



## Two Will Get You Three (or) Three Will Get You Two

*You load sixteen tons, what do you get?  
Another day older and deeper in debt.  
Saint Peter, don't you call me 'cause I can't go;  
I owe my soul to the company store.*

– Tennessee Ernie Ford

Debt will get you in trouble – on both sides of the dollar bill as Shakespeare wisely counseled long ago: Neither a lender nor a borrower be. That probably seems like a strange admonition coming from a guy who helps to lend \$1 trillion of it – and I suppose it is. But there was a time back in 1968 when lending got me in lots of trouble – deep doo-doo, to tell you the truth – and I've regretted it ever since. I was a Naval officer back then, sailing between the Mekong Delta and Manila Bay. Strangely enough, it was in the Philippines, not Vietnam, where I lost my moral compass and ran aground. I started a shipboard replica of a “payday” lending company operating under the principle of “two will get you three.” Sailors in port were always short of cash and yours truly – engaged to be married and operating under a self-imposed one-beer, nine-o'clock curfew – was more

than willing to extend them a hand. The “two gets you three” scheme sounded harmless enough, because, heck, what's a buck between friends when you're about to hit the beach and party hearty! Still, as the “payday” characterization connotes, the money was due only a few weeks down the road when we were back at sea and receivables could easily be collected. And the annualized yield, as most of us investor types can easily calculate, was well in excess of 1,000% annualized. Well, there's usury and there's grand larceny, and my payday-hayday scheme was clearly in the latter category. The amounts were small – paychecks were only a few hundred dollars – but 200 compounded into 300, which turned into 450, 675, 1,000 – well, you get the picture. It didn't take too many ports of call before Uncle Sam's next payday became the property of Uncle Bill, and I became

the financial godfather of the USS *Wish I'd Never Enlisted*. Oh but loose lips sink ships, and it wasn't too long before the *authentic* godfather – El Capitan – got wind of Ensign Gross's growing fortune. Rather than cut himself in on the scheme, he did what every good captain would do. He made me give it all back and confined me to the ship for the rest of my tour. No beer, no sightseeing in Tokyo on the way back home. No nothing. Two got me three for awhile, but it eventually got me into a heap of trouble. Well deserved, I'd say, and I've learned my lesson. Never made a 1,000% loan since!

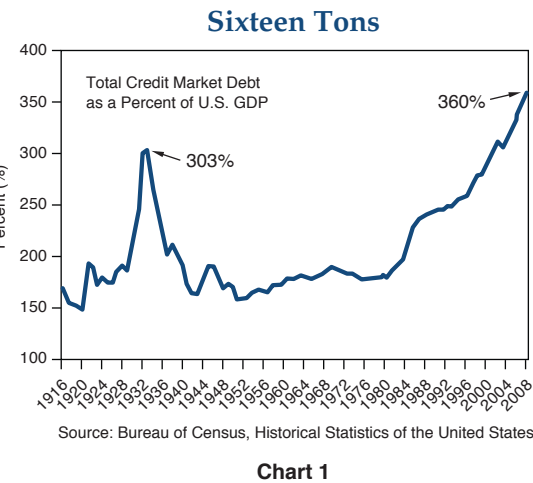
Another lesson I've learned over these last 40 years is that while "two gets you three," it's also true that "three gets you two." Sometimes it gets you zero, as in "default" – a big goose egg. That's why lenders demand a premium for "riskier" loans, a subjective judgment to be sure, like when J.P. Morgan long ago described the most fundamental principle of lending as one based on "character" as opposed to "property or collateral." Still, character will get you only so far if initial conditions are sufficiently onerous that they resemble the "sixteen tons" coal miners' lament that leads off this month's *Investment Outlook*. Owing your soul to the company store is more than descriptive of not only today's households, but of sovereign nations as

well. The burden of debt can take decades to accumulate, but only a few short months to change course into crisis. Many investors, economists and politicians alike have little understanding of why attitudes and lending standards can reverse so quickly – how a seemingly innocuous "two will get you three" build-up of debt will suddenly produce a crisis like it did aboard my ship in 1968. They operate with the mindset that markets, jobs and economies will "come back." "I'll just wait 'till it comes back" is the common saw amongst underwater investors, just as "something will turn up" is a sad refrain of many unemployed or underemployed workers. Sometimes it doesn't come back. Sometimes nothing turns up. Sometimes "three gets you two" in the real, as well as the financial, economy.

Those times are best characterized by a borrower's *amount* of debt and their ability to *grow* out of their burden. How much debt is too much? How little growth is too little? No one knows for sure. Economic historians such as Kenneth Rogoff point out that at debt levels of 80-90% of GDP, a country's real growth become stunted, and the sixteen tons becomes more and more difficult to bear. Greece is well past that standard, which is one of the reasons why lenders are balking at extending a private-market helping hand. When not only

government but corporate and household debt is included, the waters become murkier, because historical statistics are less available, and corporations are more multinational than ever before. Common sense observation tells you, though, that the debt super cycle trend in the U.S. shown in the following chart is reaching unsustainable proportions and that the “growth” required to service it if real interest rates were ever to go up instead of down would be insufficient. That is why lenders balked 18 months ago during events surrounding the Lehman liquidity crisis and why they’re beginning to balk once again. Too much debt/too little growth makes for a “three will get you two” moment, and they refuse to extend credit under those circumstances.

Not only Greece and the southern European peripherals, but France, the U.K., Japan, and even the U.S. are sounding alarms that might eventually move them towards less imbalanced budgets and lower deficits as a percentage of GDP. Still, credit and equity market vigilantes are wondering if in many cases sovereigns haven’t already gone too far and that the only way out might be via default or the more politely used phrase of “restructuring.” At the now restrictive yields of LIBOR+ 300-350 basis points being imposed by the EU and the IMF alike, there is no reasonable scenario which would allow Greece to “grow” its way out of its sixteen tons. Fiscal tightening, while conservative in intent, leads to lower and lower growth in the short run. Tougher sovereign budgets produce government worker layoffs, pay cuts, reduced pension benefits and a drag on consumption and the ability of the private sector to accept an attempted hand-off from fiscal authorities. Recession becomes the *fait accompli*, and the deficit/GDP ratio moves ever higher because of skyrocketing risk premiums and a plunging GDP denominator. **In many cases therefore, it may not be possible for a country to escape a debt crisis by reducing deficits!**



Granted, sovereign debtor nations are now saying all the right things and in some cases enacting legislation that promises to halt growing debt burdens.

Several months ago I rhetorically asked whether it was possible to get out of debt

crisis by *increasing* debt. Yes – was the answer, but it was a qualified yes. **Given that initial conditions were favorable – relative low debt as a % of GDP, with the ability to produce low/negative short-term policy rates and constructively direct fiscal deficit spending towards growth positive investments – a country could escape a debt deflation by creating more debt.** But those countries are few – the U.S. among perhaps a handful that have that privilege, and investors, including PIMCO, have strong doubts about U.S. fiscal deficits leading to strong future growth rates.

So the developing predicament is becoming more obvious to Shakespeare’s “lenders and borrowers be.” Fiscal tightening and budget conservatism may have come too late for Greece and its global lookalikes. Continued deficit spending may be an exorbitant privilege extended to only a

few. Caught in the middle are many developed countries that likely face New Normal growth rates and a continued bumpy journey toward that destination.

Investors must respect this rather tortuous journey in the months and years ahead for what it is: A deleveraging process based upon too much debt and too little growth to service it. No longer will “two get you three” in the investment world. Not 1,000%, but for 4-6% annualized returns for a diversified portfolio of stocks and bonds is the likely outcome. And be careful – sometimes “three gets you two.”

William H. Gross  
Managing Director

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**PIMCO**

840 Newport Center Drive  
Newport Beach, CA 92660  
949.720.6000

[pimco.com](http://pimco.com)