P I M C O

Your Global Investment Authority

Investment Outlook

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Six Pac(k)in'

The midsection of a 67-year-old is not a pretty sight. No matter how many sit-ups I do during my daily workouts there are no six-pacs there, or anywhere in the vicinity for that matter. I can't even get a one-pac going. Perhaps that's because so many Budweiser six-packs made their way downstream over the past half century or so. In any case, not being able to avoid seeing my spare tire, I take my wife Sue's advice when it comes to weighing herself – do it only first thing in the morning. In this case, there is the additional appeal of lights being dim and if I can creep past the bathroom mirror while turning my head the other way, then all the better.

I will say that I have lots of company – the fifties being the approximate age when the muffin top seems to magically appear. Even a "man-man" like Arnold Schwarzenegger is not immune. I saw him in a bathing suit in Hawaii five years ago and I can report that the arms and well the tummy had a certain flabby-like quality to them that was unlike any terminator I've ever seen on the big screen. Actually Jack LaLanne, now passed, was about the only aging male specimen I can recall who managed to beat the bulge. Still, he only did it by pulling barges with his teeth from Alcatraz to the San Francisco mainland. Betcha his choppers were no pretty sight even if they were still there at 80. In addition, all the vegetable juice he promoted is not my style, nor can I imagine being able to drink it down with a smile like he pretended to do on TV. I think I'd prefer the laxative I have to gulp before my colonoscopy tests. Whatever.

Sue never mentions the bulge, which is her loving style, but I know she must be looking every once in a while. I try to do the "blousy" thing when I wear tight golf shirts, but there's only so much material to go around, so to speak. Swimming also presents a problem because in this case the solution is to pull the waistband up above the navel, which is a sight for even sorer eyes. I never let Sue see my backside, however. Having not seen it myself for 20 years, I'm afraid I might tell her to buy a gun and just shoot me before the fat and the cellulite strike again.

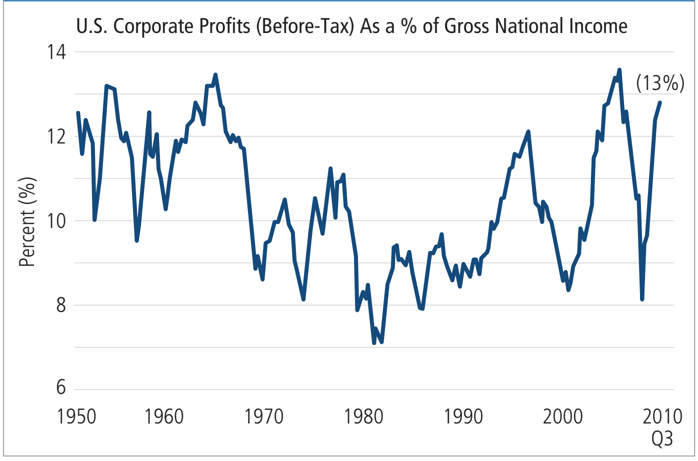
The midriff "bulge" would be a rather kind description of today's debt crisis. No muffin top there – if anything, sovereign balance sheets resemble an overweight diabetic on the verge of a heart attack. Still, if global policymakers could focus on structural as opposed to cyclical financial solutions, New Normal growth as opposed to recession might be possible. Several of the structural roadblocks have been publically identified by myself and Mohamed El-Erian over the past several years: 1) Globalization has hollowed developed economy labor markets, 2) technology has outdated entire industries that produce physical as opposed to "cloud"– oriented goods and services – books, records, postal letters and DVDs among the most recent dinosaurs, and 3) an aging demographic is now favoring savings as opposed to consumption in almost all developed nations.

It has been these three structural hurricanes that have led to our economy's six-pac becoming a one-pac over the past several decades. Globalization and technological innovation have been extremely negative influences on domestic wages and employment. China and "cloud space" have favored cheaper consumption, but have been decidedly job unfriendly in developed economies if observers were to be honest about it. Schumpeter's "creative destruction" has been destructive of product and related labor markets yet has failed to recreate many jobs in the process. In order to maintain our caloric intake, policies favoring debt accumulation as opposed to savings took hold. Falling interest rates, lower taxes, deregulation and financial innovation all favored financial asset growth that unrealistically brought future earnings and spending power forward to peak levels last seen at the popping of the dotcom and housing bubbles. Developed economies now resemble a 110-pound weakling as opposed to Charles Atlas or a much younger Arnold.

Yet to return to my initial criticism of cyclically finance-based as opposed to structural policy solutions, **almost all remedies proposed by global authorities to date have approached the problem from the standpoint of favoring capital as opposed to labor. If the banks could just be stabilized, if the "markets" could just be elevated back in the direction of peak 401(k) levels, if interest rates could just be lower so that borrowers would inevitably take the bait, then labor – job creation – would inevitably follow. It has not.** The explanation for why not must at least include the rationale that Wall Street and Main Street are symbiotically connected and if one benefits at the expense of the other, then both ultimately can falter.

That there is a current imbalance is obvious from Chart 1, which shows before-tax corporate profits as a percentage of Gross National Income (GNI). It is obvious that "capital" as opposed to "labor" – moving from 8 to 13% of GNI over the past three or even 30 years – has been the cyclical and secular champion. Why one or the other should be policy and politically advantaged is not commonsensically clear.

Chart 1: The Rich Get Richer



Source: Haver Analytics

Granted, the return on capital as opposed to the return to labor should logically be higher if only to encourage savings. But once an historical midpoint or range has been established, a relative equilibrium should be observed. Even conservatives must acknowledge that return on capital investment, and the liquid stocks and bonds that mimic it, are ultimately dependent on returns to labor in the form of jobs and real wage gains. If Main Street is unemployed and undercompensated, capital can only travel so far down Prosperity Road. Until recently, economic recovery has been relatively robust if one were a deployer of capital as opposed to the laborer who made that deployment possible. Near zero percent interest rates have allowed profit margins to widen even in the face of anemic end demand. As well, "productivity" has remained high, but only because of layoffs and the production of goods and services with fewer people. While that is a benefit to capital, it obviously comes at a great cost to labor.

Ultimately, however, both labor and capital suffer as a deleveraging household sector in the throes of a jobless recovery refuses – if only through fear and consumptive exhaustion – to play their historic role in the capitalistic system. This "labor trap" phenomenon – in which consumers stop spending out of fear of unemployment or perhaps negative real wages, shrinking home prices or an overall loss of faith in the American Dream – is what markets or "capital" should now begin to recognize. Long-term profits cannot ultimately grow unless they are partnered with near equal benefits for labor. Washington, London, Berlin and yes, even Beijing must accept this commonsensical reality alongside several other structural initiatives that seek to rebalance the global economy. The United States in particular requires an enhanced safety net of benefits for the unemployed unless and until it can produce enough jobs to return to our prior economic model which suggested opportunity for all who were willing to grab for the brass ring – a ring that is now tarnished if not unavailable for the grasping. Policies promoting "Buy American" goods and services – which in turn would employ more Americans – should also be reintroduced. China and Brazil do it. Why not us?

If structural solutions are not put in place, a six-pac market observer should look at both stocks and bonds as rather flabby knock-offs of their former selves; no resemblance at all to Jack LaLanne but more to a 55-year-old terminator grown fat and rendered out of shape by years of neglect and perhaps greed for short-term profits as opposed to long-term balance. **There are no double-digit investment returns anywhere in sight for owners of financial assets. Bonds, stocks and real estate are in fact overvalued because of near zero percent interest rates and a developed world growth rate closer to 0 than the 3 – 4% historical norms. There is only a New Normal economy at best and a global recession at worst to look forward to in future years.** A modern day, Budweiser-drinking Karl Marx might have put it this way: "Laborers of the world, unite – you have only your six-packs to lose." He might also have added, "Investors/policymaker of the world wake up – you're killing the proletariat goose that lays your golden eggs."

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