
Perspectives

Driving Without a Spare

By Mohamed El-Erian | Posted: 05-13-10 | 12:00 AM | [E-mail Article](#)

Once again, PIMCO colleagues from our 11 offices around the world gathered in Newport Beach last week for the Secular Forum – an annual event where we discuss and detail the three- to five- year outlook for the global economy and markets. Once again, we were privileged to listen to presentations by four global thought leaders who exposed us to fresh perspectives, insightful frameworks and outstanding research (see box). And, once again, our new class of MBAs and PhDs enlightened us with their views of the world, backed by comprehensive research and data.

The Secular Forum process is very important to PIMCO. Hardwired into our firm by Bill Gross more than 30 years ago, it has effectively informed and influenced our most important decisions when it comes to managing risk and delivering returns to you, our clients.

As you know, the Secular Outlook speaks to what is likely to happen (rather than what should happen). It determines the analytical guardrails that govern the positioning of your portfolios over time. It also influences many other things we do – from the design of forward-looking investment solutions for you, to the medium-term business positioning of the firm (including investments in technology and people).

Describing why the Secular Forum is so important for PIMCO is the easy part of my job in this write-up. The harder part is summarizing for you the content, nuances and conclusions of 2 1/2 days of debate (which, in typical PIMCO fashion, was vigorous, lively and wide-ranging).

Some of you may just want the bottom line; others may be interested in how we got to our conclusions. So let me deal with each in turn.

As regards the bottom line, PIMCO believes that we are living through a remarkable time of change for the global economy and markets. As discussed in last year's Forum, when looking out over the next three to five years, the global economy has embarked on a bumpy journey to a New Normal.¹

Through a series of transitions, collisions, and trade-offs (the journey), we are heading to a world that is re-regulated, de-levered, and growing less rapidly in the industrial countries (the destination). It is a world in which concerns about the dark side of globalization temper enthusiasm for its net benefits, and in which politics matter a lot for markets and the economy.

The drama playing out in Europe these days is another vivid illustration of this general secular characterization. There are many others, including the generalized and simultaneous nature of the debt explosion in industrial countries, the application and content of regulatory initiatives across the globe, the headwinds to job creation in some industrial countries, the extent of political polarization and anti-incumbency in many countries around the world and the further shift of growth and wealth dynamics to emerging economies.

Some of you may be wondering why it takes us 2 1/2 days of debate simply to reaffirm the conclusion we reached at last year's Forum. A straightforward question, and one with an equally straightforward answer. In reaffirming the conclusion, we also refined the characterization of both the journey and the destination based on additional information, research and analysis.

Our Forum again points to the changing historical context – a regime shift that is occurring at a time when the global economy as a whole (and industrial countries in particular) is operating with reduced tolerance for policy errors, political accommodation, and market accidents. There is also a sense of an unplanned convergence among important parts of the globe – east and west, north and south – to a new model of “state capitalism” that is being formulated on the fly.

For investors, this translates into a changing configuration of risks and returns – if you like, a world with a flatter distribution of potential outcomes, fatter tails, and a baseline that is subject to the unsettling dynamics of multiple equilibriums (think path dependency).

You can summarize all this with a simple yet powerful image that one of our speakers introduced: The world is on a journey to an unstable destination, through unfamiliar territory, on an uneven road and, critically, having already used its spare tire(s).

For those looking for more details, allow me to share with you the context for our discussions, the analytical building blocks for our findings and the main areas of uncertainty and disagreement.

The 2009 Forum

My PIMCO colleague, Paul McCulley, likes to say that the most constructive debates often start with a clear recognition of one's priors. So, at the start of this year's Forum, we summarized the conclusions of the May 2009 Secular Forum:

We discussed... the demise of the “great age” of private leverage, debt, and asset- and credit-based entitlements, as well as of the world of deregulation, self-regulation and great policy moderation;

We highlighted... a secular reversal from unfettered markets to greater government involvement or, as Paul likes to say, from the invisible hand of markets to the visible fist of governments – triggered in large part by massive crisis intervention;

We expected... a continued shift in global growth and wealth dynamics from the G-3 (the EU, Japan and the U.S.) toward the systemically important emerging economies (Brazil, China and India); and

We stressed... the importance of country/regional differentiation over the secular horizon, particularly after the spike in economic/financial correlation occasioned by the 2008-2009 global “sudden stop.”

All this led us last year to articulate the following medium-term global configuration:

U.S.: Gradual deleveraging and financial rehabilitation to occur in the context of lower medium-term growth, greater regulation, deteriorated public finances and an eventual inflationary bias down the road;

U.K.: Also stuck in a world of lower growth and poor public finances, but with greater vulnerability to domestic and external financial instability;

EU: Deflationary bias and growing core/peripheral frictions and tensions;

Japan: A constantly encumbered real economy due to demographics and public finances;
and

EM: A bifurcated world, with key economies (including China) maintaining their development breakout phase.

How about the big areas of uncertainty?

We cautioned that the management of public debt in industrial countries would be a delicate process and that we would likely face the uncertain consequences of erosion in the autonomy and mission of key economic institutions, including the Federal Reserve. We also warned that more than ever, politics mattered. It is not just about the aftermath of huge market excesses and a damaging global financial crisis; it is also about social contracts coming under stress, especially in countries facing high unemployment and immediate budgetary pressures.

Developments Since Our Last Secular Forum

In the last 12 months, the world has experienced a strong cyclical bounce... though, notwithstanding massive budgetary and monetary stimulus and a robust inventory cycle, most industrial countries remain below pre-crisis levels of GDP, wealth and employment. Corporate profits have come roaring back, helped by tremendous cost resizing (especially by U.S. companies) and related large productivity gains. The recovery in bank profitability has been dramatic, fueled in part by steep yield curves and cheap government-guaranteed bond issuance. Emerging economies have outperformed industrial countries, with stunning growth that has spread well beyond China.

Yet, in looking at a secular (three- to five-year) horizon, the durability of this strong recovery has skeptics, and rightly so. Several of us at PIMCO question the robustness of the handoff in industrial countries from temporary sources of growth (stimulus and inventory restocking) to sustainable drivers of growth and employment (final private sector demand). We worry that the cyclical bounce has not translated into the type of job creation and corporate investment that would be expected based on historical relationships, and we see significant structural headwinds on the horizon, some of which are already being felt.

The last 12 months have also been characterized by growing manifestation of sovereign risk issues. This has helped fuel the more general phenomenon of political polarization and anti-incumbency around the world; it is also eroding popular enthusiasm for regional cohesion. In the process, an already complex endeavor for regulators – that of striking a better balance between systemic stability and innovation – has been made even more complicated and unpredictable.

These concerns are playing out in real time in Europe. Due to the rigidity of the eurozone occasioned by the single currency/monetary policy structure, debt and deficit differences among countries have created significant frictions and disruptions. Just witness the tragic debt crisis in Greece, the contagion to other peripherals (such as Portugal and Spain) and the conflicted nature of the policy response in Germany and at the ECB. Also note how many people were caught by surprise by the speed of Greece's jump from interest rate risk to credit/default risk.

The Building Blocks

Clearly, many factors are in play in defining the 2010 Secular Outlook. Some have assumed urgency, such as those that forced Europe last weekend into taking dramatic measures to deal with its crisis. Others – including climate change, scientific discoveries, demographics and the atomization of societies – are super-secular. Yet their future impact, positive and negative, may be reflected more visibly in markets over the next three to five years.

We also came away from this year's Forum with an even greater appreciation of the medium-term complexity of more traditional economic issues, including growth, balance sheets and inflation.

On growth, we stressed the prospects for considerable differentiation among regions and countries. Specifically:

We expect systemically important emerging economies to maintain their development breakout phase, including a gradual broadening of the engines for income and employment creation. Yes, there are issues and risks in each country... but overall, this historic transition is manageable and we are a couple of secular horizons away from these economies constituting more than half of the global economy.

Over the next few years, Australia and Canada will constitute the analytical battleground as elements of the new normal come head-to-head with those of the old normal. Our sense is that the two countries' exposure to the dynamic components of global growth – through direct trade links with Asia and the commodity angle – will likely outweigh the drag from the legacy of household leverage (Australia) and the economic links to the U.S. (Canada).

The same cannot be said of Europe and Japan. The former is in the midst of a fiscal deflationary drag, with vital questions multiplying about the very makeup of the eurozone and its supporting institutions over the longer term. The latter will face increasing demographic and debt headwinds that will inevitably drain even further the already weakened drivers of sustainable growth. In all this, both will discover what many others have before them—the politics of austerity are far from straightforward.

The picture for the U.S. (and the U.K.) is more mixed, especially when compared with other regions. The country retains its position as one of the most dynamic and entrepreneurial economies in the world, with a proven ability to adapt and re-invent itself. Its corporate sector (and, especially, the large companies) has lowered its cost structure, increased cash cushions and termed out debt. It is still the provider of global public goods, including the world's reserve currency. And, with the help of policy measures, its banks have undergone a meaningful balance sheet rehabilitation.

At the same time, however, the U.S. faces large and mounting structural headwinds.

The country's public finances have taken a serious turn for the worse that will not be corrected anytime soon. Private sector credit creation remains hampered and the banking system will become more utility-like. Meanwhile, the household sector is still burdened by excessive debt, suggesting that further deleveraging lies ahead. Unemployment is high and will likely remain so for the foreseeable future, accentuating concerns about skill erosion and loss of labor market flexibility.

Politics are not helping, especially when it comes to confronting these structural issues in a timely manner. Political parties seem more interested in accentuating differences rather than in agreeing on solutions. And while there is more certainty about the response of regulatory agencies – namely, they will deploy every instrument available (regulations, taxation and enforcement) in their quest to reduce systemic risk – there is no clarity yet as to where the balance will be struck between effective regulation and bad regulation. It will also take time (and a few iterations) for all this to be reflected in the structure of the financial sector and markets.

Our concerns about the muted outlook for industrial country growth brings us to another focus of our discussions – whether there is an unencumbered balance sheet – another spare tire – that is both willing and able to maintain the leverage in the system, and do so with little collateral damage and few unintended consequences.

More than anything, the story of the last few years has been one of serial balance sheet contamination. Initially, private sector balance sheets were expanded well beyond sustainable levels, aided and abetted by financial innovation, the degradation of lending standards, and short-termism. Subsequently, too many balance sheets deleveraged simultaneously, threatening a global depression and forcing governments to step in with their own balance sheets to arrest an increasingly disorderly process.

Last weekend's drama in Europe is yet another illustration of this phenomenon. Policymakers are now forcefully using the balance sheets of the EU (ultimately Germany) and ECB to compensate for the debt excesses in the periphery (particularly Greece) and the related overexposure of European banks.

As societies start to worry even more about public finances – and this is inevitable – it will become even more difficult to sequentially deploy new balance sheets in order to sustain the levels of debt and deficit that currently prevail... that is, unless there is yet another healthy

balance sheet that can stealthily take on this debt for a while.

Some argued during the Forum that central bank balance sheets could still be used for this purpose. This view was bolstered by the ECB's recent response aimed at calming markets and safeguarding the euro. Others warned that markets and politicians (and voters, some of whom have already signaled their disdain) would consider this yet another form of inadvisable financial alchemy, thereby limiting the feasibility, desirability and effectiveness of this approach over the medium term.

I am inclined to side with the second group in warning against the long-term implications of additional steps to turn monetary authorities (with revolving balance sheets) into fiscal agencies (with more permanent exposure to dubious assets). An even larger-scale use of central bank balance sheets, if it were to materialize, would provide only a temporary respite, and the collateral damage and unintended consequences would be serious, including the impact on inflationary expectations.

This brings us to a third area where there were active discussions at our Forum – the outlook for inflation.

Some argued that given the output gap in industrial countries, it would be very difficult to generate inflationary pressures for the next three years. Indeed, the risks were tilted toward further disinflation. A larger group warned that while the output gap framework was applicable to the next 12 months, the period beyond that could witness the impact of increasing monetization of debt, gradually rising inflation rates and a worsening of inflationary expectations.

This potential evolution – from disinflation to inflation – will likely proceed at different speeds in different parts of the globe. It is already well in train in emerging economies and will remain so. Over the medium term, the U.S. will be next, with Europe and, even more, Japan lagging.

And Therefore...

The factors, dynamics and circumstances cited above play directly into the refinement of our priors regarding the bumpy journey to a New Normal.

It is even clearer today than it was a year ago that the global economy has embarked upon a multi-year journey that is subject to many tensions... between cyclical tailwinds and structural headwinds, large and small, old and new, Main Street and Wall Street, governments and markets, and core and periphery. This is a journey that possesses weak mean-reverting forces, and it could be characterized by policy flip-flops in a world where the public sector plays a much more influential role in economies and markets.

Our discussions also suggest that this bumpier journey is being accompanied by a more unstable destination when compared with our prior characterization of the New Normal.

As you know, our New Normal is one of muted growth overall, a protracted need for balance sheet rehabilitation, accelerated migration of growth and wealth dynamics to systemically important emerging economies and relatively weak global governance. It is also one of notable government involvement in the context of convergence among systemically important countries toward, for lack of a better term, state capitalism.

In industrial countries, this involves the public sector playing a larger role in defining the (reduced) areas where markets operate relatively freely. In emerging economies, it involves the government providing more freedom to market forces within the (growing) areas it defines.

Our suspicion today is that even by the end of our secular horizon (2015), this baseline will feature a number of "actuals" that still diverge from their "desired" equilibrium levels. As a result, the destination itself will still be subject to the dynamics of multiple equilibriums.

Public finances, regulation and the integrity of policymaking institutions (including central banks) are the most obvious examples of where actual will differ from desired. They are not the only ones.

We suspect that in 2015, global governance constructs will still be too weak to help properly manage a highly interconnected world that is subject to a historical change. Some industrial countries will still be resisting the need to make room for the full integration of emerging economies. And some of the latter economies will still be trying to reconcile properly their national priorities with their newly acquired global impact and responsibilities.

Balance of Risks

Most baselines are subject to two-sided risks. Our Secular Outlook is no different in this regard and, in this case, the risks are well balanced.

On the one hand, the baseline could prove to be too pessimistic on three major counts: First, emerging economies (and China in particular) could show greater willingness and ability to unleash domestic consumption; second, the balance sheets of central banks in industrial countries could indeed be used very aggressively without undermining inflationary expectations and fueling a political reaction; and third, some of the remarkable scientific advances could translate quickly into massive productivity gains.

These three factors would facilitate economic growth in industrial countries. And growth is critical for enhancing the capacity of the world economy to deal with its balance sheet problems, reverse the involvement of governments in markets and, thereby, reduce the likelihood of government failures following the recent string of market failures.

On the other hand, the baseline could be too optimistic on (also) three major counts: First, households and companies could embark upon a renewed cycle of self-insurance in reaction to the medium-term uncertainties facing the global economy. This paradox of thrift would further weaken the growth and debt dynamics; it would also increase the risk of trade protectionism. Second, some of the super-secular issues (such as climate change, demographics and the atomization of societies) could play out in secular time, significantly

increasing the structural headwinds facing the global economy. Third, the world could face a geopolitical shock, either because of frictions and tensions between certain nation-states or due to vulnerability to acts of terrorism perpetrated by small groups or individuals.

In Conclusion

We are living through a remarkable time of change for the global economy, where several anchoring parameters have become variables. It is a time of friction, collisions and renewal as we journey to a de-levered and re-regulated world with weaker growth dynamics in industrial countries and less political enthusiasm for unfettered globalization and markets.

This brings us back to the image of a car that, having used its spare tire(s), is still embarked on a bumpy road through unfamiliar territory and to a less-than-stable destination. Parts of the car are up for this journey; others will likely hold up but in a tentative and fragile manner; and yet others will fail.

For investors, this translates into a secular period of changing risks and opportunities:

The distribution of global outcomes is going through a transformation, both in terms of overall shape (flatter) and tails (fatter);

It is a world where several of the old simplifying adages that once brought comfort to investors – such as industrial country governments constitute interest rate risk while emerging economies involve credit risk – require considerable refinement;

It is a world that calls for a broader investment universe and guidelines and, for those who use them, revamped benchmarks that better capture the world of today and tomorrow rather than that of yesterday;

It is a world of significant country, regional and instrument differentiation when it comes to harvesting equity and credit premiums in high-quality corporates, financials and emerging markets;

It is a world where the currencies of the emerging (as opposed to submerging) economies will continue to warrant a greater allocation over time; and

It is a world where the safest of carry will come from duration and curve in sovereigns that, due to their economic and financial fundamentals, are truly core countries in the midst of this global paradigm shift.

Look for PIMCO to continue to work hard on your behalf to combine all this with cyclical considerations and to translate them into the appropriate positioning of your portfolios, consistent with your return objectives and risk tolerance. Look for us to provide you with the information, expertise and investment solutions that capture the evolution of both the journey and the destination. And look for us to continue to position our business so that we can provide you sustained value in this changing historical context.

Thank you.

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