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Investment Outlook

from Bill Gross

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How Could They?

Punch and Judy fought for a pie.
Punch gave Judy a sock in the eye.
Said Punch to Judy, "Would you like any more?"
Said Judy to Punch, "No my eye is too sore."

– Mother Goose nursery rhyme

Ah, nursery rhymes! Intended for kids no less! The above little ditty could serve as a modern day NFL domestic playbook, I suppose, while a century ago it was but one of many "lesson plans" on what not to do when you grow up. There was Jack and Jill, and Little Miss Muffet – all of whom had to be careful – the Muffet Ms. especially so if she ever sat on a tuffet; spiders were lurking! Then there was the Old Woman Who Lived in a Shoe, the moral being that if you lived in one, lots of kids would drag you down for the rest of your life. Honestly – conception must have been pretty awkward for the old gal, maneuvering between laces and all. And instead of scented candles, well, you get the picture. Even Buster Brown's dog, Tige, wouldn't have lived in there.

The Punch and Judy rhyme pretty much exposes the early 20th century for what it was: male dominated and domestic violence permitted. Actually, back then, the way comic strips allowed women to get revenge was a metaphorical frying pan in the kitchen. Watch out, Dagwood – here comes Blondie! Today, all of that is frowned upon and so much the better. Outside of comic strips and nursery rhymes, the AMC series "Mad Men" takes us back to the bad old days when everyone smoked in the office and right next to you on airplanes, no less. "How could they?!!" is the almost immediate response, because we have adapted and adjusted to a different set of social, moral and ethical standards.

Race, gender, sexual orientation, you name it … things are moving forward. You could shriek a "How could they?" for all of the above while understanding perhaps why they did. Maybe they didn't know any better, maybe the time wasn't right, maybe they just needed a Martin Luther King, a Betty Friedan, or a Harvey Milk to lead the way. In each case the "How could they?" can only be answered by "they did – but now they don't as much."

What I find equally interesting is to project forward and try to guess what things we are doing now as a society that our grandchildren will ask, "How could they?" That indeed is a tough one, because like cigarette smoking on "Mad Men" in the '60s, it's difficult to conceive of an alternative environment. Perhaps it will be food and cuisine oriented. Corn in everything we eat and drink; genetic modification – "How could they?" Perhaps it will be robot driven cars, prompting our grandchildren to ask, "How could they? No wonder there were so many fatalities." Maybe going to college will top the charts of future unthinkables. "Spending $200,000 for four years of partying – how could they?" We shall see, or better yet, our kids will. They will mold their own world as their environment, and developing ethical standards will mold them in turn; a wheel within a wheel. Punch and Judy would be amazed.

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Speaking of the future and life's lessons, there is an ongoing process of discovery taking place amongst the world's central bankers which they hope will rejuvenate their respective economies without creating the inflationary horror of the 1970s. If Federal Reserve Chair Janet Yellen were the fictional Little Miss Muffet, she would be hoping to eat the "curds and whey" of 2% to 3% real economic growth while avoiding spiderous increases in future prices. If European Central Bank President Mario Draghi were the old fashioned "Punch," he might figuratively be attacking German Chancellor Angela Merkel and her tight monetary and fiscal heritage. "Take that Judy/Angela!" I don't know who to compare Bank of Japan's Governor Haruhiko Kuroda to – perhaps little Jack Horner hoping to stick his thumb into a Christmas pie, pulling out a plumb and exclaiming, "What a good boy am I!" Ah, policymakers. Perhaps the last five years have been one giant nursery rhyme.

But each of these central bankers is trying to achieve the same basic objective: Solve a debt crisis by creating more debt. Can it be done? A few years ago, I wrote that this uncommonsensical feat could be accomplished, but with a number of caveats: 1) Initial conditions must not be onerous; 2) Both monetary and fiscal policies must be coordinated and lead to acceptable structural growth rates; and 3) Private investors must continue to participate in the capital market charade that such policies produced.

Let me explain each of these three caveats in turn.

1) By initial conditions, I am referring to existing structural headwinds that would thwart the successful rejuvenation of old normal, nominal growth rates. Certainly a country's current debt/GDP ratio factors enormously into the oddsmaking for success. It is difficult, for instance, to imagine Japan getting out of its quagmire of debt by simply creating more of it and buying 100% or more of the new and current supply. Similarly, Greece (which has already suffered several restructurings) as well as neighboring Euroland peripherals begin the healing process well behind the debt/GDP eight ball. But there are other significant initial conditions – structural headwinds – that my version of the "New Normal" envisioned as early as 2009: aging demographics, technology/the race (rage) against the machine, and the ongoing reversal of globalization, are all growth-stunting factors to consider. Economist and former Treasury Secretary Larry Summers has labeled this "Secular Stagnation" and rightly so, but it is just another way to describe the New Normal and its deleterious effect on future growth.

2) Monetary and fiscal policies must work side by side; they must be stimulative as opposed to being counterproductive. It makes little sense, for instance, for Euroland to be running a tight fiscal policy resembling the balanced budget mandate of Germany, while at the same time initiating quantitative easing and negative interest rate monetary policies.

The same holds true for the Bank of Japan's massive monetary stimulus on the one hand, and Japan's raising of its consumption tax on the other. One could even apply that complaint to the U.S. with its fiscally restrictive rebalancing of its budget deficit from 10% to 3% over the past five years. If not for fracking, Uncle Sam might be labeled the Old Man in the Shoe for not knowing what to do. In fact, in the U.S., as elsewhere, there has been little focus on public investment and infrastructure spending. It's been all monetary policy, all of the time, with most of the positives flowing over to markets as opposed to the real economy. The debt currently being created is not promoting real growth and solving a debt crisis – it is being used by corporations to repurchase shares and accentuate the growing inequality between the very rich and the middle class.

3) Keeping private investors playing the "game" in our financial markets even though they smack of a pyramid scheme might seem like a no-brainer. "Where else can they go" has been and continues to be the commonsensical refrain. Not sure, but perhaps Google Maps can show the way. But on the fringe and at the margin, there are alternatives to negative interest rates or artificially low cap rates, or escalating P/E ratios based on historically high profit margins. And even if investors must buy something, they don't necessarily have to buy it in their own or any specific country. If 3-year German government bonds yield -.05%, then how about a 3-year Brazilian government bond at 12.5%? At the moment the negative yielding German bond gets the market's vote, but you must see the point. Creating more debt with artificially low yields leads to currency wars and exchange rate volatilities that distort global capitalism. Solving a debt crisis by creating more debt cannot cure the disease if higher volatility distorts the historical flow of markets and associated commerce.

And of course economic theory might suggest that artificially low interest rates gradually but inevitably lead not to more consumption and real growth, but to more savings in order to meet future liabilities such as education, health care, and eventual retirement. If a household needs $250,000 for any or all of these future commitments, it will be twice as hard to meet them with 5-year Treasurys at 1.5% instead of 3%.

With each of my three primary caveats coming up short in an answer to my earlier question: "Can a debt crisis be cured with more debt?" it is difficult to envision a return to normalcy within my lifetime (shorter than it is for most of you). I suspect future generations will be asking current policymakers the same thing that many of us now ask about public smoking, or discrimination against gays, or any other wrong turn in the process of being righted.

How could they? How could policymakers have allowed so much debt to be created in the first place, and then failed to regulate their own system accordingly? How could they have thought that money printing and debt creation could create wealth instead of just more and more debt? How could fiscal authorities have stood by and attempted to balance budgets as opposed to borrowing cheaply and investing the proceeds in infrastructure and innovation? It has been a nursery rhyme experience for sure, but more than likely without a fairytale ending.

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Markets are reaching the point of low return and diminishing liquidity. Investors may want to begin to take some chips off the table: raise asset quality, reduce duration, and prepare for at least a halt of asset appreciation engineered upon a false central bank premise of artificial yields, QE and the trickling down of faux wealth to the working class. If the nursery rhyme theme is apropos to the future, as well as the past, investors should remember that while "Jack and Jill went up the hill," that "Jack fell down, broke his crown, and Jill came tumbling after."

Someday soon, perhaps.

-William H. Gross

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