

Bill Gross and the New Normal

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June 9, 2009



Nearly a half-century of global economic prosperity has ended, and investors must gird themselves for muted returns from the capital markets, according to Bill Gross, a Managing Director at PIMCO. Gross shared his outlook at the Morningstar Investor Conference, and his complete remarks can be found on the PIMCO [web site](#).

Framing the history of the current crisis with an extended biblical analogy, Gross traced the “Genesis” of the global boom to the fall of the gold standard in 1971, which ushered in an era of central banks printing money, a shift that in turn sparked financial innovation. “The combination of easy check-writing for central bankers and securitization made money cheap to the public,” he said.

The central phase of the boom began in 1980 with the Great Moderation, a period of relatively low volatility and high returns in the capital markets, while inflation was well-controlled. But financial innovation took over, and as the Shadow Banking System evolved it exposed weaknesses in the markets. Leverage ballooned and consumption grew until it was exaggerated to extreme proportions, eventually leading to the “expulsion from the Garden of Eden” – and the end of the Great Moderation.

Regulators have been piecing together a Noah’s Ark of solutions, Gross said, including the TARP, TALF, PPIP, stimulus spending, and quantitative easing. These programs, however, will not avert what Gross called the “New Normal” – slow economic growth, high unemployment, and accelerating inflation.

“The New Normal will be an inherent part of our economy for years to come,” he said.

Gross offered specific forecasts – economic growth of 1-2%, unemployment of 7-8%, and inflation kicking in over the next three to five years.

The New Normal replaces the previous paradigm, which Gross described as the “Child of the Bull Market.” Under that paradigm, investors could rely on historically generous rates of return, and whenever returns lagged they would reliably revert to the mean. Barton Biggs, who Gross called the poet laureate of the investment industry, encapsulated this line of thinking when he said that markets were good “because whenever they and the economy have gone down, they’ve gone back up to higher levels.”



In a world of de-leveraging and less globalization, Gross said things will not bounce back. “Growth will be stunted and subdued, and this will have a big impact on corporate profits” that could last ten years, he said.

Investors should be guided by a set of rules – Gross’ Seven Commandments:

1. Echoing views expressed by Peter L. Bernstein, Gross said that the policy portfolio is dead. A 60/40 allocation and the promotion of risky (equity) assets was how you got rich in the past, but past results don’t foretell future performance. Risk and return may be correlated, but Gross said investors must pay closer attention to the price they pay for risky assets. Gross also questioned whether the endowment model practiced by Harvard, Yale, and others, with its high allocation to illiquid assets, will continue to generate outsized returns.
2. “Get used to your 301(k),” Gross said. Retirement accounts will not rebound to previous levels, as corporate growth rates and profit margins are at risk.
3. Companies like Coca Cola and Proctor and Gamble, with large consumer franchises and the power to pass on price increases, are best positioned for this economy. Gross expects these companies to earn 6-8%, which he said was comparable to high-quality corporate bonds.
4. “Shake hands with the government,” he said. Gross advised investors to look at what the government is buying and buy it first, and then look for the exit. He doesn’t advise a clasping of the hands with the government, but rather a “fist bump” acknowledgment – the way comedian and germophobe Howie Mandel acknowledges his friends.
5. One day – sooner rather than later – the dollar will lose its reserve status. Investors should diversify internationally more aggressively than in the past.
6. Russia was a good bet when oil prices were high, and but investors should look at Brazil, India, and China – the BRIC economies minus the “R.”
7. Prepare for up to \$3 trillion of gross government debt issuance in the next year. Debt is now 60% of GDP and will go to 100% in four years, and this will jeopardize the credit rating of US Treasury debt.

The last point that concerns Gross the most. His fears extend beyond current budget deficits, and are more focused on the liabilities imposed by Social Security, Medicare, and Medicaid, to which he collectively attaches a \$40 trillion price tag. Gross offers bond investors the most conservative advice he can – “confine maturities to the front end of yield curves where continuing low yields and downside price protection is more probable.”



The investment business will change too, as pressure will mount to reduce fees. “The returns won’t be there” to justify them, Gross said.

Don’t plan on the New Normal era ending soon. “There won’t be an end, just a different kind of world that we all have to get used to,” Gross said.

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