Bridgewater®

Daily Observations

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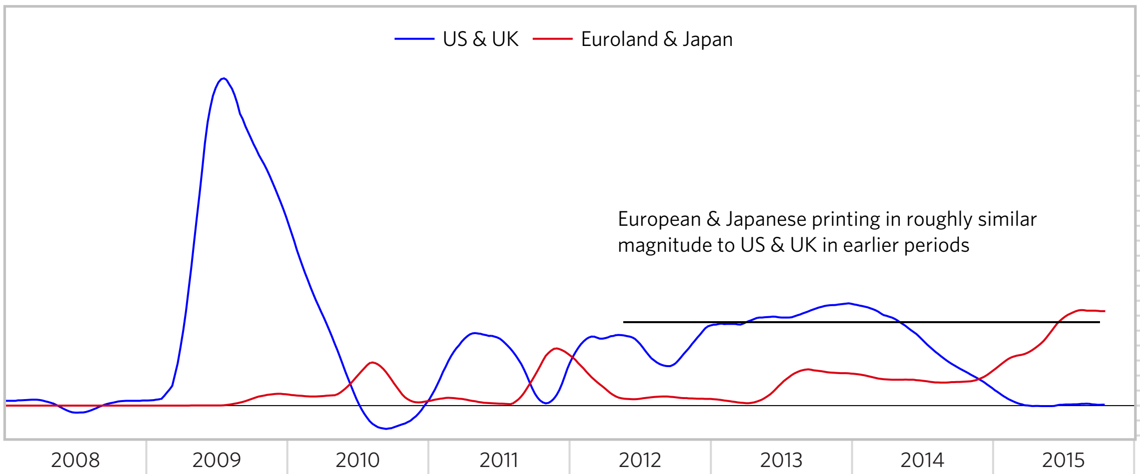
Some Thoughts on Why European and Japanese QE Are Proving Insufficient

The Fed ended QE in October 2014, and in the early part of 2015 that withdrawal of dollar printing was initially offset by an improvement in private sector credit creation and large quantitative easings in Euroland and Japan. But at this point, the evidence is mounting that these new sources of liquidity are insufficient to fill the need for dollars to sustain acceptable global growth and offset deflationary pressures. The fact that European and Japanese QE have not had anywhere near the global impact that Fed QE had illustrates both how money flows in the world and the limits of quantitative easing. Global debts are largely dollar-denominated, and while euro and yen creation helped some debtors, the dominant impact for most of them was to drive the dollar up, and thus increase debt service and lower revenue measured in dollars. In addition, the BoJ's and ECB's QE purchased assets with near 0% interest rates, making them more interchangeable with cash than the assets the Fed bought.

The rebound in global markets over the past few weeks is probably best read as the beginning of a pricing in of a counter-offensive to the global deflationary pressures that intensified through August. We think this counter-offensive will prove much needed, and the sooner it comes the more successful it is likely to be, as central banks have limited tools to offset a deflationary wave if it sets in. We suspect Euroland and Japan will probably ease again before the Fed does, given their economies are earlier in their recoveries and closer to deflation. But in the end, we expect global deflationary pressures will remain until the Fed closes the gap in the need for dollars.

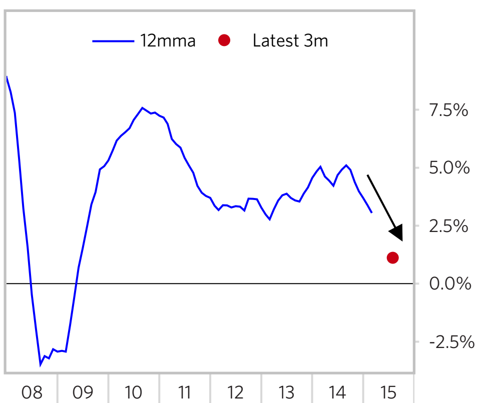
2015 has illustrated that euro and yen can't substitute for dollars globally. The chart below shows the magnitude of developed world central bank asset purchases, with each economy's purchases roughly scaled to put them in like terms (in terms of their estimated impact). You can see that in quantity terms, the ECB and BoJ printing roughly offset the Fed tapering.

Developed World Asset Purchases

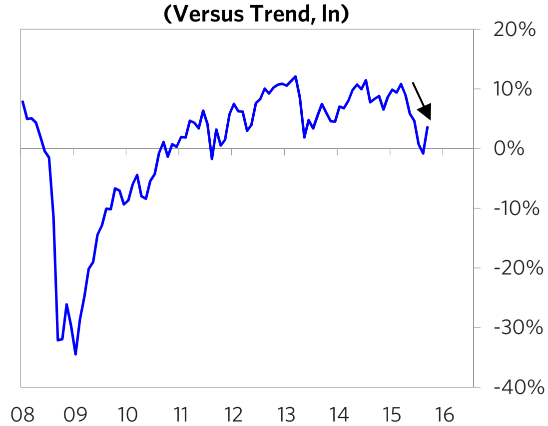


Yen and euro QE have not made up for the shortage of dollars in global capital markets. The following charts highlight the squeeze in global capital markets, even as the BoJ's and ECB's liquidity production has replaced that of the Fed. Cross border capital flows have slowed to the weakest rate since the financial crisis, and global capital markets have had their largest drawdown since the financial crisis.

Cross Border Global Capital Flows % Global GDP

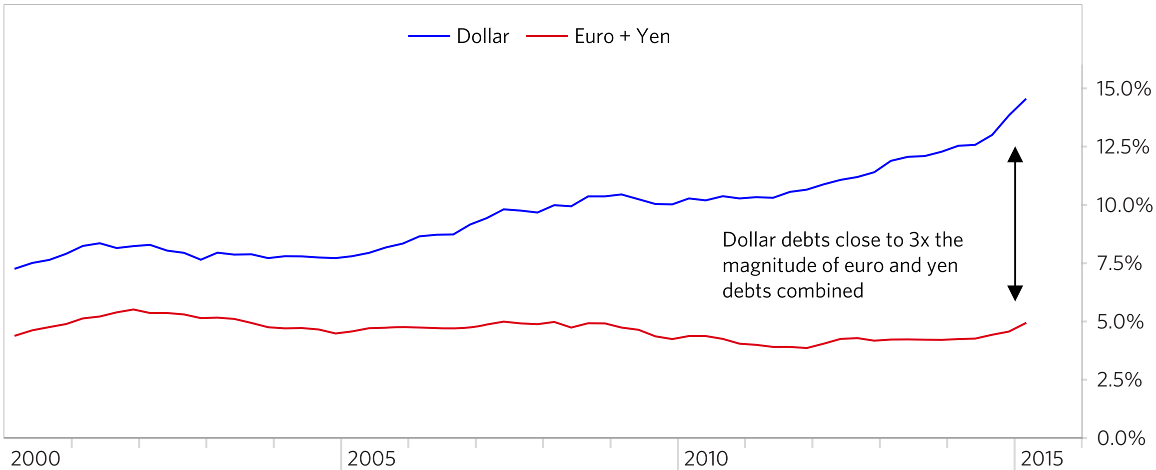


Global Asset Performance (Versus Trend, ln)

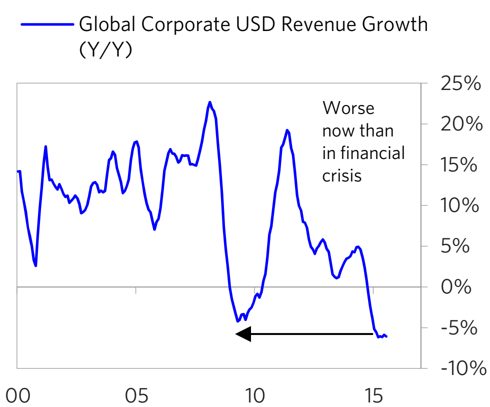


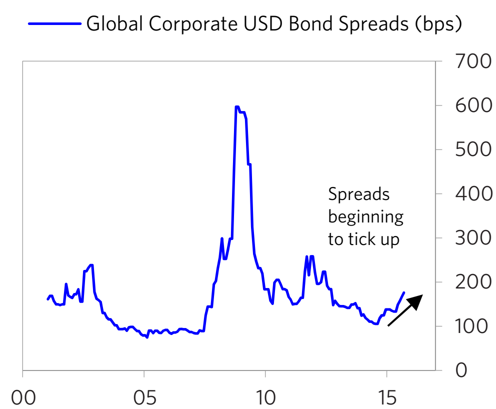
Euro and yen debtors have benefited from ECB and BoJ printing, but dollar debtors have faced deteriorating conditions as the Fed wound down its asset purchases (a tightening in and of itself) and moved closer to raising rates. Since most of global borrowing is in dollar terms, the hit to dollar borrowers has been the dominant effect on a global basis, overshadowing the benefit to euro and yen borrowers.

Global Non-Financial External Debt (% Global GDP)



As the US has moved toward tightening while the rest of the world needs ongoing easing, the dollar rally has further squeezed global borrowers with local currency revenues but dollar-denominated debts. In combination with slowing global growth and declining commodity-related revenue, this is resulting in global corporate revenues (in dollar terms) contracting even faster than during the crisis. At the same time, spreads on corporate dollar-denominated debt have begun to rise.





Looking at capital-reliant countries across the world provides another lens on the impact of the shift in complexion of global liquidity. Countries that are mostly reliant on dollar liquidity (like Brazil and Argentina) at first benefited from ample dollar liquidity when the Fed was undertaking QE; as dollar liquidity has pulled back and incomes have declined, they have been forced to reduce spending in line with income, producing a contraction in economic activity. By comparison, countries that are more reliant on euro liquidity (primarily in emerging Europe) have seen a pickup in growth as the ECB shifted toward easier policy, began printing, and European conditions improved.

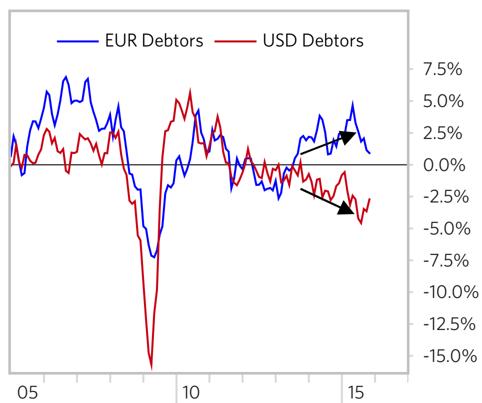
Outside of emerging Europe, most of the emerging world reliant on dollar funding

FX Composition of EM External Debt
% Total*

	Dollar	Euro
Brazil	91%	4%
Chile	88%	3%
Peru	83%	7%
Argentina	82%	13%
Colombia	71%	18%
Korea	67%	1%
Turkey	59%	31%
Mexico	57%	7%
South Africa	35%	11%
Malaysia	30%	12%
Czech Republic	17%	69%
Hungary	15%	53%
Bulgaria	11%	83%
Poland	10%	61%

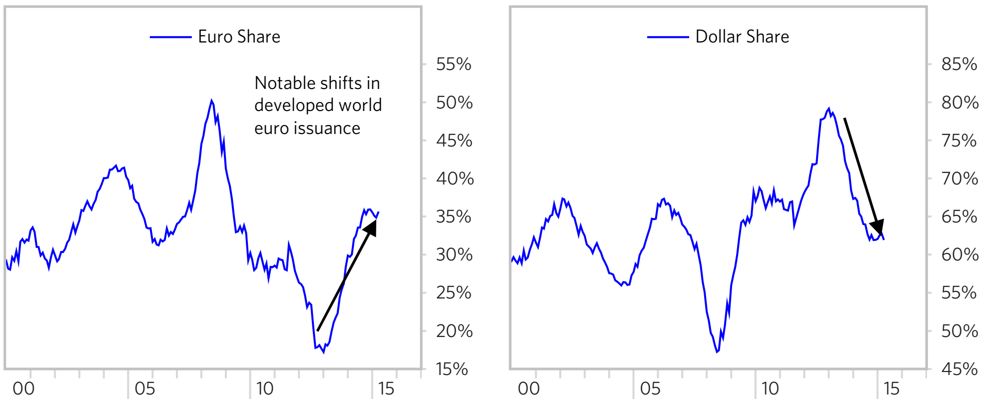
**Countries include those with either significant external debt levels or ongoing capital reliance needs*

Growth Relative to Potential

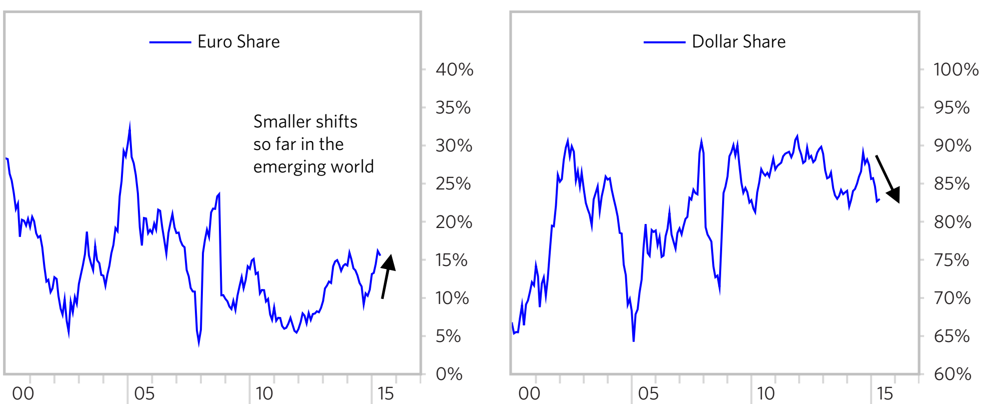


The divergence in dollar and euro liquidity is gradually being reflected in the composition of new borrowing, though it will obviously take much longer for the composition of the existing debt stock to meaningfully shift. Over the past two years—as the ECB has shifted to easier monetary policy—foreign corporates have increasingly tapped the Eurobond market for funding. In many ways, this is the reverse of the experience in the US several years ago, when issuance in the US popped following the Fed's introduction of QE, which produced relatively easy access to dollar funding. Then, Yankee issuance substantially increased and there was a heightened use of the dollar as a funding currency. Now, issuers from BlackRock to Coca-Cola are accessing the euro markets at a record pace, and foreign issuance has doubled over the past year. To date, this shift has been concentrated in the developed world. We have started to see a shift in the emerging world, but so far it remains small.

Developed World Foreign Bond Issuance



Emerging Market Foreign Bond Issuance



As the ongoing gap in dollar liquidity continues to put downward pressure on global growth and inflation, we expect central banks will need to stay easier longer than currently priced in. We think a policy counter-offensive will prove much needed, and the sooner it comes the more succesful it is likely to be, as central banks have limited tools to offset a deflationary wave if it sets in.