



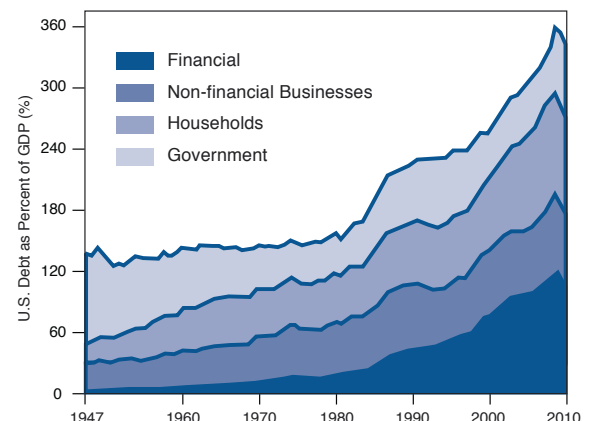
Alphabet Soup

Global financial market returns stand at the threshold of mediocrity. With bonds priced not for recession but near depression, most major global bond indices now yield less than 3%, surely a forerunner of returns to come. Stocks, long the volatile vamp of investor optimism, have not yet adjusted to the New Normal of half-size economic growth induced by deleveraging, reregulation, and deglobalization and have low single digit prospects as well. Yet, what has seemed obvious to those of us collectively at PIMCO for several years now is less than standard fare in the trading rooms of institutional money managers. While the phrase “New Normal” has been welcomed into the lexicon of reporters and commentators alike, the willingness of investors to accept its realities is fog-ridden and whispered, or perhaps softly whistled, much like midnight passersby at a graveyard. Our “New Normal” two-word duality seems to resonate more on the “normal” than the “new” to economists whose last names aren’t Roubini, Reinhart, Rogoff, or Rosenberg. It’s as if “R” has been eliminated from

the financial alphabet, and “new” from investors’ dictionaries worldwide.

Perhaps the enigma arises from a multi-generational acceptance of debt as common scrip, available for the asking and seemingly forever productive in boosting living standards – until, that is, liabilities became so large that the interest burden and probability of repayment overwhelmed borrower and lender alike in near unison. To understand why debt may have become a burden instead of a boon it is instructive as Philip Coggan points out in a recent *Economist* article, to ask why people, companies and countries borrow in the first place.

RRRRR...



Source: Bureau of Economic Analysis, Federal Reserve, *The Economist*, June 24, 2010

They do so, he intelligently argues, to boost their standard of living, to bring consumption forward instead of languishing in the present. How could almost any of us have afforded a home without a mortgage? By the time we would have saved enough money we'd have been close to retirement with the kids grown and facing a similar predicament. And so we turned to the wizardry of borrowing on time to be able to purchase and then repay in full. Crucially, since debt is a handshake between at least two parties, the lender had to believe that it would be repaid, and that belief or "credere," was based on several rather rational expectations when observed on a macro level from 30,000 feet.

First of all, capitalistic innovation fostered productivity, and an increasing standard of living through technology and innovation. Debts could be paid back via profits and higher wages if only because of rising prosperity itself. Secondly, the 20th century, which fathered the debt supercycle, was a time of global population growth despite its interruption by tragic world wars and periodic pandemics. Prior debts could be spread over an ever-increasing number of people, lessening the burden and making it possible to assume even more debt in a seemingly endless cycle which brought

consumption forward – anticipating that future generations could do the same.

But while technological innovation – much like Moore's law – seems to have endless promise, population growth in numerous parts of the developed world is approaching a dead end. Not only will it become more difficult to transfer high existing debt burdens onto the smaller shoulders of future generations, but the overlevered, aging "global boomers" themselves will demand a disproportionate piece of stunted future goods and services – without, it seems, the ability to pay for it. Creditors, sensing the predicament, hold back as they recently have in Greece and other southern European peripherals, or in the U.S. itself, as lenders demand larger down payments on new home mortgages, and other debt extensions.

Aging and population change of course are just part of the nemesis. We could have "saved" for this moment much like squirrels in wintertime but humanity's free will is infected with greed, avarice and in a majority of instances, hope as opposed to commonsense. We overdid a good thing and now the financial reaper is at the door, scythe and financial bill in one hand, with the other knocking on door after door of previously unsuspecting households and sovereigns to initiate a "standard of living" death sentence.

What is harder to understand in this demographic/psychological/sociological explanation of the crisis is why it should morph into a global phenomenon. There are 6.5 billion people in the world and will soon be 1 billion more. Many of them are debt-free and have never used a credit card or assumed a home mortgage. Why can't lenders like PIMCO lend to them, allowing developing nations to bring their consumption forward, developed nations to supply the goods and services, and the world to resume its "old normal" path toward future profits, prosperity and increasing standard of living? To a certain extent that is what should gradually happen, promoting more rapid growth in the emerging nations and a subdued semblance of it in the G-7 – a "new normal."

But they – the developing nations – are not growing fast enough, at least internally, to return global growth to its old standards. Their financial systems are immature and reminiscent of a spindly-legged baby giraffe, having lots of upward potential but still striving for balance after a series of missteps, the most recent of which was the Asian crisis over a decade ago. And so they produce for export, not internal consumption, and in the process leave a gaping hole in what is known as global aggregate demand. Developed nation consumers are maxed out because of too much debt, and developing nations

don't trust themselves to stretch their necks for the delicious leaves of domestic consumption just above.

It is this lack of global aggregate demand – resulting from too much debt in parts of the global economy and not enough in others – that is the essence of the problem, which only economists with names beginning in R seem to understand (there is no R in PIMCO no matter how much I want to extend the metaphor, and yes, Paul _Rugman fits the description as well!). If policymakers could act in unison and smoothly transition maxed-out indebted consumer nations into future producers, while simultaneously convincing lightly indebted developing nations to consume more, then our predicament would be manageable. They cannot. G-20 Toronto meetings aside, the world is caught up as it usually is in an "every nation for itself" mentality, with China taking its measured time to consume and the U.S. refusing to acknowledge its necessity to invest in goods for export.

Even if your last name doesn't begin with R, the preceding explanation is all you need to know to explain what is happening to the markets, the global economy, and perhaps your own wobbly-legged standard of living in recent years. **Consumption when brought forward**

must be financed, and that financing is a two-way bargain between borrower and creditor. When debt levels become too high, lenders balk and even lenders of last resort – the sovereigns, the central banks, the supranational agencies – approach limits beyond which private enterprise’s productivity itself is threatened. We have arrived at a New Normal where, despite the introduction of 3 billion new consumers over the past several decades in “Chindia” and beyond, there is a lack of global aggregate demand or perhaps an inability or unwillingness to finance it. Slow growth in the developed

world, insufficiently high levels of consumption in the emerging world, and seemingly inexplicable low total returns on investment portfolios – bonds and stocks – lie ahead. Stop whispering (and start shouting) the words “New Normal” or perhaps begin to pronounce your last name with an RRRRRRRRRRRR. Our global economy, our use of debt, and our financial markets have changed – not our alphabet or dictionary.

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