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Investment Outlook

From Bill Gross

How to Make Money

Because of the secular headwinds facing global economies, currently labeled as the "New Normal" or "Secular Stagnation", investors have resorted to "making money with money" as opposed to old-fashioned capitalism when money and profits were made with capital investment in the real economy.

How is money made with money? Think of it simply as an extension of maturity and risk – all beginning with those $20 or maybe $100 bills in your purse or stashed safely in the cookie jar at home. Since cash yields nothing, and in fact depreciates in value day to day given even low 1%-2% inflation, savers/investors exchange cash for alternative choices involving less liquid, longer maturity, and in some cases more risky assets. A bank deposit that earns interest but offers ATM accessibility in measured amounts would be a first step. The available yield – more than 0% but hardly attractive given bank fees and the like – would be a first example of making money with available cash.

But capitalism, or should I say finance-based capitalism, requires more return in order to be profitable for its savers/investors. The next step, for individuals and institutions alike, might be a 6-month CD or a 90-day Treasury bill where yields suddenly approach 1% (at least in the U.S. In Euroland and Japan they are negative but that's another story). But 1% will not pay the bills for most savers or financial institutions where investors demand compounding returns of 6%, 7% or 8% +, so alternative assets further out the risk/liquidity/maturity spectrum come into play. Corporate bonds, stocks, and private equity are legitimate extensions from non-yielding cash that are part of modern day finance-based capitalism. <u>Savers/investors make money with their money (cash) as long as economies grow and inflation stays reasonably conservative. There is nothing new in all of this, but it helps to outline the fundamental process to understand why today's economy is so different from that of decades ago and why it induces risks that were not present before.</u>

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Those differences and risks primarily are a result of secular headwinds whose effects are difficult to observe in the short run – much like global warming. “New Normal” high debt, aging demographics, and deglobalization along with technological displacement of labor are the primary culprits. Excessive debt/aging populations/trade-restrictive government policies and the increasing use of machines (robots) instead of people, create a counterforce to creative capitalism in the real economy, which worked quite well until the beginning of the 21st century. Investors in the real economy (not only large corporations but small businesses and startups) sense future headwinds that will thwart historic consumer demand and they therefore slow down investment. Productivity – which is the main driver of economic growth and long-term profits – slows down. Productivity in fact, in the U.S. and almost everywhere in the developed world has flat-lined for nearly five years now and has increased by only 1% annually since 2000 and the aftermath of the Dot-Com recession.

So instead of making money by investing in the real economy, savers/investors increasingly are steered toward making money in the financial economy – making money with money. And that, thanks to nearly $8 trillion of QE asset purchases from major central banks and the holding of short-term borrowing rates near zero or even negative, has made this secular shift in monetary policy extremely profitable. Bank margins have been lowered but their stocks and almost all other stocks have soared here in the U.S. and globally. <u>Investors have discovered that making money with money is a profitable enterprise and have exchanged the support of central banks for the old-time religion of productivity growth as a driver of their strategy. The real economy has been usurped by the financial economy. Long live the financed-based economy!</u>

<u>But asset prices and their growth rates are ultimately dependent on the real economy and, the real economy’s growth rate is stunted by secular forces which monetary and even future fiscal policies seem unable to reverse.</u> In fact, as I have mentioned many times in prior Investment Outlooks, monetary policy may now be a negative influence in terms of future economic growth. Zombie corporations are being kept alive as opposed to destroyed as with the Schumpeterian/Darwinian “survival of the fittest” capitalism of the 20th century. Standard business models

forming capitalism's foundation, such as insurance companies, pension funds, and banking, are threatened by the low yields that have in turn, produced high asset prices. These sectors in fact, have long-term maturities and durations of their liabilities, and their assets have not risen enough to cover prior guarantees, so we see Puerto Rico, Detroit, and perhaps Illinois in future years defaulting in one way or the other on their promises to constituents. Faulty finance-based capitalism supported by the increasingly destructive monetary policy begins to erode, not support the real economy.

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My point in all of this is that making money with money is an inherently acceptable ingredient in historical capitalistic models, but ultimately it must then be channeled into the real economy to keep the cycle going. Capitalism's arteries are now clogged or even blocked by secular forces which when combined with low/negative yielding "safe" assets promise to stunt U.S. and global growth far below historical norms. Ultimately investors must recognize this risk along with increasingly poorly hedged liabilities and low growth resulting from "New Normal" secular headwinds in developed economies. Add global warming to this list, and you have the potential for low asset returns in which the now successful strategy of "making money with money" is seriously threatened. How soon this takes place is of course the investor's dilemma, and the policymakers' conundrum. But don't be mesmerized by the blue skies created by central bank QE and near perpetually low interest rates. All markets are increasingly at risk.

Money will currently be made, or at least conservatively preserved, by acknowledging the exhaustion of "making money with money". Strategies involving risk reduction should ultimately outperform "faux" surefire winners generated by central bank printing of money. It's the real economy that counts and global real economic growth is and should continue to be below par.

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