to a beach where a fortune awaited them much like a pirate's buried treasure.

I remember as a child my parents telling me, perhaps resentfully, that only a doctor, airline pilot, or a car dealer could afford to join a country club. My how things have changed. Now, as I write this overlooking the 16th hole on the Vintage Club near Palm Springs, the only golfers who shank seven irons into the lake are real estate developers, investment bankers, or heads of investment management companies. The rich are different, not only in the manner intoned by F. Scott Fitzgerald, but also in who they are and what they do for a living. Whether some or all of them are filthy is a judgment for society and history to make. Of one thing you can be sure however: over the next several decades, the ability to make a fortune by using other people's money will be a lot harder. Deleveraging, reregulation, increased taxation, and compensation limits will allow only the most skillful – or the shadiest – into the Balzac or Forbes 400.

Readers who are interested in such things as the Forbes annual list of hoity-toities will have noticed that more and more of them are global, not U.S. citizens. The U.S., in other words, is not producing as much wealth in proportion to the rest of the world. Its fortune-producing capabilities seem to be declining, which might suggest that its relative standard of living is doing so as well. If so, the implications are serious, not just for Donald Trump but for wage earners and ordinary citizens, as reflected in their income levels and unemployment rates. Stockholders, 401(k) investors, and yes, bond managers will be affected too. Last week's furor over the possibility of an eventual downgrade of America's AAA rating demonstrates that only too clearly. On the night of May 20, Standard & Poor's announced a downgrade watch for the United Kingdom and since the U.S. and U.K. are Siamese-connected, financially-levered twins, the implications were obvious: the U.S. might be next. In the space of 48 hours, the dollar declined 2%, and U.S. stocks and long-term bonds were down by similar amounts. Such a trifecta rarely occurs but in retrospect it all made sense: a downgrade would cast a negative light on the world's reserve currency, and since stocks and bonds are only present values of a forward stream of dollar-denominated receipts, they went down as well.

The potential downgrade, while still far off in the future in PIMCO's opinion, seemed dubious at first blush. While country ratings factor in numerous subjective qualifications such as contract rights, military might, and advanced secondary education, the primary focus has always been on the objective measurement of debt levels, in this case sovereign debt, as a percentage of GDP. Yet, as shown in Table 1, both the U.S. and the U.K. entered the Great Recession with attractive ratios compared to such grievous offenders (and AA rated) as

Japan.

Sixteen Tons?

Table 1

Country	Federal Gov't Debt to GDP Ratio
U.S.	45%
U.K.	50%
Japan	171%
Germany	39%
Canada	42%
China	20%
Brazil	36%

Source: PIMCO. All data as of Q4:2008, sourced from individual country national accounts.

Yet as the markets recognized rather abruptly last week, both countries seem to be closing the gap in record time. To zero in on the U.S. of A., its annual deficit of nearly \$1.5 trillion is 10% of GDP alone, a number never approached since the 1930s Depression. **While policymakers, including the President and Treasury Secretary Geithner, assure voters and financial markets alike that such a path is unsustainable and that a return to fiscal conservatism is just around the recovery's corner, it is hard to comprehend exactly how that more balanced rabbit can be pulled out of Washington's hat.** Private sector deleveraging, reregulation and reduced consumption all argue for a real growth rate in the U.S. that requires a government checkbook for years to come just to keep its head above the 1% required to stabilize unemployment. Five more years of those 10% of GDP deficits will quickly raise America's debt to GDP level to over 100%, a level that the rating services – and more importantly the markets – recognize as a point of no return. At 100% debt to GDP, the interest on the debt might amount to 5% or 6% of annual output alone, and it quickly compounds as the interest upon interest becomes as heavy as those “sixteen tons” in Tennessee Ernie Ford's famous song of a West Virginia coal miner. “You load sixteen tons and whattaya get? Another day older and deeper in debt.” Pretty soon you need 17, 18, 19 tons just to stay even and that describes the potential fate of the United States as the deficits string out into the Obama and other future Administrations. The fact is that supply-side economics was a partial con job from the get-go. Granted, from the 80% marginal tax rate that existed in the U.S. and the U.K. into the late 60s and 70s, lower taxes do incentivize productive investment and entrepreneurial risk-taking. But below 40% or so, it just pads the pockets of the rich and destabilizes the country's financial balance sheet. Bill Clinton's magical surpluses were really due to ephemeral taxes on leverage-based capital gains that in turn were due to the secular decline of inflation and interest rates that at some point had to bottom. We are reaping the consequences of that long period of overconsumption and undersavings encouraged by the belief that lower and lower taxes would cure all.

The current annual deficit of \$1.5 trillion does not even address the “pig in the python,” baby boomer, demographic squeeze on resources that looms straight ahead. Private think tanks such as The Blackstone Group and even studies by government agencies, such as the Congressional Budget Office, promise that Federal spending for Social Security, Medicare, and Medicaid will collectively increase by 6% of GDP over the next 20 years, leading to even larger deficits unless taxes are increased proportionately. Collectively these three programs represent an approximate \$40 trillion liability that will have to be paid. If not, you can add that present value figure to the current \$10 trillion deficit and reach a 300% of GDP figure – a number that resembles Latin American economies such as Argentina and Brazil over the past century.

So the rather conservative U.S. government debt ratio shown in Table 1 will likely be anything but in less than a decade's time. The immediate question is who is going to buy all of this debt? Estimates suggest gross Treasury issuance of up to \$3 trillion this calendar year and net offerings close to \$2 trillion – almost four times last year's supply. Prior to 2009, it was enough to count on the recycling of the U.S. trade/current account deficit to fund Treasury borrowing requirements. Now, however, with that amount approximating only \$500 billion, it is obvious that the Chinese and other surplus nations cannot fund the deficit even if they were fully on board – which they are not. Someone else has got to write checks for up to \$1.5 trillion additional Treasury notes and bonds. Well, you've got the banks and even individual investors to sponge up some of the excess, but a huge, difficult to estimate marginal supply will have to be bought. **The concern is that this can be accomplished in only two ways – both of which have serious consequences for U.S. and global financial markets. The first and most recent development is the steepening of the U.S. Treasury yield curve and the rise of intermediate and long-term bond yields.** While the Treasury can easily afford the higher interest expense in the short term, the pressure it puts on mortgage and corporate rates represents a serious threat to the fragile

“greenshoots” recovery now underway. **Secondly, the buyer of last resort in recent months has become the Federal Reserve, with its publically announced and near daily purchases of Treasuries and Agencies at a \$400 billion annual rate.** That in combination with a buy ticket for over \$1 trillion of Agency mortgages has been the primary reason why capital markets – both corporate bonds and stocks – are behaving so well. But the Fed must tread carefully here. These purchases result in an expansion of the Fed’s balance sheet, which ultimately could have inflationary implications. In turn, nervous holders of dollar obligations are beginning to look for diversification in other currencies, selling Treasury bonds in the process.

The obvious solution to both dollar weakness and higher yields is to move quickly towards a more balanced budget once a sustained recovery is assured, but don’t count on the former or the latter. It is probable that trillion-dollar deficits are here to stay because any recovery is likely to reflect “new normal” GDP growth rates of 1%-2% not 3%+ as we used to have. **Staying rich in this future world will require strategies that reflect this altered vision of global economic growth and delevered financial markets. Bond investors should therefore confine maturities to the front end of yield curves where continuing low yields and downside price protection is more probable. Holders of dollars should diversify their own baskets before central banks and sovereign wealth funds ultimately do the same. All investors should expect considerably lower rates of return than what they grew accustomed to only a few years ago. Staying rich in the “new normal” may not require investors to resemble Balzac as much as Will Rogers, who opined in the early 30s that he wasn’t as much concerned about the return on his money as the return of his money.**

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