# Bob Prince says Diversify East and West

By Amanda White on December 3, 2019

Bob Prince, co-chief investment officer of Bridgewater, says that institutional investors should consider diversification in the context of different economic exposures which could manifest in splitting portfolio allocations to the east and west.

He says that while the west has experienced the longest expansion in history it has also been the slowest and in the next decade there will be low-positive growth in the developed world.

“The western world will have 1 per cent growth over the next 10 years but in emerging economies there will be 6 to 8 per cent growth, and in the Asian economic block 4 to 6 per cent growth,” he says in an interview. “So there are big differences in secular longer-term 10-year growth rates in different parts of the world, without the ability to generate an above trend growth rate in the developed world.”

Conventional economic analysis and portfolio allocation techniques tend to be western world-centric but Prince is advocating thinking beyond that.

“How many of our words are in reference to the developed world and currencies? We are not talking about the other half of the world and they are not experiencing what we are talking about. There is an increasingly integrated economic block in Asia which has the same output of Europe and US combined, and two and a half times the contribution. Out of self-defense, they are increasingly independent and have an internal inwardly-focused economic system driven by the monetary policy of China. There are now three major systems – the dollar, Euro and RMB. For an investor, that is fantastic because you’ve just increased diversification by 50 per cent. The problem is the securitization for those cash flows hasn’t occurred. The question I like to ask is, does it make sense to balance east and west in a portfolio?”

Diversification of cash flows is one of the levers investors have available to them in the current economic environment, and Prince believes 25 years from now investors will have a distinct east/west split in their allocations.

“People have a benchmark centric view of investing, so benchmark weights are the frame of reference of where the money goes, it’s an investor standard for the management of assets. Because of that, the weight of money allocated to the Asia block is lower than its economic share of the world because a much lower percentage of the business cash flows have been securitized and trade in public markets. But there are cash flows, there are lots of businesses that are privately and family owned in China that those cash flows are going through, it’s just not publicly traded,” he says. “Five years ago it was a closed market so you couldn’t invest but they’ve opened up and the west hasn’t grabbed that because of a lack of understanding, a lack of trust, skepticism, and they have just been slow to adapt. Image if the market cap was 50:50? The question is do you wait for that or do you get in ahead of that.”

In Prince’s view, investors can’t avoid investing in China the only question was how to engage.

This strategic positioning in China is a subject he has been discussing with various investors such as the [University of Texas Investment Management](https://www.top1000funds.com/2019/10/bridgewater-and-utimco-talk-china/), in the context that Bridgewater’s raison d’etre is to bet on economic changes via the markets that reflect them.

Prince says investors can view an exposure to an Asia block through three different dimensions: the first is a policy or issues perspective; the second is by geography so investing directly in China, in Asia or the eastern hemisphere, or as a global investor buying companies that do business with China; and the third is the degree of intimacy of the investment, such as investing in a private company and sitting on the board, or through the public market. And investors can buy individual stocks, or buy asset classes, or buy global assets that are exposed to China.

“No one is making you do one or the other, you can choose, but you can’t avoid it,” he says. “Make your choice and go in with eyes wide open and realize you’re going to have risks that you’re not used to having.” Regardless of the access point, Prince says the most important thing is to learn through direct engagement.

“If you make a good investment in China today and it’s only a good investment that’s not good enough. It needs to be an investment that’s also an education process about how that system works and equip yourself for the future for when it really matters.”

Prince says Bridgewater’s own exposure to China is only constrained by liquidity. It is in all of the firm’s alpha strategies and has a share of the global All-Weather product. In addition, the firm has created two China-centric All-Weather products that primarily hold Chinese assets, one for local investors and one for offshore.

“This is intended for our clients to have that type of learning experience,” he said. “It’s designed to be a perfectly good investment return stream lowly correlated, but mostly it’s a great window into China to get your feet wet in a way that is somewhat arms’ length – it has more derivatives and asset class positions – where they can get to know policy and how policy shifts are effecting risk premiums and start to build that understanding.”

**MP3 – Fiscal and Monetary Levers**

Prince says investors should be looking at diversification through the lens of macroeconomic conditions and cash flows related to the differences in economic regimes around the world.

“Prices tend to move together but over long periods of times the ups and downs net out and what you are left with is the compounded effects of cash flows of these different economic regimes around the world. Hence the east/west division is one way to think about that. Diversification of cash flows, diversification of monetary systems, that very macro diversification is really where you want to be.”

The key to stimulating growth in the western world, he says, is the management of both monetary and fiscal policies. Bridgewater is advocating MP3 which it describes as increasing reliance on fiscal policy coordinated with accommodative monetary policy. [Modern monetary policy](https://www.top1000funds.com/2019/10/mmt-a-solution-to-broken-policy/) could be thought of as one version of MP3.

“There’s not much ability to put the juice into the economy if you look at the level of interest rates and how much they can be cut or the level of risk premiums and so how asset prices can be raised through QE, that’s not available. QE has been spent, monetary policies are approaching the end of their useful lives. We need fiscal policy action.”

He says both the Bank of Japan and the European Central Bank have already recognized that monetary policy is at the end of its usefulness and are “handing the baton to fiscal policy”.

So what is MP3? Prince describes MP1 as interest rate driven monetary policy, where borrowers are induced to spend. MP2 is essentially quantitative easing and MP3 involves direct spending by the government in the economy which is supported by the liquidity of the central bank.

“That’s where we are headed,” he says. “Europe, Japan and Switzerland are on MP3. The US and the UK are close to done on MP1 and MP2, rates could be cut a little bit but they are going to MP3 next. China still has all three available and a lot of MP3 fuel because they coordinate monetary and fiscal policy anyway.

“We are headed to a world where the existing reserve currencies are going to low growth, low inflation, zero interest rates but lots of liquidity to avoid a down turn. MP3 is the bazooka you have to fire which brings into play government involvement in the management of the economy from a cyclical standpoint, which is a much messier approach.”

“When we talk of MP1, MP2, and MP3 what we are really talking about is the levers to manage the variations in growth around the trend,” Prince says. “If we have a downturn how do I reverse it, if I am below trend how do I get back up, and if I’m above how do I get back down? It’s the wiggles/cycles that are being managed but they don’t change the long-term productivity path.”

Through history the lack of independence of central banks in relation to government has been a source of inflation mismanagement, Prince says.

“When Tony Blair became prime minister of England the first thing he did was to establish the independence of the central bank, literally the first day in office. And real yields on UK gilts fell 50 basis points. The credibility of an independent central bank was something that was accepted. For 250 years the Bank of England was not independent and a decision was made it would be better if they were. There has been a huge wave over the last 30 years of establishing an independent central bank, and that has been a big contributor to low inflation because they all have inflation targets. If you’re worried about inflation it makes total sense to have independence because you’re going to do politically unpopular things. But today they couldn’t get inflation if they tried, the system is sluggish and now it’s like why would we have an independent central bank, why not have the government coordinated? It’s a function of the conditions at the time, we want inflation now,” he says. “At the end of the day it is probably better to have government and central banks coordinated but only if it is done well. Abuse of that is bad, that’s why we had inflation and why the central banks became independent because government had too big a role.”

Bridgewater focuses on three sources of spending as a template for understanding the economy: productivity, long term debt and short term debt.

“We’ve been in an economic expansion for 10 years, it would be easy to dive into that but it would miss some really important things to be thinking about, particularly as institutional investors have to have their head on the 10-year picture,” he says. “It will be the compounded effects of the next decade that will have a bigger impact than reactions to the boom bust cycle that we are used to over the past 50 years.”

He says the convergence of the cyclical conditions to the secular conditions will be an important driver of how things play out over the next decade.

“This convergence will be an important part of the next 10 years. It’s the combination of productivity and the long-term debt cycle that gives you your long-term trend growth, and the short-term debt cycle that gives you the wiggles around that. We are now at the tail end of a 10-year economic expansion on the short term debt cycle, which has been an outperformance of that long term trend growth rate, but we are coming to the end of that. That thing is running out of gas and there is going to be converging to the long term trend growth rates which are going to be fairly low in the developed world, but not necessarily low in other parts of the world,” he says.

“Because you’ll have very big differences in these secular growth rates, that will have compounded effects over the next decade which might be more important than how we think about monetary policy and the next interest rate change and all that kind of stuff.”

Prince says the mission at Bridgewater is to understand the economic system and how it relates to markets and then respond accordingly and “so wherever that takes you is where we go”.

“Our existing process is actually positioned pretty well to what I described, as if you approached it from a long term secular view even though our process is looking at what is the next shoe to drop. Our systems are continuously processing long term and short term elements. The short term elements are somewhat subdued now so naturally the longer term elements are more dominant in our positioning at the moment, and that comes and goes naturally as a function of the shifts, last year it was the opposite.

“If they’re giving you the short pass, take the short pass. If they’re giving you the long pass take the long pass. We try to understand the economic system and just fit in with that, so that’s what we are doing. We haven’t made any major changes, anything we will do will be a gradual evolution but our research is about understanding that system and how it is connected to the markets and then evolving an investment strategy that fits into that. If that meant longer term strategies in more illiquid markets that’s what we’d do and then we’d talk to clients about that. We will always try to do what we think will be right.”