



Your Global Investment Authority

Kings of the Wild Frontier

“Over the years we’ve had some fun together – killin some ‘bars,’ drinkin moonshine – some even in these chambers. (Whiskey that is – the ‘bars’ I’ve seen once or twice, but only when I was plum drunk). But the time for funnin is over. They’ll be no jokes from David Crockett today.”

Davy Crockett Speech to Congress, 1830

Figurative coonskin cap on head, I echo the sentiments of Davy Crockett – Indian fighter, Alamo defender and Tennessee Congressman – not necessarily in that chronological order. The debt ceiling may have been raised and the palpable sighs of relief heard across global financial markets, but the fun times are over. They’ll be no jokes from Bill Gross today, nor across this land for years to come I suspect. Even though the U.S. has managed to avert a debt crisis and perhaps a ratings downgrade, there remains a stain on our reputation, a scarlet “A” for budgetary “Abuse,” that will not disappear. The whole world was watching, and what they saw was a dysfunctional government taking its country to the financial precipice and backing off at the very last moment. “Shades of a Banana Republic,” as former Reagan budget director David Stockman opined somewhat harshly last week. We may not be Greece just yet, but Mr. Stockman is looking in the right direction.

Nothing in the Congressional compromise reached over the weekend makes a significant dent in our \$1.5 trillion deficit. “Out year” fantasies, as opposed to “current year” realities, is an apt description of the spending cuts that characterize this compromise. The Office of Management and Budget (OMB) estimates that future deficits will be reduced at most by .5%, and if so, it would be welcomed, but that .5% comes with no new taxes and a continuation of the belief that we don’t have to pay for our trespasses. Like many a Banana Republic, we may one day be invoking the Lord’s Prayer, pleading – “Forgive us our debts, as we forgive our debtors,” yet at the same time looking towards the heavens à la Saint Augustine with a fervent “let me be chaste, but let it be tomorrow.”

Treasury Secretary Tim Geithner noted last week that it would be unthinkable that the U.S. would not meet its obligations on time. Now that the timeliness has temporarily been put aside, an investor must logically ask how we will meet our obligations, and how much they really are. In addition to an existing nearly \$10 trillion of outstanding Treasury debt, the U.S. has a near-unfathomable \$66 trillion of future liabilities at “net present cost.” As shown in the following table from a Mary Meeker “USA Inc.” study, and validated by the Department of Treasury and Congressional Budget Office (CBO) calculations, the combined present cost “payment due” from Medicaid, Medicare and Social Security is over six times our current obligations of Treasury debt.

The press and most professional investors are accustomed to measuring “paper” debt as opposed to walking/living liabilities in the form of people. I call these liabilities “debt men walking” because as long as 330 million living Americans require promised

entitlements – the \$66 trillion that wear shoes are as much of a liability as the \$10 trillion on paper.

Admittedly, as Meeker’s table (Figure 1) points out, we can address these liabilities by improving the efficiency of our healthcare system, reducing benefits, raising retirement ages, increasing tax rates or a combination of all of the above. We likely will. So reduce that \$66 trillion if you care to, but the subjective remainder still hangs over financial markets like a Damocles sword. How will we meet these obligations as Secretary Geithner asked?

Aside from the unthinkable outright default, there are numerous ways that, a government – especially a AAA rated one – can employ to reduce its future liabilities. Highlighted below are the prominent tools that can significantly affect investor pocketbooks:

- 1) Balance the budget and/or grow out of it
- 2) Unexpected inflation

Figure 1: FIXIN’ IT?

Rank	Financial Challenge	Net Present Cost (\$T / % of 2010 GDP)	Potential Policy Solutions
1	Medicaid	\$35 Trillion/239%	<ul style="list-style-type: none"> ▪ Isolate and address the drivers of medical cost inflation ▪ Improve efficiency/productivity of healthcare system ▪ Reduce coverage for optional benefits and optional enrollees
2	Medicare	\$23 Trillion/156%	<ul style="list-style-type: none"> ▪ Reduce benefits ▪ Increase Medicare tax rate ▪ Isolate and address the drivers of medical cost inflation ▪ Improve efficiency/productivity of healthcare system
3	Social Security	\$8 Trillion/54%	<ul style="list-style-type: none"> ▪ Raise retirement age ▪ Reduce benefits ▪ Increase Social Security tax rate ▪ Reduce future initial benefits by indexing to cost of living growth rather than wage growth ▪ Subject benefits to means test to determine eligibility

Source: USA, Inc., Published by KPCB, February 2011

3) Currency depreciation

4) Financial repression via low/negative real interest rates

Let me address each of them in brief:

- 1) Balance the budget/growth – The current Congressional compromise is but one small step for fiscal solvency. There is no giant leap for mankind anywhere on the horizon. Trillions of further spending cuts, and yes trillions of tax hikes, are necessary to stabilize our “official” debt/GDP ratio of 90% or so. One important detail to keep in mind: projected deficits in 2012 and 2013 of 7-8% of GDP rely on OMB growth estimates of 3%+ in the next few years. Recent trends give pause to these estimates as does PIMCO’s New Normal, which believes 2% not 3% is closer to reality. If so, deficits move right back up to near-double-digit percentages of GDP. Likewise, should interest rates ever rise from current 2% average levels, a 100 basis point increase raises the deficit by 1% and erases any hoped for gains. Sisyphus would be familiar with this seemingly unsolvable dilemma.
- 2) Unexpected inflation – While markets are global these days, figures sometimes lie and policymakers often figure. Focusing investors’ attention on statistics emphasizing “core” or “chain-linked” methodologies can entice investors to stay home, or in the case of foreign nations, to “invest American.” Central bankers, not just in the U.S., but the U.K., have long been arguing for a reversion of headline 3% CPI numbers to the 2% or lower “core” standard expectation. “Patience,” they argue, but “prudence” might be the better watchword. If so, then the expected “unexpected” inflation would mimic the old Roman custom of coin shaving or its substitution with base metals instead of silver or gold. Inflation is the result no matter how you coin it, which puts more

money in government coffers to pay their bills and less money in your pocket to pay yours.

- 3) Currency depreciation – High deficits, both fiscal and trade, combined with low interest rates for extended periods of time produce declining currency valuations against more prosperous, and more policy conservative competitor nations. Few Americans are aware that the dollar’s recent 12- month depreciation of over 15% is an explicit tax on their standard of living. Uncle Sam, the government overseer, benefits enormously: one rather clever way for the U.S. to pay its bills to foreign creditors is to pay them in depreciated dollars. The Chinese and other offshore holders wind up getting not only .05% interest on their Treasury Bills, but 12 months later – voila! – their Bills are worth only 85 cents on the dollar in global purchasing power. The Chinese should be reading Shakespeare, not Confucius – especially the second half of “neither a borrower nor a lender be,” when it comes to U.S. dollars.
- 4) Financial Repression via low/negative real interest rates – I have commented on this Carmen Reinhart, commonsensical technique in prior *Outlooks*. If the Treasury is borrowing money from you or PIMCO at .05% for the next six months and CPI inflation is averaging 3%, then lenders/savers are being shortchanged beyond even rather egregious historical examples. The burden of “sixteen tons” of debt á la Tennessee Ernie Ford is considerably reduced at 5 basis points of annual interest. “Loading” coal or debt in this case at near 0% yields doesn’t make the borrower another day older, nor deeper in debt. Actually it’s a shot of Botox for the borrower, but a shot of lead for the lender. Duck!

By using these four life rafts available to U.S. and other AAA sovereign borrowers, one can almost imagine a half century from now, that they remain solvent – although

chastened perhaps with a lower credit rating. Based on historical example at Moody's and Standard & Poors, it just might take 50 years for them to downgrade U.S. credit, but be that as it may, you and PIMCO as savers and savings intermediaries can take precautionary or even retaliatory measures to preserve purchasing power. **Favor countries with cleaner "dirty shirts" and higher real interest rates: Canada, Mexico, Brazil and Germany come to mind. Shade equity and fixed income investments away from dollar based indexes towards those of developing nations with stronger growth prospects. Purchase commodity based real assets before reserve surplus nations do. And above all, don't be lulled to sleep by Congressional law makers that promise a change in Washington. The last change I believed in was on Election Day 2008, and that turned out to be more fiction than reality. Davy Crockett, where are you? You may have been drinkin' whiskey in those Congressional Chambers and those "bars" may have been half fiction, but you were a coonskin hero of a forgotten age, a hero the likes of which we have yet to see in 21st century Washington. We're stuck with the new Kings and Queens of a wilder frontier.**

William H. Gross
Managing Director

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Newport Beach Headquarters
840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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