Bridgewater Daily Observations

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The First Day of the New… Decade, Century or Millennium: What It Means to Me

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Personally, I have never been one for assigning much significance to dates passing round numbers, or hitting other forms of anniversary. Even my wife has given up on getting me to think about our anniversary and I am only now learning to cope with birthdays. However, recently (perhaps triggered by my own passing the half-century mark) I have come to figure that one should reflect on the bigger trends every now and then, and that these occasions are good reminders. While I have no interest on pondering the millennium or century changes because it would be foolish of me to attempt to summarize and contrast those in the past, I did have few mundane reactions to us entering a new decade that I will pass along.

Through a combination of personal experiences, studying, and talking with the people of my parents' generation, I feel my understanding of the world economy is reasonably intimate going back to the 1920's, meaning that I believe that I have both an intellectual and visceral sense of what they were like. For times before, my understanding is as dry as the archives that I have drawn it from. So, based on what I think I have a feel for, I would observe that every decade had its own unique characteristics…

1920s = "roaring" – slow growth early building to a boom later, low inflation, extreme inventiveness, stock market boom
1930s = depression – basically the opposite of the 1920's, bad for stocks and good for gov't bonds
1940s = war/post war – the economy and markets were classically war dominated
1950s = stability – good stock and bond markets
1960's = economic acceleration – greater optimism and prosperity; good for stocks
1970's = stagflation -- good for inflation hedge assets and bad for stocks and bonds
1980's = disinflation -- bad for inflation hedge assets and good for stocks and bonds
1990's = "roaring" – slow growth early leading to a boom later, low inflation, extreme inventiveness, stock market boom.

…**yet, at the ends of each of these periods, most people assigned a high likelihood to the future being similar.** In other words, though the environments have always changed dramatically (in fact, each decade was more likely to be opposite than similar to the decade that preceded it), most people who experienced consistent reinforcement for 10 years were inclined to believe that this would continue indefinitely.

At the ends of all the distinctive "periods" that I remember, the arguments explaining why they would continue indefinitely were like gospel. For example, at the end of the 1960's I remember most everyone believing that managing an economy is like managing most things in that we get better at it with time; that is what the lower economic volatility reflected and it is why we could expect even lower volatility in the future. This view was held just prior to the one of the most volatile decades ever. At the end of the 1970's a popular tenant was that all currencies in recorded history were either destroyed or debased so that betting on falling inflation is insane. As you know, inflation in the 1980's fell more than during any other. So, I have learned that dramatic change is the norm and to doubt the new era theories. Given this, I am inclined to believe that the next decade will be very different from the last decade and in ways that are not consistent with current popular thinking.

What will it be like? Another thing that I learned is not to believe my own forecasts, so the short answer is that I do not know. However, that hasn't stopped me from thinking about this question and, since people are inclined to read meaningless prognostications about the new decade, century or millennium at this time, I will proceed. So, for what it's worth (probably not much) I will give you my read of where we have come from leading up to where we are going. I will take an American perspective because that is what I have and it will limit the scope of my ramblings.

Because I believe that reality and perception affect each other and that this is a major driver of cyclicality and change, I will touch on both. I believe that the relationship between reality and perception tends to reinforce trends, cause excesses and lead to big changes. Yet, economists don't pay much attention to perception because it is difficult to measure. For example, even though worker attitudes affect productivity, since the economists cannot say something like "In December 1999 workers' attitudes were 17.4 percent better than 10 years earlier", they just ignore them. In my recollections of decades past, they are integral. So, please bear with my subjectivity, as I can not objectify these observations with stats.

The '50's

As the fifties began, American psychology could be described as cautiously confident -- cautious because that was the instinct created by twenty years of depression and war, and confident because the United States was indisputably the most powerful nation on earth. World War II left the United States with the only industrialized economy still intact and holding miracle weapons which could not be challenged. American goods and services and American dollars were essentially without competition. Besides dominating the world economy (over half), America's share of the industrialized world's exports was then 1/3. Businesses and investors in most other countries held so little confidence in their own economies that they refused to keep their money in anything but dollars. At this time, the Americans' perception of the rest of the world as being relatively underprivileged was essentially accurate.

After twenty years of being unable to spend or save, Americans gradually developed sense of well being in being able to do both. Unlike the 1930's, Americans entered the fifties with large savings, low debts, and a huge pent-up demand – the optimal ingredients for economic expansion. Hence, it is no surprise that the 1950's exhibited all the characteristics of a healthy economy. While real GNP growth averaged around 3%, inflation was around 2%, the prime rate was around 4% and unemployment was around 4%

The 60's

By the sixties, Americans had become accustomed to their new position of affluence and power. Bolstered by a decade of prosperity, in the sixties Americans lost their cautiousness and kept their confidence. Since the world was our oyster, conquering outer space was our next logical goal. In an America of strength and wealth, just about everyone agreed that poverty should be eliminated. I really don't think Americans ever thought about how much a space program and a war on poverty could cost. They just felt so rich that they assumed that they could afford it.

As it turned out, they found spending easier than taxing, causing the government to become a heavy borrower. While the government's debts grew fast, the public's debts grew even faster. While in the "old fashioned" fifties Americans settled for more modest aspirations in order to save, Americans in the "modern" sixties, became more familiar with how credit could raise their living standards. The more we borrowed and bought, the more people were employed, the stronger the economy became, and hence the more we could afford to borrow & buy. It was the miracle of Keynesian economics. In the sixties Americans really believed that the economy could be turned into a sort of perpetual wealth machine.

The Federal Reserve, the agency vested with the responsibility of controlling money supply growth, certainly did not want to be the one to put a wrench in the machine's works by letting interest rates get too high. So when the money supply became too tight, it created more money. This kept interest rates down and further encouraged borrowing and buying. The governments deficits increased as the costs of Vietnam were added to the costs of space and poverty programs. The increased supply of money stimulated inflation which made it that much more desirable to borrow and buy. During the second half of the 60's the trade-off between inflation and growth which would determine the economic landscape over the next decade began to emerge. For example, for the first time since 1929 the yield curve became inverted in 1966. We entered recession. Inflation adjusted stock prices peaked, not to be exceeded for 18 years. Going into this long bear market in stocks Americans were over-invested in them because their tendency to extrapolate the past. As the sixties came to a close real GNP growth was around 2.5%, inflation was around 5%, the prime rate was around 8% and unemployment was around 4%.

The 70's

The character of the 1970's clearly emerged in 1971. As inflation accelerated, the dollar nose-dived. Rather than running trade surpluses, we ran huge deficits. While we weren't noticing, other industrialized countries were regaining their economic strength, becoming increasingly competitive in the world markets. In August of 1971, President Nixon was forced to float the dollar gold and other currencies allowing it to nosedive to more fundamentally justified levels. Like a stag, noticing his first twinge of maturity, rather than seeing these problems as signs of things to some, Americans viewed them as nothing more than a temporary setback. Yet, as the decade progressed, problems fed on each other. With the anguish of Vietnam and Watergate weighing on the American mentality, Americans were not in the mood to cut their living standards in response to OPEC induced oil prices and drought induced food price hikes. Instead, as costs rose, Americans simply borrowed more in order to maintain their lifestyles and the Fed allowed accelerated money supply growth in order to accommodate these high borrowings and prevent unacceptably high interest rates. Since Americans saw their incomes rise, but inflation rise faster, inflation was blamed for the slipping living standards. The fact is, if the Fed restrained money supply growth and inflation did not accelerate, we still would have experienced a slipped standard of living. As Americans were forced to service large debts while industrialized and OPEC countries became richer, our living standards had to erode.

Early in the 1970's, Americans had never experienced inflation so they weren't wary of it, allowing it to blossom. By the end of the decade, they were traumatized by it and assumed that it would never go away. Just about everyone knew to own inflation hedge assets and to stay clear of bonds and stocks. While the American mentality in the early fifties was cautiously confident, in the late seventies, it was neither cautious nor confident. Thirty years of prosperity and peace created a faith that our problems will be resolved. Inflation, being the most obvious cause for the pinch, became the primary target of all politicians and the economists they hired. Jimmy Carter and Ronald Regan were elected to lick all inflation and to bolster America's sagging self-esteem.

Above all else, the Federal Reserve System under Paul Volcker was vested with responsibility of beating inflation. At the end of the seventies real GNP growth averaged less than 2%, inflation was over 10 percent, the prime rate was over 15 percent, and unemployment was nearly 7 percent.

The '80's

At the turn of the decade, in 1979-81, Paul Volcker raised interest rates to "the highest level since Jesus Christ" (Helmut Schmidt), broke the back of inflation (which has been declining ever since) and with it broke the backs of developing countries (which entered their "lost decade") commodity producers and the global banking system. This tightening created a short-squeeze for dollars which propelled it higher for 5 years. Simultaneously, a global electorate which was frustrated by the socialist policies of the 1970's, drove political shifts from the left to the right in the U.S. (Reagan), U.K. (Thatcher) and Germany (Kohl) in 1980-82. This right of center coalition pretty much ran the industrialized world for the next decade. Falling inflation, the stronger dollar and government deregulation drove interest rates down and lower interests rates propelled bonds, stocks and consumption higher. The eighties were almost exactly opposite the 1970's as inflation hedge assets fell while financial assets rose, and the trade-off between growth and inflation that no one doubted, ceased to exist. As in the past, early in the new decade most people considered these reversals implausible (fearing inflation would become a problem) and later believed in it to the core.

The 90's

While no two periods are totally alike, to me the 1990s have been most like the 1920's. In both periods the trade-off between growth and inflation did not exist so that monetary policy never had to become tight enough to burst the bubbles. Both decades were sustained periods of creativity and, more importantly the development of previously developed technologies leading to improved living standards and relatively rapid earnings growth. In the 1920's there were more inventions patented than ever before or any time since, until just recently. The widespread availability of the automobile, radio, film and early commercial flight had substantial direct and indirect effects (e.g. via the development of the rubber and mining industries) on living standards, profitability and psychology, in much the same way as widespread ownership of cheap/powerful computing power, internet communications and cellular communications are affecting today's living standards, profitability and psychology. Then, as now, unemployment was low, real income growth was strong and investing in the miracles of the day turned into rampant speculation. RCA in the 1920's was akin to AOL in the 1990's. Stocks were great investments throughout the 1920's and the 1990's so that there was broad stock ownership at the end of both decades. At the end of both decades there was unbounded optimism concerning the future and how easy it is to get rich by speculating in the stock market or working for one of these new technology firms.

The New 00's

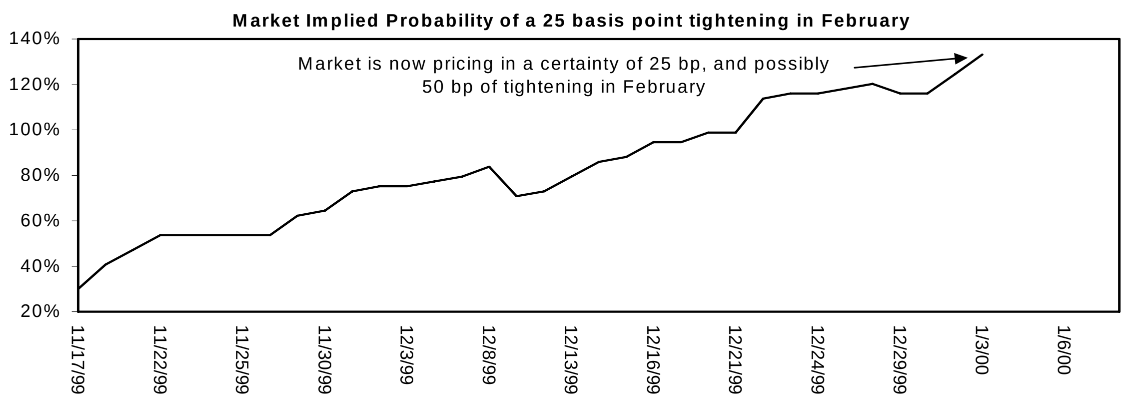
I think it is unlikely that the next decade turn out to be like the '30's just because economic scenarios rarely pan out in such pat ways. However, I do think that stocks will be a poor investment both because of what history has taught me about extrapolating the past (especially when there is unanimity of opinion and over-investment in it) and because our U.S. equity model is now so bearish. Other than that, and the belief that whatever the future holds it will not be anything like what is expected, I hold no strong views concerning what is in store. Tomorrow, I will show you some interesting big picture charts and make some more equally worthless comments. Then I'll get past this period of reflection and down to trying to make some money in the markets. Fortunately these big anniversaries and the reflections they prompt only come along once every 10 years.

Market Expecting Fed to be Aggressive Early This Year:

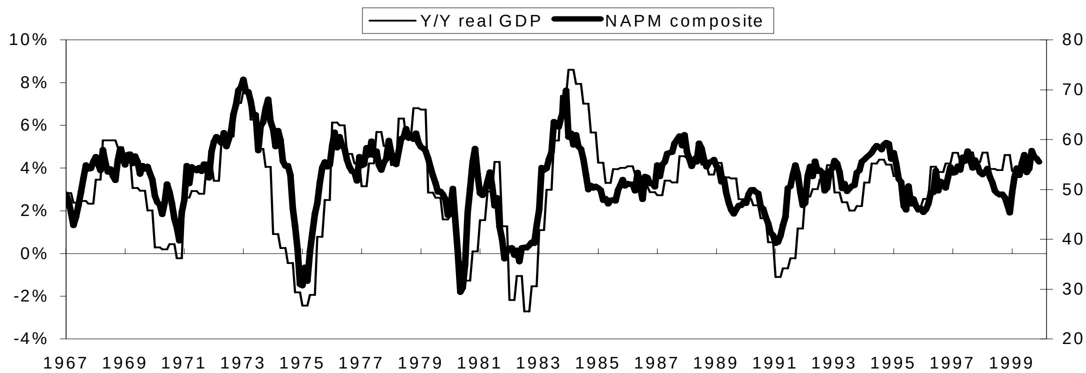
Since the Y2K turnover went without a hitch, US credit markets are now expecting the Fed to aggressively tighten early this year. In the comments after its meeting in December, the Fed made clear that they were holding back on any tightening as a precaution against Y2K problems. With the turnover going smoothly and economic stats remaining strong, the market is now expecting the Fed will turn its attention to the concerns they made clear in the statement released after the December meeting:

> *Based on the available evidence, however, the Committee remains concerned with the possibility that over time increases in demand will continue to exceed the growth in potential supply, even after taking account of the remarkable rise in productivity growth. Such trends could foster inflationary imbalances that would undermine the economy's exemplary performance.*

The market is now expecting that the Fed will raise rates at least 25 basis points in February and possibly 50. The following chart illustrates how much the market perception about the probability of a tightening in February has changed since the Fed raised rates in November. On November 16 when the Fed raised the overnight rate to 5.5% the market was pricing in only a 30% chance of a 25 basis point tightening in February. That probability has increased consistently to 130% meaning more than 25 basis points are now priced in.

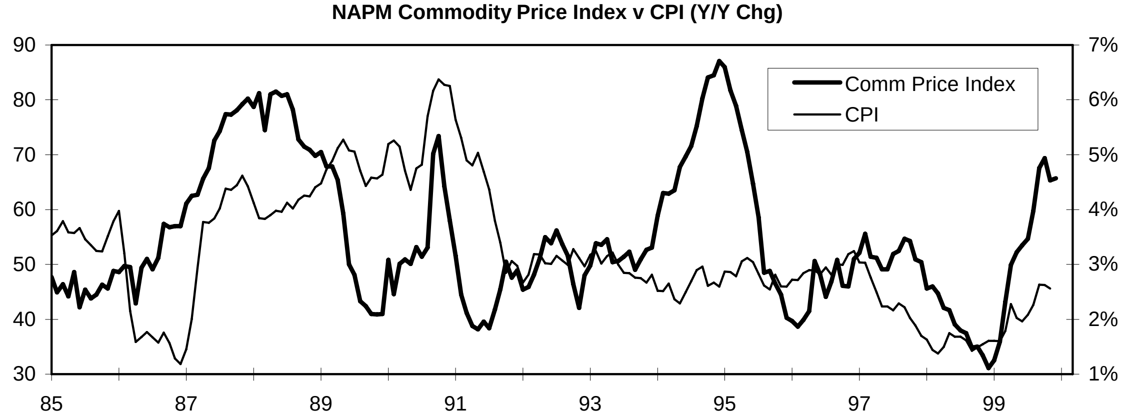


Monday's release of the National Association of Purchasing Manager's (NAPM) report supports the notion that the US economy continues to hum along. Manufacturing expanded for the 11th straight month in December. The overall index checked in at 55.5, down slightly from November's 56.2 reading but still well above the 50 line which indicates more purchasing managers saw a pickup in activity in December. The following chart illustrates the tight relationship between the overall NAPM and real GDP growth. The current reading of 55.5 is consistent with continued 4% growth.



Prices paid for raw materials continued to rise at a fast rate in December. The NAPM prices paid index rose to 65.7 in December from 65.3 in November. The following chart shows the prices paid index along with CPI inflation. Generally rapid increases like the recent one in the NAPM prices paid index have been associated with rises in CPI inflation, but 1995 was a notable exception.

NAPM Commodity Price Index v CPI (Y/Y Chg)



Overall, we think there is a lot of pressure on the Fed to tighten. The market, however, is already pricing in aggressive tightening. We agree with the current pricing and are neutral on US credit markets both short and long. The bond system output follows:

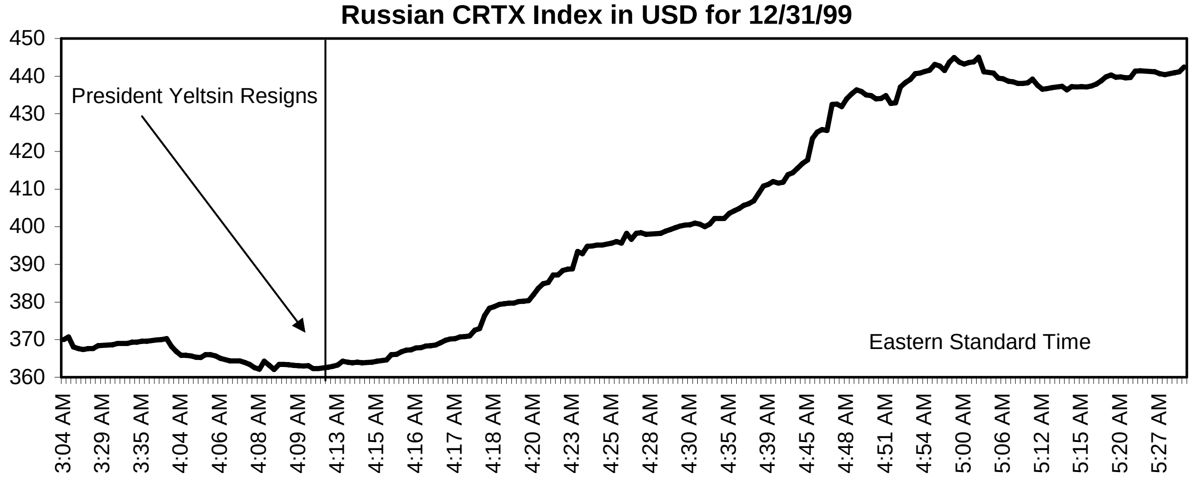
U.S. Bond Market System: 01/03/00	
Momentum	
Money/Credit Growth	45%
Economic Growth	27%
Inflation	-55%
Fed Policy	-16%
Total Momentum	-1%
Value	1%
Total Fundamental	**-1%**
Total Inter-market Action	**-17%**
Trend	-92%
Counter-trend	100%
Total Technical	**4%**
System	Position: (Neutral)

Emerging Markets

Yeltsin and Putin:

The last decade of the century was Boris Yeltsin's last day in office. On Friday December 31, Yeltsin resigned after 8 years in office as president of Russia, handing the office to Vladimir Putin, the former Prime Minister. With Yeltsin's departure, the haze of political uncertainty and the faltering policies from the last two years came to an end, and the door opened for a politician who, as a result of strong popular and government support, has the means to potentially bring real change to Russia. As you can see from the intraday chart below, the stock market's reaction to the news was swift and decisive. In less than an hour and a half, the CRTX equity index rallied to close up 19%—the largest daily move in either direction in 1999. Russian credit spreads also fell as Russian external debt rallied in very thin holiday trading.

Russian CRTX Index in USD for 12/31/99

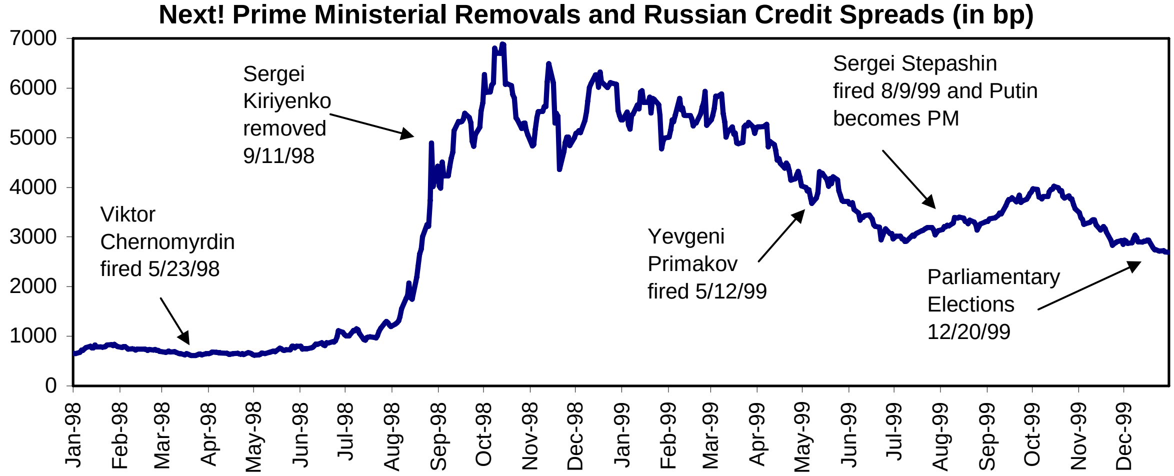


At first glance though, the huge market rally seems slightly odd. After all, for much of the past decade (since 1991) Boris Yeltsin has stood as the one relatively stable leader in the maelstrom of Russian politics. Why then did his departure elicit such a strong reaction from the stock market?

To begin, let's recap the role Yeltsin has played in Russian politics over the last decade. After serving as mayor of Moscow, Yeltsin became the first popularly elected president of Russia in 1991, a position he held until last week as a result of his 1996 re-election. Since the demise of the Soviet system in December 1991, he has led Russia through the transition from dictatorship to democracy and from Communism to free-market economy. Yeltsin has been one of the pivotal world leaders of the 1990s, and a frequent ally of the West. That said, during his long tenure in office, corruption has become rampant, central power has largely devolved to provincial governments, and the Russian economy has contracted at an average annual rate of over -6.5%. On his watch, Russia has developed a small urban middle class, but wealth remains narrowly concentrated among those who control fiefdoms of privatized, Soviet-era assets.

From a markets' perspective, however, the real problem over the last two years has been the uncertainty surrounding Yeltsin. Although the president's perpetual ill health has been a concern since 1995, in the last two years his leadership style has become increasingly abrupt and unpredictable. Through the critical crisis period that began in August of last year, Yeltsin has faltered and floundered on critical economic policy issues, and engaged in plenty of political maneuvering (which only exacerbated the inability to make policy). Yeltsin has played a game of musical chairs with the prime minister position: there have been five PMs in the last two years, in case you lost count (a turnover rate in the executive branch even the Italians and Japanese cannot match). The chart below shows what has happened with Russian credit spreads over that time frame. The economic mismanagement that ultimately led to the collapse of the ruble and partial default on external debt in August 1998 are not directly linked to all the changes in the Prime Minister position, but the inconsistent policies they contributed to certainly did not help to avert it. This shows up in the relatively muted response of the market to each government change. We should also point out that the strained ties to the West during the Kosovo conflict, the war in Chechnya and allegations of money laundering (and the interruption of support from the IMF they caused) have added to the environment of uncertainty surrounding Russia.

Next! Prime Ministerial Removals and Russian Credit Spreads (in bp)



Within this context, Yeltsin's resignation, although at first blush surprising, is the final act in the career of a relatively shrewd political actor. Events of the moment strongly favor his hand picked successor, Vladimir Putin, who takes over as acting president of Russia until the March 26 elections. That the market should endorse his resignation so loudly reflects the fact that Yeltsin's power to affect change has been diluted by his increasing unpopularity and brief remaining tenure—put simply, it was time to go. In and of itself then, Yeltsin's departure removes some lingering uncertainty over his departure. Perhaps more importantly, however, the period of maneuvering ahead of the elections is shortened by three months, bringing forward the prospect of getting economic policy back on track sooner. Finally, Putin himself holds out the possibility of meaningful reform for the Russian system.

Putin is a political unknown. He is 47 and truthfully has more experience as a technocrat than a politician. After graduating from Leningrad University in 1975, he served as a KGB agent for 15 years. He then climbed his way through a series of administrative posts in the 1990s—from deputy mayor of St Petersburg in 1994 to deputy chief of the presidential administration in 1996 to a series of important security posts, including secretary of the Security Council in early 1999, and finally to PM in August. Despite his lack of electoral experience, Putin has a host of factors working in his favor. As a result of his success in Chechnya, he is extremely popular: Putin enjoys a 63% approval rating in Russian polls. The fact that he is better known as a technocrat than a politician lends credibility to the belief that he will be capable of carrying out significant policy reforms. Unlike Yeltsin, Putin will also enjoy political support in the Duma. In the December parliamentary election, his Kremlin-sponsored Unity Party placed a close second to the Communists, while the political voice of the minor ultranationalists parties was effectively diminished. The Unity Party will also likely enjoy the support of the Union of Right Wing Forces, the political party headed by Sergei Kiriyenko, the 37 year-old, reform-minded former PM. On top of this, Putin inherits an economy in better shape than could have been expected at the end of 1998. Largely on the back of energy prices, the economy grew 2% in 1999, one of only two years of positive growth during the 1990s. Alongside the economy, the budget is in the best shape of the last few years after the enforced discipline of 1998. Finally, Putin is quite likely to be reelected. His enormous popularity, combined with the spotlight and the influence of the Kremlin strongly favors his candidacy, especially in a shortened election season—provided the war in Chechnya doesn't take a turn for the worse. In sum, with Putin now in office and likely to be reelected, a clear political path for change has been paved.

The question now is the nature of the policies that Putin will pursue; and that remains open to speculation. We do know he is unlikely to halt his tough stance on Chechnya, since it's the primary reason he is politically popular (indeed, over the weekend he showed up in Chechnya for a photo op). And it is notable that one of his first acts as president was to shield Yeltsin from future inquiry into his actions while in office—the price of power succession, a favor for a favor. On the policy front, Putin outlined an economic program last week in which he called for quickening the pace of free-market reform, but simultaneously for a "comprehensive system of state regulation"; but he provided no concrete details. Nevertheless, Putin's political support (including in the Duma) stems from reformers—which makes it likely he will tread the IMF path toward greater economic reform: cutting government spending, increasing revenues, revamping the banking system, keeping the exchange rate flexible, and rescheduling its Soviet debt. Not doing so would mean that Russia would not get the 7.5 billion US dollars worth of loans it is expected to receive over the next year and a half, and that debt re-negotiation with the Paris and London clubs would break down.

So as we noted before, the response to major political changes has been quite muted in recent years, overshadowed by much more important developments on the economic and debt-servicing fronts. For once, the events of late last week seem to foretell a brighter political picture ahead, with Yeltsin's resignation enhancing the chances that Putin will become the next president. And with the country's external position in excellent shape, again thanks to soaring energy prices, Russia has not needed to borrow in the capital markets, and has been effectively paying down debt from the post-1991 era. The combination of these developments leaves us with a bullish outlook on Russia, even with the big rally over the last few months. We remain strongly overweight Russia in dedicated EMD portfolios, and we own a good chunk of eurobonds for crossover accounts as well.