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Developed world cannot thrive at ‘stall speed’

By Bill Gross

Debt is the disease – growth is the cure, but as the latter falters, economies and their associated financial markets hang in the balance.

Academics Kenneth Rogoff and Carmen Reinhart have outlined what happens when countries assume liabilities that future growth cannot comfortably pay. Ninety per cent debt to gross domestic product is their Maginot line beyond which leverage dynamics begin to work in reverse, slowing growth instead of enabling it, promoting too much risk as opposed to potential gains.

The developed world as a whole is now approaching that key percentage. The Rogoff/Reinhart analysis also shows that, as it does, economic growth slows by approximately 1 per cent. Almost on cue, developed economies are experiencing 2 per cent instead of 3 per cent annual growth.

We at Pimco labelled this the “new normal” back in 2009, well before *This Time is Different* was published. It was a qualitative assessment instead of a historically validated model, based on our assumed effects of deleveraging and re-regulation bound to characterise the post-Lehman future. So far, so good for the forecasting.

What lies ahead, however, is a precarious “bumpy journey”, as my colleague Mohamed El-Erian describes it, in which growth moves slightly above and then frighteningly below this 2 per cent “new- normal” rate. The danger rests not so much on the 90 per cent debt-to-GDP ratio, high as it is, but on the 2 per cent real rate of growth, because that number approaches what is known as “stall speed.”

If the developed world was growing at 5 per cent like developing economies, the risks would be far less. At 2 per cent, however, “stall speed” connotes an inability to behave like the historical capitalistic model should. Corporations lose incentives to invest because profit growth stagnates, unemployed workers are not rehired and the standard cyclical model of seasonal rebirth is jeopardised.

These structural headwinds in turn confuse policymakers. Central banks apply a dose of liquidity and negative real interest rates that fail to stimulate investment, while fiscal authorities and political parties stagger from one election to another, recommending balanced budgets in one year and stimulus packages in another.

The burden of debt, however, which was the initial catalyst, is a slow-moving glacier in retreat. While the Rogoff/Reinhart research somewhat incompletely produced an analysis of sovereign debt instead of a debt analysis across the total economy, the past two years have produced negligible total debt deleveraging across almost all countries. Lower interest rates have relieved the burden somewhat and stimulus packages have reduced unemployment marginally. Now, however, as these policies reach mathematical and/or political limits, the developed economies stand at the mercy of unpredictable cross-currents: 1) the necessary continuation of Chinese growth; 2) the required and in some cases regulated moderation of commodity prices; and 3) the avoidance of systemic collapse in euroland.

These risks and the associated 2 per cent growth stall speed have several overall investment implications. For one, risk spreads will be constantly volatile as good and bad news hit the tape intermittently. Sovereign credit spreads will be subject to rather desperate policy endgames and equity and corporate bond risk spreads will follow in line, despite the overall health of the corporate sector in the current upturn. Secondly, investors should expect an extended period of “financial repression” during which policy rates are kept extraordinarily low. Picking the pockets of investors and savers is a historically validated manoeuvre to rebalance sovereign balance sheets. Instead of an inflation plus 1 per cent policy rate, which has characterised the past 30 years, we must get used to inflation minus 1 or 2 per cent, a dramatic reversal in the fortunes of financial markets.

The expected negative real-policy rate will influence much of the US Treasury curve as well. Like a black hole, 25 basis point interest rates suck 2- and 5-year rates down with them, producing shockingly low returns that cannot possibly cope with the higher inflation they produce. Alternatively, 30 year rates stay high for fear of inflationary consequences in future decades. The result is a dramatically steep yield curve that promotes roll-down strategies as bonds appreciate in value, as yields decline over time and, for banks and hedge funds, levered positions which take bets on duration, as opposed to on credit risk.

One thing, however, seems certain. The west will not thrive in this “new normal” economy. It can only hope to survive, so that in future years the lessons of too much leverage and debt are taught to a new generation of capitalists. Hopefully that future will be different, and the Rogoff/Reinhart title will be descriptive as opposed to a parody.

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