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Maybe Warren Buffett agrees with Bill Gross on financial asphyxiation

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The financial press tracks Janus Capital Group Inc.'s star fixed-income portfolio manager Bill Gross closely. His Saigon-like helicopter roof departure from Pacific Investment Management Co. LLC (PIMCO) last year has been forgotten. His accomplishments as one of the best fixed-income investors the past four decades are more important than a short, messy chapter in his life. Many have one or two anyway.

As a bond manager, Gross is dour compared to equity investors, who usually ask two questions: What's the upside and what's the margin of safety if I am wrong? Plus, equity investors cheer from the rafters for actions that are detrimental to corporate bond holders: buybacks, dividend recaps, debt-financed M&A and spinoffs of profitable units.

For bond investors like Gross, what is bad for equities typically is good for bonds. A weaker economy can translate into rising bond prices and declining yields. Rising prices and coupon clipping can generate great total returns, except for our age when only the lower rungs of the high-yield market offer much coupon to clip.

With commodity prices in a free fall and credit spreads beginning to widen, the markets' tone has been negative lately. Gross was quoted in an Aug. 11 Bloomberg News story about the yuan devaluation and the exporting of Chinese deflation to other countries as "Bullish for bonds. Bearish for stocks." During an interview with Bloomberg's Tom Keene on Aug. 7, Gross opined that our finance-based economy needs 2% inflation. I did not exactly hear him say it, but I think he means the economy needs a little inflation for two reasons. One is that a finance-based economy (as Gross describes it) is playing the carry trade: finance assets with cheap debt or deposits and earn a positive carry. A little bit of inflation means the yield curve is positively-sloped most of the time and therefore produces a wider spread on the carry assuming the duration of the funding is shorter than the assets'. Also, a little inflation ensures that asset prices have an upward bias and therefore losses may be less for collateralized lenders in the event of default.

I guess that makes sense for our finance-based economy; however, I definitely know that I did not hear Gross cite the rule of 72 that mathematically states that the value of the currency will be cut in half every 36 years if annual inflation is 2% over that time frame. That is a great argument for equities.

A deflationary blast from China, if that is what is coming, is a risk to the finance-based economy and its carry trade. Even without the blast, Gross has said on more than on one occasion that central banks' zero interest rate policies (ZIRP) and negative interest rate policies (NIRP) cause the business models of banks, insurance companies and pension funds to break down. Assets yield little, while the liabilities of insurance companies and pension funds expand when the discount rate is low.

A slow financial asphyxiation might be a good metaphor. Deflation and central bank policies to combat it neuter the carry trade and create risks that indebted borrowers will struggle with debt service as corporate earning power and wages come under pressure — or so goes the theory. If borrowers have trouble, the financial system has troubles. Inflation can be priced into the lending rate; deflation cannot be priced easily. I think this is why central bankers have a predisposition to a "little inflation"; it makes their job easier.

Maybe Warren Buffett agrees with Gross. Buffett is the equity-equivalent, but bigger, to Gross, the fixed-income investor. Ironically, Buffett as a value investor has used an insurance company and the carry earned from investing premiums over decades to create an unbelievable track record. Buffett epitomizes two fixed-income dictums: there are no bad bonds, only bad bond prices; and bought right is half-sold. Loosely translated, the bond guys are saying if the entry price is right, the return should work out fine. Buffett's $5 billion preferred equity investment in Goldman Sachs Group Inc. in September 2008 in which the preferred had a 10% dividend and warrants to purchase $5 billion of common stock with a strike price of $115 per share is a good example.

I know Berkshire Hathaway Inc. has bought many financial companies and financial assets over the years. Smaller bolt-on insurance and financial-oriented acquisitions continue to be made, based upon SNL's cataloging of the company's M&A activity. That said, I think it is interesting that Berkshire Hathaway's three larger acquisitions the past few years have not been financial companies, but companies that operate within the core of the U.S. economy: Burlington Northern Santa Fe Corp., H.J. Heinz Co. and most recently Precision Castparts Corp.

What is going on? Maybe it is Buffett's way of affirming Gross. The insurance model of investing premiums to fund future liabilities breaks when relatively safe assets yield close to nothing and the present value of the liabilities are much bigger than when rates are high. Maybe insurance companies can raise premiums enough to overcome this, but I bet not. Berkshire's last-12-months ROAE and ROATCE, according to SNL, are 7.5% and 11.1% as of June 30. If rates stay near zero, Gross is right that returns for companies that invest in bonds and earn a carry have to go down; it is just math.

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