

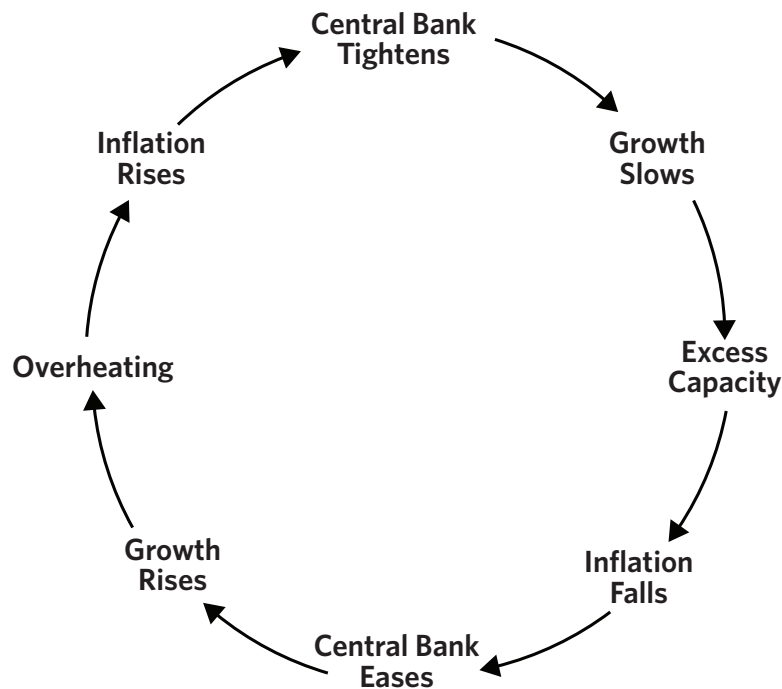
"The End of the Boom-Bust Cycle as We Know It," Explained

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BOB PRINCE

Last week at Davos, in an interview with Bloomberg TV I led off the discussion with a statement that “we’ve probably seen the end of the boom-bust cycle as we know it.” The headline and the interview got a lot of attention and are worth a more complete explanation.

First, to define “the boom-bust cycle as we know it” ...There is a sequence of events that typically characterizes the business cycle. Summarizing broadly: starting from a recession, the central bank eases monetary policy, triggering a credit expansion and economic boom, which carry forward until capacity utilization is high and the economy overheats, raising inflation, prompting the central bank to tighten monetary policy, causing a contraction of credit and downturn that eventually produce enough excess capacity that they bring down inflation, at which point the central bank eases and the cycle starts again. The cycle is largely under the control of the central bank and managed through monetary policy, which is typically executed through interest rates (MP1) or QE (MP2). The following diagram summarizes the typical boom-bust cycle.



To be clear, what this boom-bust cycle is *not* is the return of the stock market. Markets reflect the discounting of future economic scenarios, and their returns are driven by how conditions transpire in relation to what is discounted and how that discounting changes. The return of equities is certainly related to the economic cycle, but it is different. The boom-bust cycle refers to the economy, not a market’s pricing or returns in relation to the economy.

How about today and going forward?

We are unlikely to have a boom. The US and most developed economies are already 10 years into an economic expansion. And despite cutting interest rates to zero and lots of QE, this expansion never was a boom—it was the slowest expansion on record. Sputtering moderate growth finally approached capacity limits, prompting a tightening of monetary policy that was intended to mostly be a normalization of interest rates and central bank balance sheets, as well as a precautionary move against inflation. But there was a heightened sensitivity to that moderate tightening for understandable reasons, and it caused all assets to fall in 2018 and nearly caused a recession in 2019. Over the past decade, growth was only moderate because there was a lack of credit growth in response to the interest rate cuts, substantially due to what we refer to as the long-term debt cycle downwave, i.e., limitations on incremental borrowing due to the amount of debt already incurred.

Starting from today, debts are still high and interest rates are now near zero, so the ability to stimulate a credit and economic boom is even more limited than it was. Ten years ago the unemployment rate was 10%. That allowed a lot of room to fall, and as it did it produced the income growth that financed above-trend growth. From today's low unemployment rate it can't fall much more, leaving less potential for above-trend growth. If the unemployment rate stabilizes, growth will converge toward trend growth. And because productivity is low and demographics are rolling over, trend growth is already slow and slowing further. So projecting forward, we are unlikely to have a boom, and we are likely to have a slowing of growth toward a level that will approach stagnation.

We are also unlikely to have a bust due to a tightening of policy. The “busts” in the boom-bust cycle described above occur when central banks tighten in response to perceived inflation risks, eventually causing a pullback in credit, spending, and incomes that becomes self-reinforcing on the downside. Today, we are unlikely to get a preemptive tightening of monetary policy, and policy has shifted to waiting for a clear rise in relation to the target (i.e., allowing inflation to “average” the target with oscillations around it). Given the low level of unemployment, there is some threat of wages rising faster than productivity, but there are still few signs of this pressure overwhelming the secular deflationary pressures from technology and globalization.

The Fed is in a box, as are other reserve currency central banks. Their ability to ease is substantially limited, and while they have an unlimited ability to tighten and the economy is sensitive to tightening, they are unlikely to tighten because they can't ease. With the experience of 2018-19 fresh on their minds, they would not want to tighten enough to cause a downturn that they would be challenged to reverse. This will only change once inflation is clearly an observable developing problem.

There is still the risk of a downturn, but it is unlikely to come from a tightening of monetary policy as is typical in the boom-bust cycle. Downturns can also be triggered by a tightening of fiscal policy or some form of accident. With respect to fiscal policy, the pendulum has swung toward easing, not tightening. And with respect to accidents, these have their biggest impacts when they trigger a contraction in credit. Currently, the financial system is not over-extended and is less prone to a pullback. The biggest risk is political. A slow-growth environment would amplify both domestic and international political conflict. Domestically, a slowly growing pie would lead to more fighting over the pie. And internationally, a stagnant US and Europe combined with a growing China and Asia would increase the pressure from the rising power threatening the incumbent power, probably accompanied by some blaming of weak conditions on the rising power.

Markets can fall simply because they over-discount things. A number of equity markets and equity sectors are extrapolating past earnings growth and are vulnerable to what is likely to be a slow-growth environment, particularly if it is accompanied by adverse policy shifts with respect to business. In time, we do expect this to happen. Furthermore, when the next downturn eventually arrives, the risks will be amplified because the Fed won't have its usual ability to ease and trigger the next boom, as we have discussed in depth.

Overall, the transition in the environment from boom-bust to something else reflects a set of mechanics that we've laid out in our template for what drives economies. Applying that template, with developed economy reserve currency countries now positioned in the latter stages of their long-term and short-term credit cycles, with interest rates near zero, a high level of debts in relation to income, and secular deflationary forces related to globalization and technology, you get what we're describing above.

To watch the Bloomberg interview, [click here](#).¹

And as a point of reference for what a boom-bust cycle is really like, below we included an excerpt from our 1984 research report titled “Understanding the Boom-Bust Cycle,” which summarizes the world of the boom-bust cycle as it existed. The mental image of that world is far different than the world that we are now in or headed toward.

¹ Please note that discussion about strategies managed by Bridgewater in response to questions posed during the interview should be understood in the conversational nature in which they were made and were not intended to be, nor should they be construed as, precise discussions about the performance about all strategies managed by Bridgewater. Note for clarification that Bridgewater has generated positive net alpha in its flagship alpha strategy for 16 or 17 of the last 19 years, depending upon the particular product. Additionally note for clarification that Bridgewater’s equity strategy returned approximately 29% in 2019, though it lagged its benchmark by about 2%. Past performance is not indicative of future results. There is no guarantee that results referred to can or will be achieved.

BRIDGEWATER ASSOCIATES, INC.

PART I UNDERSTANDING THE BOOM-BUST CYCLE

MAY 11, 1984

We believe that economic and market forecasting is a lot easier than it's generally made out to be. Specifically, we feel that while the economy is complex, its broad determinants are really quite simple; as a result, while all forecasts are imperfect, there is no good excuse for their broad directions' being wrong. The purpose of Part I of this report is to explain these determinants and give our outlook for the important economic and market directions over the next few years. Then, in Part II, we will focus our attention on the next year, giving our projections in considerable detail.

Admittedly, since we are forecasting significant changes, our outlook is controversial. Yet anyone who is familiar with past economic and market movements knows that rather than being static, it is normal for the economy and financial markets to undergo great swings. To us, the fact that most economists cluster their projections around a consensus in which the future is always projected to be a very modified version of the present, is more a reflection of their fear of being wrong than it is an indication of what is most likely to occur. As the future economic environment would have to be more stable than at any time in the past for the popular consensus forecast to be accurate, one would think that it would be this outlook which would be considered controversial. We hope that you will evaluate the merit of our projections based on whether you think our reasoning process is sound, rather than whether they adhere to or differ from those projections which are most popular.

Given the complexity of the economy and financial markets, how should we best explain our reasoning process so that it is clearly understood? The answer is, simply. Suppose you knew nothing about the economy or financial markets, and were presented with the task of having to forecast the timing and levels of all peaks and troughs in the economy, inflation, unemployment, interest rates, stock market and gold prices over the next three years. The obvious starting point is to pull out past peaks and troughs to see what they show. Then, in order to get some sense of the relationships, you might calculate the change and duration from trough to peak and peak to trough. Similarly, you probably would want to get some sense of the sequence between one thing happening and another following (e.g. a change in interest rates and a change in the direction of the economy). Having done this, you could then make some obvious observations and conjecture about the reasons behind them. This, very simply, is the purpose of this part of the report. Additionally, we will give our projections for the timing and levels of the next three years' peaks and troughs in the economy, inflation, unemployment, interest rates, the stock market and gold prices in order for you to judge whether they, or those of the consensus, appear more controversial in this context.

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THE BOOM-BUST CYCLE

Before we get into the actual numbers, we'd like to highlight the two most important observations to be made and explain the rationale behind them.

OBSERVATION #1 - Over the last thirty years there has been a clear and regular sequence in which:

A) All economic expansions inevitably lead to significantly higher inflation rates with the most rapid inflationary increases developing when capacity utilization exceeds 85%.

B) All expansions continue and inflation rates increase until short-term rates rise substantially relative to long-term rates and a recession begins.

C) All recessions lead to higher unemployment and reduced inflation, continuing until short-term interest rates fall sharply relative to long-term rates, at which time the next expansion begins and the cycle starts all over again.

In other words, rather than the economy's growing at a slow steady pace with inflation rates remaining stable, it instead bounces back and forth between inflationary boom and recessionary bust, with the relationship between short-term and long-term interest rates signaling the turning points. This is the "boom-bust" cycle at its simplest. In truth, it is extremely complex with numerous cycles and trends interwoven around the above-described pattern. For example, there are cycles for money supply growth, velocity, housing activity, auto sales, stocks, bonds, precious metals, currencies, etc. All of these and many more are examined in Part II of this report.¹

REASONS--This cycle reflects the shifting priorities of the Federal Reserve. When inflation becomes "unacceptably high" the Federal Reserve reduces it by tightening credit which forces short-term interest rates up relative to long-term rates. This in turn causes the economy to contract, unemployment to rise and inflation to decline. Then, when the falling economy supersedes inflation as the primary concern, the Federal Reserve increases the availability of credit which allows short-term interest rates to fall relative to long-term interest rates. This in turn causes the economy to expand, the unemployment rate to decline and the inflation rate to turn up.

1. While these cyclical relationships definitely exist, we do not mean to imply that the boom-bust cycle is predestined or that we should blindly assume that the sequence will always be exactly the same. We should closely monitor the adherence of all important economic and market indices to their cyclical pattern in order to confirm that they are being broadly adhered to (this is the purpose of Part II). However, all significant deviations from normal patterns, such as the 1982 contraction, are really quite easy to anticipate by simply monitoring the relationship between short-term and long-term interest rates.

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