

## Spotlight

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### Mohamed El-Erian and Bill Gross Discuss PIMCO's Cyclical Outlook and the New Normal



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*More than two years after the start of the financial crisis, markets and economies are showing signs of recovery, yet the many factors affecting them remain complex and the outlook is still uncertain. PIMCO calls this the New Normal, a world in which growth prospects may be lower and long-held assumptions about portfolio allocations are being challenged. PIMCO Co-CIOs Bill Gross and Mohamed El-Erian recently discussed PIMCO's outlook for the global economy and their views on investing in this new world.*

**Q: PIMCO calls the economic environment the world is transitioning into the New Normal. What were the defining characteristics of the old normal?**

**Gross:** In order to talk about the New Normal it is a good idea to step back and review what we mean by the old normal. For instance, how long did it exist? It may be that history books in the future will say that it started as far back as Bretton Woods, shortly after World War II, or at least following Bretton Woods II in the early 70s, but in any case it's certainly existed for the past 20 to 25 years. Economists, including Fed officials, have described it as the Great Moderation, and investment managers have dubbed it Goldilocks. At any rate, it was a period characterised by declining interest rates beginning around 1982, a transition to low inflation beginning in the late 70s, accelerated use of financial leverage, increasingly complex financial innovation and loose regulation.

All of this led to a period of reliable growth of around 6%–7% nominal GDP. Importantly, this consistent growth led to appreciation of most assets: bonds, stocks, real estate and commodities. The key to this asset appreciation was, of course, financial leverage, but also operational leverage. In an environment of consistent growth companies can gear their plants, equipment and human resources to take advantage of that predictability in order to produce returns and return on equity. That was the old normal.

**Q: What spurred this transition?**

**Gross:** We're transitioning due to popped bubbles and de-risking of portfolios and balance sheets. In the wake of all the bubbles over the last ten years – from the dot-com bubble in the beginning of the decade to the dual housing/finance bubble that precipitated the current crisis, all of the players at the table – corporations, investors and government – now believe that bubbles need to be contained. There is broad recognition that we have to transition through a period of deleveraging, reregulation and even a mild reversal of

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globalisation, which, in particular, had been driving significant productivity gains over the past decade.

A simple way to look at it is that private market capitalism simply went too far over the last 10–20 years, and now we're in the process of pulling back and accommodating deleveraging, reregulating and de-globalisation.

### **Q: What will the New Normal look like?**

**Gross:** The new scenario has a number of implications for both growth and investment. For instance, we expect nominal GDP growth rates to trend lower in the New Normal, probably around 3%–4%. And because of the financial and operational deleveraging we are seeing, returns on assets will likely be half of what they were during the previous 10–20 years. And the deleveraging, reregulation and de-globalisation that will weigh on growth is likely to be the new model in the foreseeable future.

### **Q: Why does this shift imply that investment will be lower?**

**Gross:** The old economic models that propelled higher growth and returns are broken. I think it's instructive to look at a few examples where the old paradigm has broken down.

First, the housing market: I don't think anyone would argue that US housing will be moving back to two million starts per year, or to the type of torrid pace we'd seen in many markets around the world leading up to 2007. The explosive growth in the housing market was driven by a combination of rising demand, increasing speculation, financial innovations including subprime loans and, in the US, the belief that everyone should own a home. As a result, home ownership in the US spiked to an all-time high of 69%, but it is now likely to fall back to the 62%–63% range. The “new age” housing model, which relied in particular on subprime lending, cannot be put back together. This means that employment associated with housing, such as construction work, real estate, etc., will likely be structurally reduced for the foreseeable future.

Second, savings and consumption: The model that supported 0% savings and high consumption simultaneously is obviously broken. Continually rising asset prices meant that consumers could spend income from investments and equity from their homes even if savings rates were negative. But now the US savings rate is above 5% and headed higher. Consumers represented 70% of US consumption in the old model, so increased savings means reduced consumption. And lower consumption leads to lower growth rates, perhaps lower inflation and, of course, lower investment returns.

Third, the financial sector: Not just on Wall Street, but throughout the world, the finance-, asset- and paper-driven engine of economic growth is being dismantled and will result in lower rates of growth. The entire global model, in which exporters were willing to accept US paper – some of it relatively worthless, e.g., subprime-filled Collateralised Debt Obligations (CDOs) – in exchange for their manufactured goods, has imploded. We are leaving the world where the US dominated consumption and was the engine of global growth. Now the rest of the world, whether it's China, Brazil or other future tigers, will begin to dominate and must in turn replace their export-driven growth with internal demand-generated growth.

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So for all those reasons, it becomes easier to see tangibly why the New Normal versus the old normal must be a world of slower growth, potentially lower inflation and perhaps half the appreciation in terms of asset prices.

**Q: What does this complicated transition suggest for the economic outlook?**

**EI-Erian:** Taking into account the context of a major global transition is critical when considering the most likely direction for the economy. We are leaving the “old” world but we are not quite in the “new” one. As a result, we are at the point of maximum confusion in the transition because the parameters themselves are in motion. In these circumstances, human nature is to resort to an “active state of inertia” and look back to what we are familiar with, rather than try to define the new paradigm. That kind of old normal oriented behaviour is clouding many peoples’ view.

The context PIMCO is operating in is a multi-year process of deleveraging, reregulation and de-globalisation that is being compounded by not just a global recession but, in particular, a balance sheet recession.

Consider the notion of an “escape velocity” for the economy – a forward movement that is significant enough for a sustained economic expansion to set in. There are three contributors. The first is the unprecedented amount of global fiscal and monetary stimulus. This is now in play in a big way. The second is the inventory rebuilding cycle, which is starting to take hold. While these two factors are necessary for reaching escape velocity – and are very much in play, contributing to seemingly robust growth numbers for the third and fourth quarters – they are not sufficient. We also need sustainable private sector demand.

In PIMCO’s Investment Committee deliberations, Bill came up with an analogy of a rocket, which has fired two boosters but needs to fire a third in order to escape the earth’s gravitational force. That third booster, which is the final component necessary to achieve escape velocity, has to come from a source of private demand: either consumption, investment or exports.

When we look at the extent to which the major economies, especially the US, are challenged by their balance sheets right now, we are not yet expecting that the third booster is going to fire. As a result, we question the expectations in the marketplace for a V-shaped recovery.

The “cash for clunkers” program is a prime example. It was an aggressive fiscal stimulus, which led to a rundown in auto inventories and then to a response on the production side. But the equation is not complete if there is not a final handoff of the new production to incremental consumer demand. A buildup in indigenous sources of demand is required. Our analysis suggests this is not yet happening and therefore it is too early to assume that growth in 2010 will be as robust as some public and private sector projections. The concern is that the recovery won’t be a “V” because the economy will not reach the escape velocity in the current environment.

**Q: Are there other causes for concern you see ahead that are also making you sceptical of a V-shaped recovery?**

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**EI-Erian:** The problem with crises is that their impacts unfold over time. Given the nature of the financial crisis, including the fact that it hit at the core of the global economic system, we expect an additional set of lagged effects that will play out over time and will contribute to a scenario of lower growth, investment and nominal GDP. Banks have not yet initiated any significant new lending to the real economy; most financial institutions are still in the process of rehabilitating their balance sheets. And in addition to the current market-led de-risking in the financial system, we expect significant regulatory changes to drive further de-risking down the road.

There is also the problem that the social contract is failing to address a number of key post-crisis issues. In the US, the assumption has always been that the labour market will bounce back quickly, because labour and capital are highly mobile, and the approach to unemployment benefits and other benefits is based on that view of a flexible labour market. But in this crisis we have seen unemployment rise very rapidly, and we do not expect employment to rebound soon.

All this reinforces our view that while the third and fourth quarter will register good growth numbers around the world, the probability is that in 2010 growth will be anaemic, especially in the US.

**Q: Why does the market generally seem to be anticipating a more robust recovery than PIMCO sees?**

**EI-Erian:** There are a number of reasons the markets appear to be pricing in a V-shaped recovery, but these factors are likely to be both temporary and reversible.

The extraordinarily low fed funds rate has pushed money out of low-risk and “risk-free” assets into higher risk assets, which has led to the bounce in asset prices. However, this is not sustainable: Rates are as low as they can go, and the appetite for increased fiscal spending is waning. The monetary and fiscal stimulus will become contractionary next year, due to “subtraction through the absence of addition.” The government has the only available balance sheet, and when that is exhausted, we do not believe another one is likely to materialise.

Finally, companies have surprised to the upside by delivering higher-than-expected profits, but the earnings have been derived from massive cost-cutting. There is only a finite amount of cost-cutting that can drive earnings. Eventually, private demand is necessary to generate top-line revenue.

There is a risk that markets may be experiencing a “sugar high.” The combination of high liquidity, massive fiscal stimulus and cyclical forces is enticing too many observers to react in a backward-looking fashion, whereas the New Normal requires forward-looking analysis that recognises the secular structural changes that are occurring in the global economy.

**Q: How would you recommend investors position portfolios to help protect them against both the surprises and challenges of the New Normal, as well as the opportunities?**

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**Gross:** The initial stages of deleveraging and liquidation – from the beginning of June 2008 and lasting about nine months – were a period of panic and forced sales where asset prices declined by as much as 50%. Then in March 2009, global governments' checkbooks came into play, which has helped to partially re-inflate asset prices.

In the context of PIMCO's growth and profit expectations for 2010, there may be substantially more potential for downside risks than upside risks for most asset classes.

Basic questions that affect asset prices are substantially unanswered: Will there be accelerating inflation, or is deflation possible? What will default rates look like going forward? How will the commercial real estate market play out? What will the new regulations concerning bank capital requirements look like?

We don't expect a return to levels seen in June 2008 in most markets because the financial system has been salvaged, re-liquefied and significantly de-risked, but a slow recovery, lower corporate profits, potential for disappointments and potentially displaced confidence all suggest pulling back risk positions that have been acquired over the last six months.

### Thank you, Bill and Mohamed.

#### About the authors:

**William H. Gross, CFA**, is a founder of PIMCO, managing director and co-CIO in the Newport Beach office. He has been associated with PIMCO for more than 38 years and oversees the management of more than \$800 billion of fixed income securities. He is the author of numerous articles on the bond market, as well as the book *Everything You've Heard About Investing is Wrong*, published in 1997. He appears frequently in national publications and media. Among the awards he has received, Morningstar named Mr. Gross and his investment team Fixed Income Manager of the Year for 1998, 2000, and 2007, making him the first person to receive this award more than once. Morningstar stated that he demonstrated "excellent investment skill, the courage to differ from consensus, and the commitment to shareholders necessary to deliver outstanding long-term performance." In 2000, Mr. Gross received the Bond Market Association's Distinguished Service Award. In 1996, he became the first portfolio manager inducted into the Fixed Income Analysts Society's hall of fame for his major contributions to the advancement of fixed income analysis and portfolio management. In a survey conducted by Pensions and Investments magazine in 1993, Mr. Gross was recognized by his peers as the most influential authority on the bond market in the US. He has 40 years of investment experience and holds an MBA from the Anderson School of Management at the University of California, Los Angeles. He received his undergraduate degree from Duke University.

**Mohamed A. El-Erian** is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO at the end of 2007 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, *When Markets Collide*, was a New York Times and Wall Street Journal bestseller, won the Financial Times/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by The Economist. Dr. El-Erian has served on several boards and committees, including

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the US Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

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