



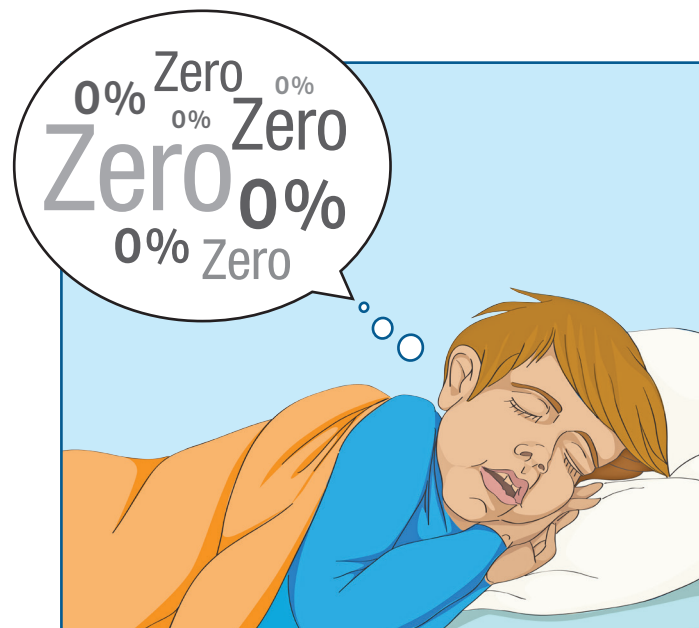
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Investment Outlook

from Bill Gross

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Saved by Zero?



So the Fed has chosen to hold off on their goal of normalizing interest rates and the ECB has countered with the threat of extending their scheduled QE with more checks and more negative interest rates and the investment community wonders how long can this keep goin' on. For a long time I suppose, as evidenced by history at least. Ken Rogoff and Carmen Reinhart have meticulously documented

periods of "financial repression", long stretches of years and in some cases decades where short-term and even long-term yields were capped and suppressed below the level of inflation. In the U.S. the most recent repressive cycle extended from 1930 to 1979, nearly half a century during which investors on average earned 1.5% less than the rate their principal was eroding due to inflation. It was a savers nightmare.

But then Paul Volcker turned the bond market upside down and ever since (until 2009), financial markets enjoyed positive real yields and a kick in the pants boost to other asset prices, as those yields gradually came down and increased the present value of bonds, stocks and real estate. Low or zero interest rates it seems do wonders for asset prices and for a time even stabilize real economies,

but they come with baggage and as zero or near zero becomes the expected norm, the luggage increasingly grows heavier. Model driven central banks seem not to notice. Accustomed to Taylor Rules and Phillips Curves, their commentary is almost obsessively focused on employment statistics and their ultimate impact on inflation. Lost in translation however, or perhaps lost in transition to a New Normal financial economy, is the fact that while 0% or .25% or other countries' financially suppressed yields might be appropriate for keeping their economy's head above water, they act as a weight or an economic "sinker" that ultimately lowers economic growth as well.

No Model will lead to this conclusion. Only the Japanese experience of the last several decades seems to give a hint, but the aging demographics of their society is offered as a convenient excuse for their experience. Zero is never mentioned as a complicit accomplice, especially since inflation itself has averaged much the same. But models aside, there should be space in an economic textbook or the minutes of a central bank meeting to acknowledge the destructive influence of 0% interest rates over the intermediate and longer term.

Zero destroys existing business models such as life insurance company balance sheets and pension funds, which in turn are expected to use the proceeds to pay benefits for an aging boomer society.

How so? Because zero bound interest rates destroy the savings function of capitalism, which is a necessary and in fact synchronous component of investment. Why that is true is not immediately apparent. If companies can borrow close to zero, why wouldn't they invest the proceeds in the real economy? The evidence of recent years is that they have not. Instead they have plowed trillions into the financial economy as they buy back their own stock with a seemingly safe tax advantaged arbitrage. But more importantly, zero destroys existing business models such as life insurance company balance sheets and pension funds, which in turn are expected to use the proceeds to pay benefits for an aging boomer society. These assumed liabilities were based on the assumption that a balanced portfolio of stocks and bonds would return 7-8% over the long term. Now with corporate bonds at 2-3%, it is obvious that to pay for future health, retirement and insurance related benefits, stocks must appreciate by 10% a year to meet the targeted assumption. That, of course, is a stretch of some accountant's or actuary's imagination.

Do central bankers not observe that Detroit, Puerto Rico, and soon Chicago, Illinois cannot meet their promised liabilities? Do they simply chalk it up to bad management and inept governance and then return to their Phillips Curves for policy guidance? Do they not know that if zero were to become the long-term norm, that any economic participant that couldn't print its own money (like they can), would soon "run on empty" as Blackstone's Pete Peterson once expressed it in describing our likely future scenario? The developed world is beginning to run on empty because investments discounted at near zero over the intermediate future cannot provide cash flow or necessary capital gains to pay for past promises in an aging society. And don't think that those poor insurance companies and gargantuan pension funds in the hundreds of billions are the only losers. Mainstream America with their 401Ks are in a similar pickle. Expecting 8-10% to pay for education, healthcare, retirement or simply taking an accustomed vacation, they won't be doing much of it as long as short term yields are at zero. They are not so much in a pickle barrel as they are on a revolving spit, being slowly cooked alive while central bankers focus on their Taylor models and fight non-existent inflation.

My advice to them is this: get off zero and get off quick. Will 2% Fed Funds harm corporate America that has already termed out its debt? A little. Will stock and bond prices go down? Most certainly. But like Volcker recognized in 1979, the time has come for a new thesis that restores the savings function to developed economies that permit liability based business models to survive – if only on a shoestring – and that ultimately leads to rejuvenated private investment, which is the essence of a healthy economy. Near term pain? Yes. Long term gain? Almost certainly. Get off zero now!

-William H. Gross

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