



As GM Goes, So Goes the Nation

I'm not going to affirm the old saw about what's good for General Motors is good for the nation, or even turn it on its head and suggest that what's bad for General Motors is bad for the nation. Mainstreet Americans know that the auto industry in terms of its dominance of U.S. economic activity is not what it once was. They also know that the industry is under siege from foreign competition and that a series of mistakes made over several decades by both management and labor have compounded the predicament. But the U.S. economy for better or worse, now stands on service and finance, as opposed to manufacturing legs. "What's good for Microsoft or Citigroup" would probably be a better fit for the modern day version of Charles Wilson's metaphor even though Gates or Prince would never acknowledge it.

But as an entropic symbol of U.S. manufacturing aside, I think it is important to recognize that General Motors is a canary in this country's economic coal mine; a forerunner for what's to come for the broader economy. Their mistakes have resembled this nation's mistakes; their problems will be our future problems. GM commands the headlines today, but as General Motors goes, so goes the nation. Following their progress over the next few months and years will be like getting a 2010 Wall Street Journal in June of 2006. But rather than describe in detail

every similarity of General Motors and the U.S. economy, I invite you to digest the following schematic for its rather frightening similarities and possible future consequences. I will sum up my own conclusions in the paragraphs to follow.

If the U.S. and General Motors have similar flaws and indeed symbiotic fates, they appear to be conjoined primarily by the uncompetitiveness of their existing labor cost structures and the onerous burden of their future healthcare and pension liabilities. That is not to say that other automobile manufacturers or countries don't share similar characteristics: they do – but GM and the U.S. are compared here because of their historical dominance and therefore the influence that they will have on investment markets as they struggle to adjust. If GM is a canary, let's hope for the canary's long life, but be mindful of its chirping deep in the mineshaft of future events that speak to broader implications for the U.S. economy.

Because diminished labor cost competitiveness and excessive future unreserved liabilities are descriptive of both GM and the U.S. economy, GM's efforts to survive and ultimately prosper should be our own as well. Although the following graphic contains my own assumptions, I am struck by several primary investment conclusions:

GM Problem/Solution

Problem	Current Remedy	Possible Future Solution
1) Eroding competitiveness compared to global auto industry.	<ul style="list-style-type: none"> a) Downsize and outsource production. b) Provide cheap financing via low interest rates to promote sales. c) Reorient product line. 	<ul style="list-style-type: none"> a) Solicit favorable trade legislation/cheaper currency to regain market share.
2) Uncompetitive labor costs compared to global competition.	<ul style="list-style-type: none"> a) Renegotiate (Delphi for now) wages downward, eliminate unproductive labor practices (workbank, etc). b) Outsource production overseas 	<ul style="list-style-type: none"> a) Continued wage negotiations. b) Continued outsourcing of production.
3) Burdensome future liabilities – healthcare, pensions.	<ul style="list-style-type: none"> a) Buyout labor contracts and negotiate worker givebacks. b) Sell assets to remain solvent. 	<ul style="list-style-type: none"> a) Enlist government funding of healthcare and favorable pension legislation. b) Potential default in order to shift burden to creditors, government.

U.S. Problem/Solution

Problem	Current Remedy	Possible Future Solution
1) Eroding competitiveness of manufacturing and some services (declining share of exports as a % of trade), resulting in a growing and excessive trade deficit	<ul style="list-style-type: none"> a) Downsize and outsource manufacturing and some services. b) Pressure China to revalue Yuan. 	<ul style="list-style-type: none"> a) Fed provides cheap financing via low interest rates. b) Devalue currency to regain market share. c) Erect trade barriers via legislation.
2) Uncompetitive labor costs compared to global competition	<ul style="list-style-type: none"> a) Allow real wages to decline – delay enactment of minimum wage legislation. b) Encourage immigration and tolerate illegal immigration. 	<ul style="list-style-type: none"> a) Devalue currency. b) Political backlash may lead to immigration controls.
3) Burdensome future liabilities – healthcare, pensions.	<ul style="list-style-type: none"> a) Delay and modify pension legislation which would otherwise increase corporate burden. b) Sell assets (bonds for now) to foreigners to maintain economic growth and remain solvent. 	<ul style="list-style-type: none"> 1) Revise healthcare system to contain costs and restrict benefits. 2) Revise social security to lengthen retirement age. 3) Sell assets (bonds, real estate, stocks) to foreigners to maintain economic growth and remain solvent. c) Promote inflation via increased budget deficits and loose monetary policies. Keep short-term interest rates low to reduce interest expense. d) Implicitly default by devaluing currency to reduce debt liabilities to foreign interests.

1) The current attempt on the part of GM to address the high cost of its labor draws a comparison to potential future U.S. efforts to do so via currency devaluation. While a company must deal directly with its employees and/or its unions in order to lower wage/benefit expenses, a country – certainly a capitalistic oriented one – goes about it in another way. By depreciating the dollar, U.S. Treasury or Federal Reserve policies aimed in that direction explicitly do the same thing. Such policies make our products cheaper to buy than those of competitor nations. In terms of global purchasing power experienced by America citizens, a significantly lower dollar in turn leads to declining real wages which is the ultimate consequence in order to restore competitiveness. My point is that the survival tactics employed by General Motors in the form of contract renegotiations (the heavy lifting of which is now being expressed via its parts supplier Delphi in bankruptcy court) will likely be replicated at some point via U.S. economic policies emanating from the U.S. Treasury and Federal Reserve. Look for an eventual abandonment of our stated mantra of a “strong dollar policy” for something more elusive but nonetheless potently obvious. Look also for the Fed to support such a policy – not openly or in public statements – but via a substantive period of low real interest rates compared to history. This one-two punch by the Treasury and the Federal Reserve amounts to what is known in economic circles as a competitive devaluation,

a maneuver that may or may not be welcomed by competitor nations with mercantilistic intentions of their own. Nonetheless, at some point in America’s future, a rather drastic rebalancing of wage rates compared to primarily Asian competitors will be required and these are the policies that accomplish that.

2) Perhaps the most significant comparison between GM and the U.S. economy lies in the recognition of enormous unfunded liabilities in healthcare and pensions. Reportedly \$1500 of every GM car sold in dealer showrooms goes to pay for current and future health benefits of existing and retired workers, a sum totaling nearly \$60 billion. The total future healthcare liability for all U.S. citizens can be measured in the tens of trillions.

GM’s pension and this country’s social security liabilities are of similar magnitudes. While GM’s plan is currently fully funded, the necessity for future contributions, especially if investment return assumptions are not met, are substantial. “I have a social security system hooked to our balance sheet,” admits GM CFO Fritz Henderson. Since America’s existing social security scheme is for all intents and purposes a “pay as you go” funding plan, the U.S. balance sheet is tipped even more to the liability side.

How are we to pay for this future burden of healthcare and social security expenses? Aside from contractual legislative changes to both areas (which

are surely just around the corner), the way a reserve currency nation gets out from under the burden of excessive liabilities is to inflate, devalue, and tax.

Another way the U.S. could escape the burden of its future liabilities is to “grow” its way out, much in the same manner GM is attempting to make its models more attractive and relevant to current car buyers. We could do that by accelerating relative productivity gains, by emphasizing innovation, and upscaling education. Other nations however, understand the same rules and it will be difficult to “grow” assets and/or reduce liabilities via increased savings if we have a reduced “product line.” With our manufacturing and service base being increasingly hollowed out by foreign competitors, the primary export we have that can be made more attractive are our Treasury bonds in the form of higher relative yields. It will be an easier task, in fact for GM to renovate its product line than for the U.S. to revamp its.

Owners of these liabilities (either existing/future debt holders, or tax paying corporations/citizens) will likely be the sacrificial lambs of the future. Investors, therefore, should factor in an increasing propensity for higher inflation in future years as debt principal is eroded much like the shaved edges of a Roman coin. Higher taxes, as well, are just around the corner. Finally, currency devaluation effected through a low Fed Funds policy vs. competitor nations and/or global policy coordination should apply the coup de grace for foreign holders of U.S. liabilities. Chinese, Japa-

nese, OPEC, and other substantive holders of U.S. Treasuries will have two ways to lose in future years: they will watch U.S. inflation erode their principal and on top of that the real dollar value of their global purchasing power will decline as the dollar sinks. Actually, the same applies to U.S. citizens although the decline in global purchasing power can be masked by domestic asset appreciation in the short-term (houses, stocks).

If the U.S. chooses to pursue many or most of the above policies, the investment implications are significant, although it must be recognized that I am not speaking to “overnight” developments but instead to changes that should occur in future years. Higher inflation, higher personal and corporate taxes, and a lower dollar point U.S. and global investors away from U.S. assets and toward more competitive economies less burdened by health and pension liabilities – those personified by higher savings rates and investment as a percentage of GDP. Need I say more than to sell U.S. assets and buy Asian ones denominated in their local currencies; or if necessary to hire a global asset manager with sufficient flexibility and proper foresight to thrive in an increasing difficult investment environment?

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