INVESTMENT OUTLOOK

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Strawberry Fields – Forever?

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Excerpts:

… (T)he real cause of slower economic growth lies hidden in a number of structural as opposed to cyclical headwinds that may be hard to reverse. While there are growth potions that undoubtedly can reduce the fever, there may be no miracle policy drugs this time around to provide the inevitable cures of prior decades. These structural headwinds cannot just be wished away as we move "forward" whether it be to the right, the left or dead center. Last month in a major policy speech at the New York Economic Club, Fed Chairman Ben Bernanke concurred that the U.S. economy's growth potential had been reduced "at least for a time." He in effect confirmed PIMCO's New Normal which has been in place for three years now, laying the blame in part on the financial crisis, diminished productivity gains, and investment uncertainty due to the near-term fiscal cliff. We do not disagree. However, there are numerous other structural headwinds that may reduce real growth even below the New Normal 2% rate that Bernanke has just confirmed, not only in the U.S. but in developed economies everywhere.

They are:

1) Debt/Delevering

Developed global economies have too much debt – pure and simple – and as we attempt to resolve the dilemma, the resultant austerity should lower real growth for years to come. There are those that believe in the "Brylcreem" approach to budget balancing – "a little dab'll do ya." Just knock a few percentage points off the deficit/GDP ratio, they claim, and the private sector will miraculously reappear to fill the gap. No such luck after 2–3 years of austerity in Euroland, however. Most of those countries are mired in recession and/or depression. Political leaders there should have studied the historical evidence presented by Carmen Reinhart and Ken Rogoff in a critically important paper titled, "Growth in a Time of Debt." They conclude that for the past 200 years, once a country exceeded a 90% debt/GDP ratio, economic growth slowed by nearly 2% for both developed <u>and</u> developing nations for an average duration of nearly a decade. Their work displayed below in Chart 1 shows the result in the United States from 1790–2009. The average annual U.S. GDP rate growth, while clearly influenced by the Great Depression, was -1.8% once the 90% barrier was exceeded. The U.S., by the way, is now at a 100% debt/GDP ratio on the basis of the authors' standard measuring yardstick. (Note as well the 5½% average inflation rate during the same periods.)

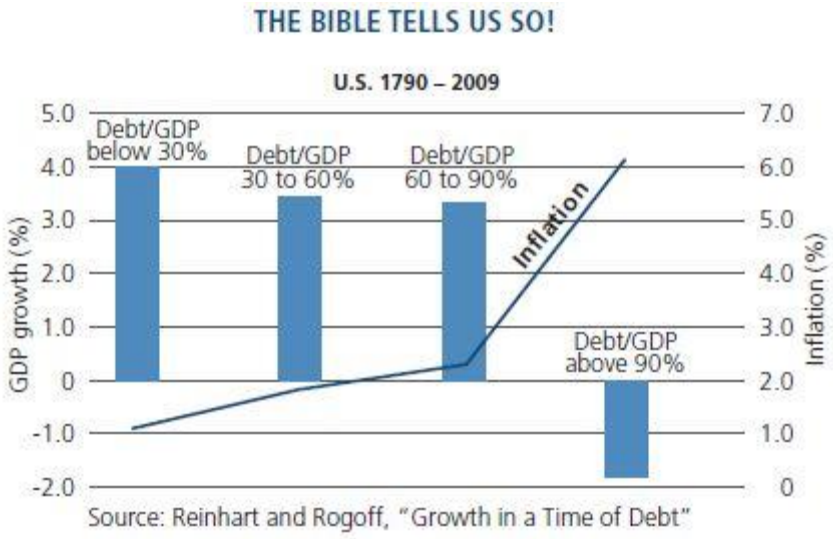

Chart 1

In addition to sovereign debt levels which were the primary focus of the Reinhart/Rogoff studies, it is clear that financial institutions and households face similar growth headwinds. The former needs to raise equity via retained earnings and the latter to increase savings in order to stabilize family balance sheets. The combined need to increase our "net national savings rate" highlighted in last month's *Investment Outlook* is a long-term solution to the debt crisis, but a near/intermediate-term growth inhibitor. The biblical metaphor of seven years of fat leading to seven years of lean may be quite apropos in the current case with the observation that the developed world's growth binge has been decades in the making. We may need at least a decade for the healing.

2) Globalization

Globalization has been an historical growth stimulant, but if it slows, then the caffeine may wear off. The fall of the Iron Curtain in the late 1980s and the emergence of capitalistic China at nearly the same time was a locomotive of significant proportions. Adding two billion consumers to the menu made for a prosperous restaurant, increasing profits and growth in developed economies despite the negative internal effects on employment and wages. Now, however, these tailwinds are diminishing, producing an airspeed which inexorably slows relative to the standards of prior decades. Is it any wonder that markets now move up or down as much on the basis of policy changes coming out of China as opposed to the U.S. or Euroland? If China and the accompanying benefits of globalization slow, so too may developed economy growth rates.

3) Technology

Technology has been a boon to productivity and therefore real economic growth, but it has its shady side. In the past decade, machines and robotics have rather silently replaced humans, as the U.S. and other advanced economies have sought to counter the influence of cheap Asian labor. Almost a century ago, Keynes alerted the economic community to a "new disease," what he called "technological unemployment" where jobs couldn't be replaced as fast as they were being destroyed by automation. Recently, Erik Brynjolfsson and Andrew McAfee at MIT have affirmed that workers are losing the

race against the machine. Accountants, machinists, medical technicians, even software writers that write the software for "machines" are being displaced without upscaled replacement jobs. Retrain, rehire into higher paying and value-added jobs? That may be the political myth of the modern era. There aren't enough of those jobs. A structurally higher unemployment rate of 7% or more is the feared "whisper" number in Fed circles. Technology may be leading to slower, not faster economic growth despite its productive benefits.

4) Demographics

Demography is destiny, and like cancer, demographic population changes are becoming a silent growth killer. Numerous studies and common sense logic point to the inevitable conclusion that when an economic society exceeds a certain average "age" then demand slows. Typically the dynamic cohort of an economy is its 20 to 55-year-old age group. They are the ones who form households, have families and gain increasing experience and knowhow in their jobs. Now, however, almost all developed economies, including the U.S., are gradually aging and witnessing a larger and larger percentage of their adult population move past the critical 55-year-old mark. This means several things for economic growth: First of all from the supply side, it means productivity and employment growth rates will slow. From the demand side, it suggests a greater emphasis on savings and reduced consumption. Those approaching their seventh decade need fewer cars and new homes as shown in Chart 2. Almost none of them have babies (thank goodness!). Such low birth rates and a significant reduction in demand have imperiled Japan for several lost decades now. A similar experience will likely turn many developed economy "boomers" into "busters" within the next several years.

Chart 2

Investment Conclusions

I'm fond of reminding PIMCO's Investment Committee that you can't buy GDP futures – at least not yet. Hypotheses about real growth rates, no matter how accurate, must be translated into investment decisions in order to justify the discussion. Before doing so, let me acknowledge that these structural headwinds can and will likely be somewhat countered by positive thrusts. Cheaper natural gas and the possibility of reversing or even containing the 40-year upward trend of energy costs may be a boon to productivity and therefore growth. There is talk of the U.S. being energy independent

within a decade's time. Housing as well may be experiencing a multiyear revival. In addition, unforeseen productivity breakthroughs may be just over the horizon. How many gloomsters could have forecast the Internet or any other technical breakthrough before it actually happened? Jules Verne we are not.

But if a 2% or lower real growth forecast holds for most of the developed world over the foreseeable future, then it is clear that there will be investment consequences. Shown below, as recently published in a *TIME Magazine* article by Rana Foroohar, is a PIMCO list of future Picks and Pans based upon these ongoing structural changes:

Picks

- Commodities like Oil and Gold
- U.S. Inflation-Protected Bonds
- High-Quality Municipal Bonds
- Non-Dollar Emerging-Market Stocks

Pans

- Long-Dated Developed-Country Bonds in the U.S., U.K. and Germany
- High-Yield Bonds
- Financial Stocks of Banks and Insurance Companies

The list to a considerable extent reflects the view that emerging economy growth will continue to be higher than that of developed countries. Their debt on average will remain much lower, and their demographic age much younger. In addition, the inevitable policy response of developed economies to slower growth will be to reflate in order to minimize the impact of the aforementioned structural headwinds. If successful, reflationary policies will gradually move 10 to 30-year yields higher over the next several years. The 30-year Treasury hit its secular low of 2.50% in July and such a yield may seem ludicrous a decade hence. Investors should expect future annualized bond returns of 3–4% at best and equity returns only a few percentage points higher.

As John Lennon forewarned, it is getting harder to be someone, and harder to maintain the economic growth that investors have become accustomed to. The New Normal, like Strawberry Fields will "take you down" and lower your expectation of future asset returns. It may not last "forever" but it will be with us for a long, long time.

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