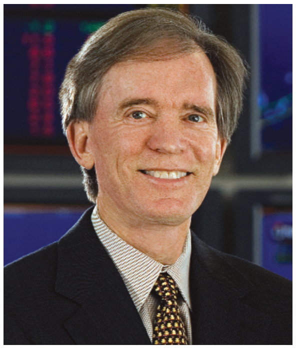
PIMCO's Investment Outlook



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Doo-Doo Economics

The world is turning "green"—global warming or not. Electric cars, free-range chickens, and White House vegetable gardens are the wave of the future, but the defining badge of environmentalists may be none of those and might, in fact, be colored blue, as opposed to green. Dog owners would be the first to acknowledge it. Having converted reluctantly to felines nearly ten years ago, I myself am only forced to humble myself by emptying the litter box once or twice a year when Sue is visiting the relatives. But dogs? Well, Bowser has to be walked, and Bowser owners these days are being forced to subserviently follow in step, holding those little blue "doo-doo" bags at the ready that keep the neighbors' grass green instead of brown and minimize the number of summer flies to a billion per square mile. No longer will the current generation be allowed to use pooper-scoopers; they must in fact be pooper "stoopers," bending down, turning the bag inside out to form a glove, and then—EEECH—making the grass environmentally friendly again by picking it up, reversing the bag and hurriedly looking for the nearest neighbor's garbage can who might conveniently be at church or shopping at the grocery store. One can only hope that Fido is mildly constipated, if you get my drift. I can recall the diaper days with my three kids. It wasn't a pleasant experience, but those non-environmentally friendly Pampers at least afforded one-stop dropping—easy on, easy off—no touchy, no feely. In those days, a doggie bag was something you asked for in a fine restaurant to take home the steak bones. Now it's a blue plastic reminder that the world is changing and in many respects our daily routine is becoming a dog's life.

A similar metaphor could be applied to the 45 million citizens of the State of California. Once "golden" and the land of entrepreneurial opportunity, the state has turned from filet mignon to ground chuck and its residents are now on a short leash as opposed to masters of their own universe. Unemployment at 12.2% is near the nation's highest and its Baa bond rating is the country's lowest. Its schools are abysmal, competing with Louisiana and Mississippi for the lowest rating in the federal government's National Assessment of Educational Progress. While the air is much cleaner than it was 20 years ago, the freeways are stereotypically jammed and increasingly less free—the age of the toll road serving the exasperated (or simply the Mercedes owners) is upon us.

Our canine existence has many fathers. Perhaps more than any other state, California has been affected by its perverted form of government, requiring a two-thirds vote by state legislators to effectively pass a budget. In addition, the state's laws are almost tragically shaped by a form of direct democracy more resemblant of the Jacksonian era, where the White House furniture was constantly at risk due to unruly citizens, high on whisky, and low on morals and common sense. Propositions from conservatives and liberals alike have locked up much of the budget, with Proposition 13 in 1978 reducing property taxes by 57% and Prop. 98 in 1988 requiring 40% of the general fund to be spent on schools. Recently, much of any excess has been gobbled not only by teachers, but unbelievably by a prison lobby that would be the envy of any on Washington's K Street.

The result has been a $26 billion deficit that was supposedly "closed" in recent weeks, but which largely was a "kick the can" accounting scheme that postponed the pain, or better yet, pled for a federal solution to self-inflicted wounds. State budgets of course are required to be balanced each year, but that has long been a fiction throughout most of the country. Still, California's 2009 fix was perhaps the longest kick of the can in history, refusing effectively to raise taxes, superficially cutting expenses, and shaming its fading image by refusing to disburse required billions to local counties and communities, as well as using accounting tricks that couldn't fool a grade-schooler. In the process, they managed to reinvent the IOU, paying bills in virtual scrip that then traded at substantial discounts on eBay of all places. They have issued tax anticipation notes of all sorts with a multitude of lettered configurations that anagram aficionados would revel in. Just last week the state extended its begging bowl for $8 billion of "RANs" (Revenue Anticipation Notes) at an onerous money market rate of 1½%. Previously they had issued "RAWs" (Revenue Anticipation Warrants). "BAGs" might be next—blue BAGS, that is, full of the doo-doo that California citizens have grown used to picking up.

There are signs that California voters are ready to make some tough choices, having recently refused to pass five propositions that would have extended tax hikes and failed to address spending. Whether or not Governor Schwarzenegger and legislators will agree to a constitutional convention to address the poisonous proposition plebiscite itself is a larger question that will likely be affirmatively answered only if the state economy continues to remain in the tank, which it likely will. But California's problems, while somewhat unique and self-inflicted, are really America's problems, and not just because the California economy is 15% of national GDP. While California's $26 billion deficit is not directly comparable to the federal gap of $1 trillion-plus, they both reflect a lack of discipline and indeed vision to perceive that the strong growth in revenues was driven by the same excess leverage and the same delusionary asset appreciation that was bound to approach cliff's edge. California's property taxes, income taxes, and sales taxes were all artificially elevated by national and indeed global imbalances as the U.S. manufactured paper, and Asia manufactured things in mercantilistic exchange. Total tax revenues have actually fallen 14% over the past 12 months in California and substantially more in other states. At some point, that Fantasyland merry-go-round had to stop and whether the defining moment was marked by Bear Stearns, Lehman Brothers, or the tumultuous week that followed in September of 2008 is really not the point.

What is critical to recognize is that both California and the U.S., as well as numerous global lookalikes such as the U.K., Spain, and Eastern European invalids, are in a poor position to compete in a global economy where capitalism is morphing from its decades-long emphasis on finance and levered risk taking to a more conservative, regulated, production-oriented system advantaged by countries focusing on thrift and deferred gratification. The term "capitalism" itself speaks to "capital"—the accumulation of it and the eventual efficient employment of it—for growth in profits and real wages alike.

What California once had and is losing rapidly is its "capital": unquestionably in its ongoing double-digit billion dollar deficits, but also in its crown jewel educational system that led to Silicon Valley miracles such as Hewlett Packard, Apple, Google, and countless other new age innovators. In addition, its human capital is beginning to exit as more people move out of the state than in. While the United States as a whole has yet to suffer that emigration indignity, the same cannot be said for foreign-born and U.S.-educated scientists and engineers who now choose to return to their homelands to seek opportunity. Lady Liberty's extended hand offering sanctuary to other nations' "tired, poor and huddled masses" may be limited to just that. The invigorated wind up elsewhere.

Now that our financial system has been stabilized, one wonders whether California's "Governator" and indeed the Obama Administration has the capital, the vision, and indeed the discipline of its citizenry to turn things around. Our future doggie bags can hold steak bones or doo-doo of an increasingly familiar smell. For now investors should be holding their noses, their risk orientation, as well as their blue bags, until proven otherwise. Specifically that continues to dictate a focus on high quality bonds and steady dividend paying stocks that can survive, if not thrive, in our journey to a "new normal" economy of slower growth, muted profit gains, and potential capital destruction via default, abrogation of property rights, and dollar devaluation.

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About the Author

Bill Gross is the founder and co-CIO of PIMCO, and is widely regarded as one of the world's foremost fixed-income investors. In 2000, he received the Bond Market Association's Distinguished Service Award, and in 1996 was the first portfolio manager inducted into the Fixed Income Analysis Society's Hall of Fame. He holds a BA from Duke University and an MBA from UCLA.

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