Bill
Gross

Investment Outlook

PIMCO

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Privates Eye

I write this month to condemn the inventor of the electronic "seeing eye" toilet. Yes, that's right, I'm talking toilets here, doo-doo-stuff, some of which I hopefully won't step in myself over the next few paragraphs. I know there must be more substantive and less objectionable topics to bring before you, but I have a sense that many of you join me in spirit if not common experience and so I devote this month's *Outlook* to another trivial snippet emphasizing our joint humanity and sense of loss due to the recent disappearance of the hand flusher.

I don't know where it is located exactly, but there's an electronic eye in the plumbing of public toilets these days that can sense when you get up and down (or is it down and up) and are finally finished with your "business," if you get my drift. My doctor says a proctology exam is a necessary evil but cameras in toilets? Never having seen myself from this particular angle, it is particularly embarrassing to turn over the assignment to a camera and in effect say, "Snap away – see anything that doesn't look right?" I figure if there's an eye there, then there could also be a little voice that says, "Have a seat," which of course I do, usually with much haste and a sense that I'd better get on with it before I attract a crowd.

It's after the dirty deed is complete, however, that the real intrigue begins. Does it flush or doesn't it? Only the computer chip knows for sure. Sometimes, though, after the paperwork has been filed, pants pulled up and an attempted getaway initiated – nothing happens. No flush. Well, what is one to do in such circumstances? You can't just leave it there, you know. Sometimes when the toilet's plugged and there's no plunger like in European bathrooms, you can get out of there quick with conscience in tact, but only, of course, after checking to see that there's no one else in the restroom who might be able to testify against you in court for being a non-flusher. With electronic eye toilets, however, the conscience is never clear and so you wave your hand in front of the camera, hoping to convince it by the breaking of light waves that someone really has used the toilet and that somehow it just forgot, or maybe the deposit was so minuscule that it just didn't merit a flush. Hello in there! Having failed to trick it, however, the next step is to look for that little button in the back that you

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supposedly push in an emergency – sort of like a "break glass in case of fire" toilet equivalent. But think of all the billions of germs! At least with an old handle you could kick it with your shoe, hold up your arms like a doctor scrubbing for surgery and make an exit looking like you're auditioning for a part on *ER*. Finally I suppose you head for the door, all the while listening for the flush, the flush, that beautiful sound of the flush. I could have done it myself, you know, with a lot less hassle. Which is why I support a retreat to the old days, (not the backyard outhouse), but the good old-fashioned hand flusher. One push, and presto – you're good to go!

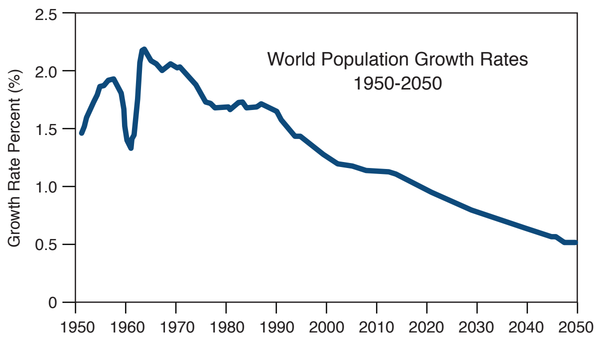
I really do have a serious message this month, an adjunct to the New Normal that will likely impact growth and financial markets for years to come. Our New Normal, to repeat ad nauseam, is predicated upon deleveraging, reregulation and deglobalization, all of which promote slower economic growth and lower inflation in developed economies while substantially bypassing emerging market countries that have more favorable initial conditions. In recent months, Mohamed El-Erian has added a developing corollary that emphasizes the lack of an appropriate policy response to what is a structural as opposed to a cyclical development, and you should read his frequently published op-eds for a more thorough analysis as well as those written by Jeffrey Sachs and others who are constructively suggesting a way back to the old normal.

That return journey will be all the more difficult to accomplish, however, because of demographics, an influence that much like gravity is hard to see but whose effect is all too powerful. Demographics – or in this case population growth – is so long term in its influence that economists and observers are inclined to explain the functioning of economic society without ever factoring in the essential part that it plays in growth. Production depends upon people, not only in the actual process, but because of the final demand that justifies its existence. The more and more consumers, the more and more need for things to be produced. **I will go so far as to say that not only growth but capitalism itself may be in part dependent on a growing population.** Our modern era of capitalism over the past several centuries has never known a period of time in which population declined or grew less than 1% a year. Currently, the globe is adding over 77 million people a year at a pace of 1.15% annually, but slowing. Still, that's 77 million more mouths to feed, 77 million more pairs of shoes to make, 77 million more little economic units of demand – houses, furniture, cars, roads, oil – more, more, more. Capitalism, I would assert, thrives on more, more, and more, but not so well when there is less or an **expectation** of less. **This is not the Malthusian thesis, which maintained that**

at some point the world would run out of food to satisfy a growing population; it is an assertion that capitalism depends upon final demand and that if there ever comes a time when population growth slows, then the world's most efficient economic system will be tested. If anything, my thesis is anti-Malthusian in its assertion that there will always be enough **production** to satisfy a growing **population**, but perhaps not enough new **people** to sustain growing **production**.

Observers will point out, as shown in the following chart, that global population growth rates have been declining since 1970 with no apparent ill effects. True, until 2008, I suppose. The fact is that since the 1970s we have never really experienced a secular period during which the private market could effectively run on its own engine without artificial asset price stimulation. The lack of population growth was likely a significant factor in the leveraging of the developed world's financial systems and the ballooning of total government and private debt as a percentage of GDP from 150% to over 300% in the United States, for example. Lacking an accelerating population base, **all** developed countries promoted the financing of more and more consumption per capita in order to maintain existing GDP growth rates. Finally, in the U.S., with consumption at 70% of GDP and a household sector deeply in debt, there was nowhere to go but down. Similar conditions exist in most developed economies.

Deep Demographic Doo-Doo



Source: U.S. Census Bureau, International Data Base, July 2007 version

Chart 1

The danger today, as opposed to prior deleveraging cycles, is that the deleveraging is being attempted into the headwinds of a structural demographic downwave as opposed to a decade of substantial population growth. Japan is the modern-day example of what deleveraging in the face of a slowing and now negatively growing population can do. Prior deleveraging periods such as what the U.S. and European economies experienced in the 1930s exhibited a similar demographic with the lowest levels of fertility in the 20th century and extremely low population growth. Things did not go well then. Today's developed economies almost assuredly offer substantially less population growth than the 1.5% rate experienced over the prior 50 years. Even when viewed from a total global economy perspective, population growth over the next 10–20 years will barely exceed 1%.

The preceding analysis does not even begin to discuss the **aging** of this slower-growing population base itself. Japan, Germany, Italy and of course the United States, with its boomers moving toward their 60s, are getting older year after year. Even China with their previous one baby policy faces a similar demographic. And while older people spend a larger **percentage** of their income – that is, they save less and eventually dissave – the fact is that they spend far fewer dollars per capita than their younger counterparts. No new homes, fewer vacations, less emphasis on conspicuous consumption and no new cars every few years. Healthcare is their primary concern. These aging trends present a one-two negative punch to our New Normal thesis over the next 5–10 years: fewer new consumers in terms of total population, and a growing number of older ones who don't spend as much money. The combined effect will slow economic growth more than otherwise.

PIMCO's continuing New Normal thesis of deleveraging, reregulation and deglobalization produces structural headwinds that lead to lower economic growth as well as half-sized asset returns when compared to historical averages. The New Normal will not be aided nor abetted by a slower-growing population nor by cyclical policy errors that thrust Keynesian consumption remedies on a declining consumer base. Current deficit spending that seeks to maintain an artificially high percentage of consumer spending can be compared to flushing money down an economic toilet. Far better to create and mimic other government industrial policies aimed at infrastructure, clean energy, more relevant education and less costly healthcare services. Until we do, policymakers will continue to wave their hands in front of the electronic eye – waiting for the flush, waiting for the flush, waiting for the flush, with very little success. Try another way, Washington. El-Erian, Sachs and other 21st century policy thinkers have a better way to push the handle.

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