Bridgewater®
Daily Observations

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Ray Dalio

Our Relationships

We are now in the process of defining how we are going to be with each other. We can either have...

...1) cooperative-competitive relationships, in which we take into consideration what's really important to the other and we try to give it to them in exchange for them doing the same with us. In that type of win-win relationship, we will have tough negotiations done with respect and consideration, as we compete like two friendly merchants in a bazaar or two friendly teams on the field. In this case, we interact through "negotiation."

Or

...2) mutually threatening relationships, in which we think about how we can harm each other, and we exchange painful acts in the hope of forcing the other into a position of fear so that they will give in. In this type of lose-lose relationship, we interact through war rather than negotiation. The main question is how far we are willing to take it.

History has shown that whichever relationship is chosen, these directions tend to be self-reinforcing until a catharsis is reached that leads to a reversal, which is why tiny wars often grow into big wars over time. History has also shown that wars are typically much more painful than even those who chose this path imagined, so that virtually all parties wish that they chose the first path.

Either side can force the second path on the other, while it takes both sides to follow the first path. Both sides will inevitably follow the same approach as the other.

In the back of the minds of all parties, regardless of which path they choose, should be their relative powers. In the first case, the parties should realize what the other could force on them and appreciate the quality of the exchange without getting too pushy, while in the second case, the parties should realize that power will be defined by the relative abilities to endure pain as much as the relative abilities to inflict it. When it isn't clear exactly how much power either side has to reward and punish the other because there are many untested ways, the first path is the safer way. On the other hand, the second way will certainly make clear which party is dominant and which one will have to be submissive after the hell of war is over.

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Give Feedback

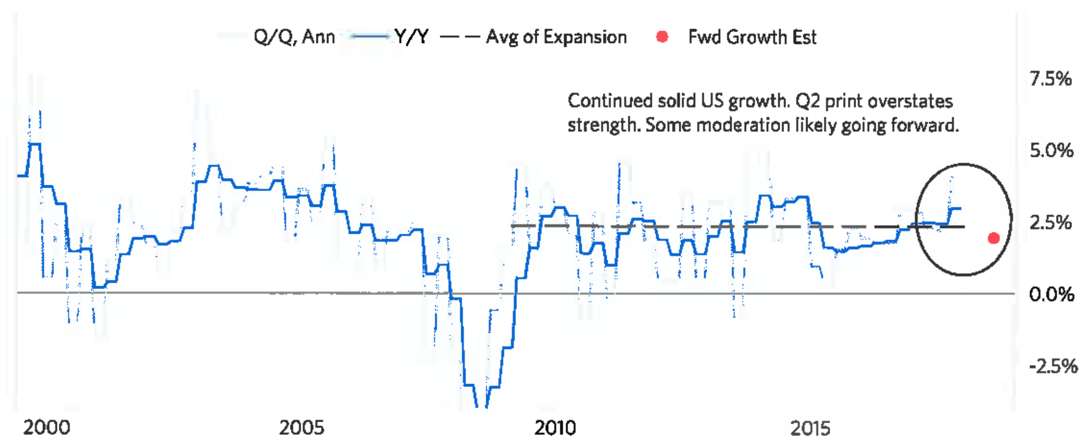
GDP Report Overstates Prior US Economic Strength; Moderation Likely Going Forward

Jason Rotenberg | Matt Karasz

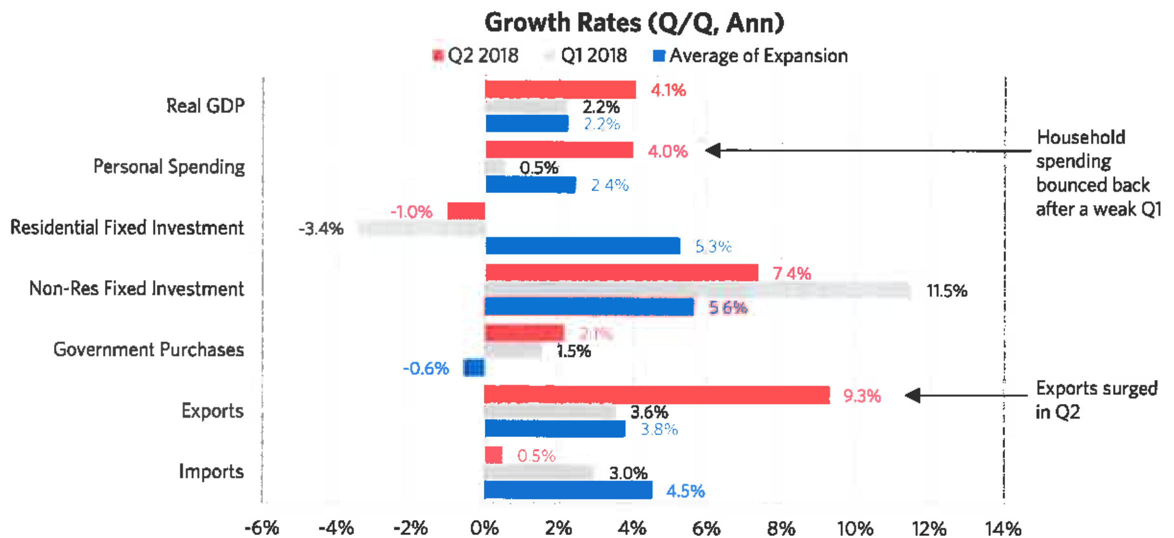
Friday's US GDP report illustrates how any one statistic, even one as broad as GDP, can paint a misleading picture of underlying economic conditions. This is why we take the time to look across a broad set of stats and surveys, as well as the fundamental drivers of conditions, in order to assess how an economy is doing and how it is likely to do going forward. At this point, basically everything suggests that the US economy continued to grow at a moderate pace in recent months (~2.5%), consistent with still-strong global conditions, the fiscal boost kicking in, and the Fed tightening only beginning to bite. Friday's GDP report, which suggested that US growth accelerated to more than 4% (the strongest print in years), was likely a fluke: it was driven by a statistical bounce in household spending after a statistically weak prior quarter and by a one-off surge in soybean exports, as producers tried to get in front of the new tariffs.

Looking at the drivers of growth helps us assess whether it is likely to be sustained. In this case, we expect growth to slow somewhat, and we see most of the risk to the downside. The strength to date has prompted tightening, which takes some time to impact asset markets and the economy. The Fed is discounted to continue tightening (both through higher rates and a smaller balance sheet), fiscal policy is set to become less supportive, and increased tariffs will be, at a minimum, a modest drag as well. When we net all of these pressures together, we see downside risks to asset prices, manifesting in higher bond yields (if the economy proves resilient in the near term) and/or lower equity prices. Either way, we see most pressures lining up to much softer growth sometime next year. The chart below highlights how choppy quarterly GDP is. Our measures of underlying growth are at around 2.5%, similar to what GDP growth has averaged over the last year. We expect some moderation in growth going forward.

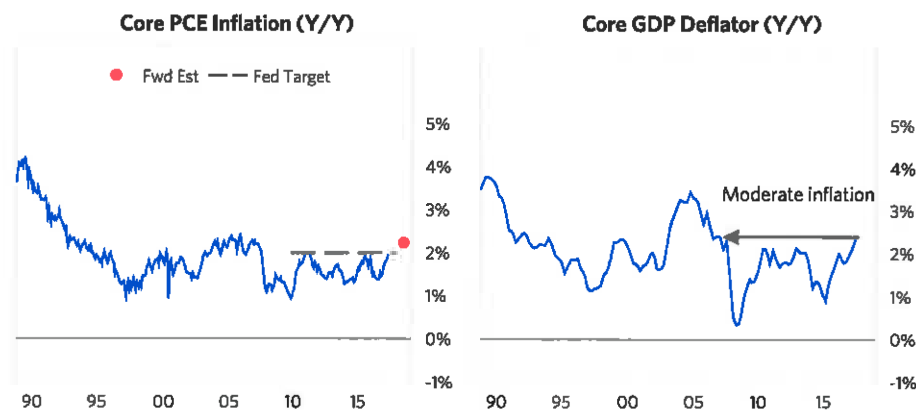
Real GDP Growth



When we take a closer look at Friday's GDP report, we see clear signs that it overstates the strength in underlying US economic growth. As you can see below, the meaningful pickup in the second quarter was driven almost entirely by a surge in exports, as soybean producers tried to get ahead of new tariffs, and by a statistical bounce in household spending after a weak Q1. Both of these dynamics look like one-off idiosyncratic pickups that aren't reflective of underlying economic drivers. Growth was still strong across the rest of the economy, but it was more in line with what we've averaged over the course of the expansion than with the very strong growth that the headline GDP number would suggest. Business fixed investment (referred to as "non-residential" below and in the report) was strong, but only about 2% stronger than the average of the expansion, consistent with our view that corporates are reacting to some extent to tax cuts and incentives to invest more. On the weak side, residential investment continued to be soft and may be to some extent impacted by the tightening. Inventories produced a 1% drag on growth.



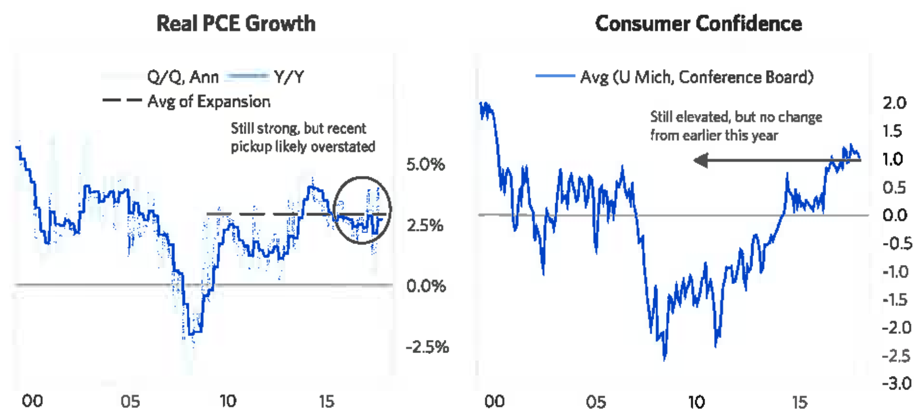
The report also showed inflation firming but remaining low enough not to be a problem for monetary policy yet. As the chart on the left shows, the core PCE deflator, the Fed's preferred inflation measure, has been below target for years. More recently, it has been gradually picking up and is likely to rise a bit above the Fed's target over the next year, as cyclical conditions continue to rise and short-term pressures boost it further. However, even if inflation continues to drift a bit higher over the course of the expansion, we remain more concerned about how low it could get during the next downturn. Below, we also show the core GDP deflator; it has picked up a bit more in recent months, given its sensitivity to global commodity prices, but it also still remains pretty low relative to history.



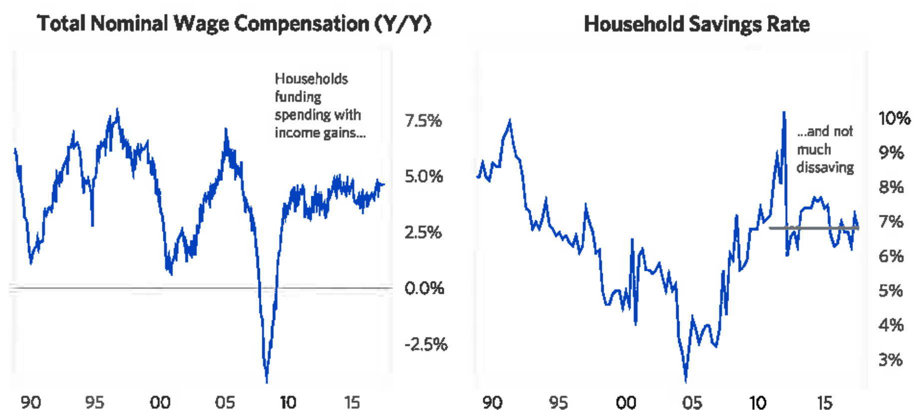
Below, we go through our read on economic conditions across the major sectors of the economy in more detail.

Household Demand Has Been Strong but Is Likely to Soften

Household demand has been the primary driver of the US expansion over the last couple of years, since the household sector is big (accounting for about 70% of overall spending) and has been one of the prime beneficiaries of the extremely stimulative financial conditions we've seen. We think household demand continued to grow at a moderate pace in the second quarter, as households enjoyed the tax cut from late last year and the Fed tightening hadn't really begun to hit asset prices. Actual household spending growth, which accelerated to 4% in the second quarter, likely overstates the strength of the household sector, reflecting spending that shifted from a weak Q1 as opposed to a meaningful change in economic conditions. One way to see this is by looking at other measures of underlying demand, such as consumer confidence, which remained elevated but didn't show much of a meaningful change from earlier in the year.



Household spending has been supported by steady income gains and hasn't been too reliant on credit growth or dissaving. This looks to be the case even more so now with the latest revisions in the savings rate, which has shown less of a decline in recent years and is at higher levels. That said, as we look ahead, we would expect household demand to slow. Household spending decisions are heavily influenced by interest rates and asset prices, and so the household sector is likely to face headwinds as the ongoing Fed tightening cycle begins to bite.



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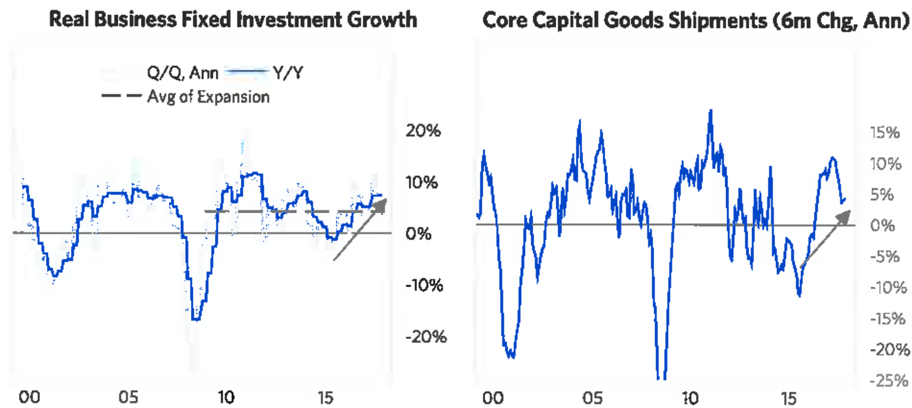
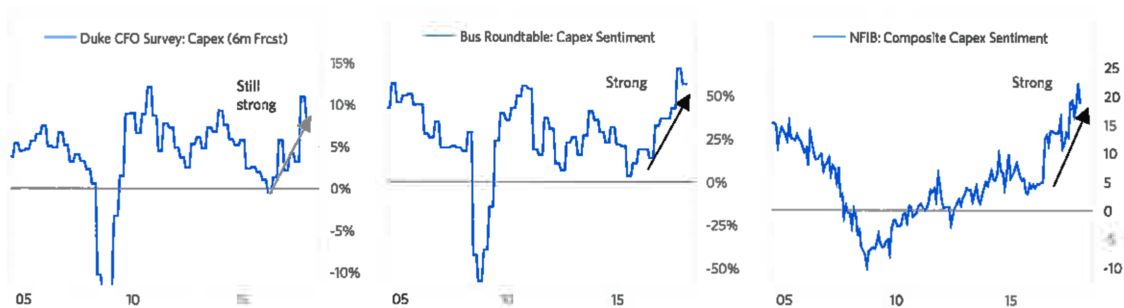
Business Fixed Investment Is Strong, Proving a Moderate Boost to Growth

Pressures on corporate capital investment spending remain aligned for continued strength, maintaining what has been a significant support to US economic growth at a time when other parts of the economy face more pressure from the Fed's continued tightening. Heading into this year, corporates' ability to spend was already strong—cash flows were at highs, with many companies piling up extra savings on balance sheets. Then came the additional windfalls from changes to the corporate tax code and more favorable treatment of overseas profits at the end of last year, alongside ongoing broad strength in global demand that increased the need to invest. Even with these supports, however, investment growth is just modestly stronger than the average of the expansion, and some more timely measures, like capital shipments, are pointing to some moderation.

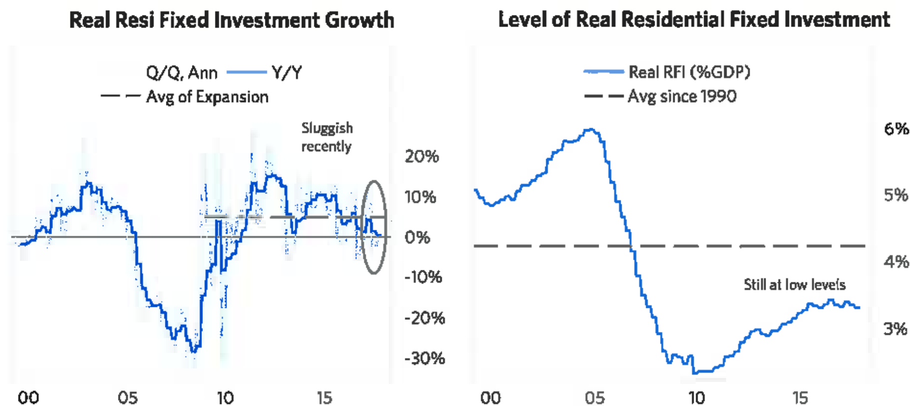


Consistent with the favorable conditions facing businesses, recent surveys also broadly point to strong capex plans.



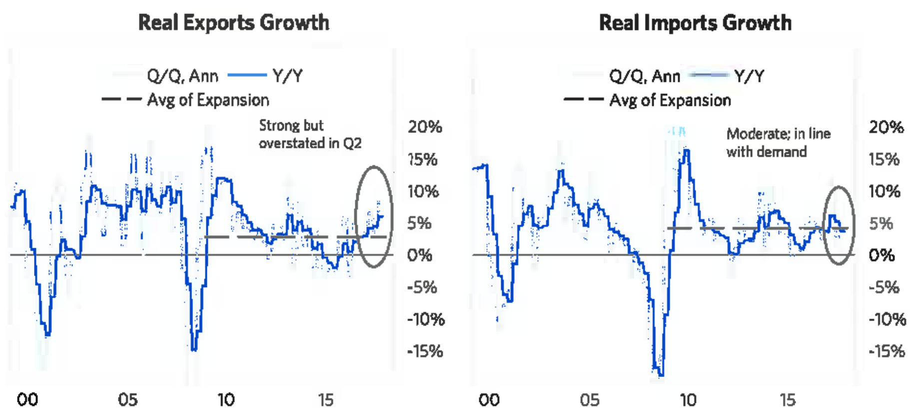
Housing Investment Was Pretty Sluggish in the Second Quarter and Is Unlikely to Be Much of a Support or Drag Going Forward

Housing construction has been recovering in fits and starts over the course of the expansion. More recently, it has been pretty sluggish, contracting in the second quarter and staying roughly flat over the last year. Looking ahead, we expect it to be a bit stronger than it has been but not a meaningful driver of growth. Rising rates are a clearly bearish pressure, but there's been very little new supply brought online in recent years, and the supply overhang from the financial crisis has long been gone.



Exports Have Been Strong, but the Strength Was Overstated in the Second Quarter

Exports have been picking up over the last year, in line with the broader pickup in global growth. Exports surged in the second quarter, but, as we will explain below, this was likely a fluke, as producers front-loaded exports to get ahead of China's retaliatory tariffs. Imports were a bit softer in the second quarter, but we wouldn't read too much into this. Imports are choppy on a quarterly basis and have grown at a comparable pace to what we've seen over the course of the expansion on a year-over-year basis, consistent with still-strong domestic demand.



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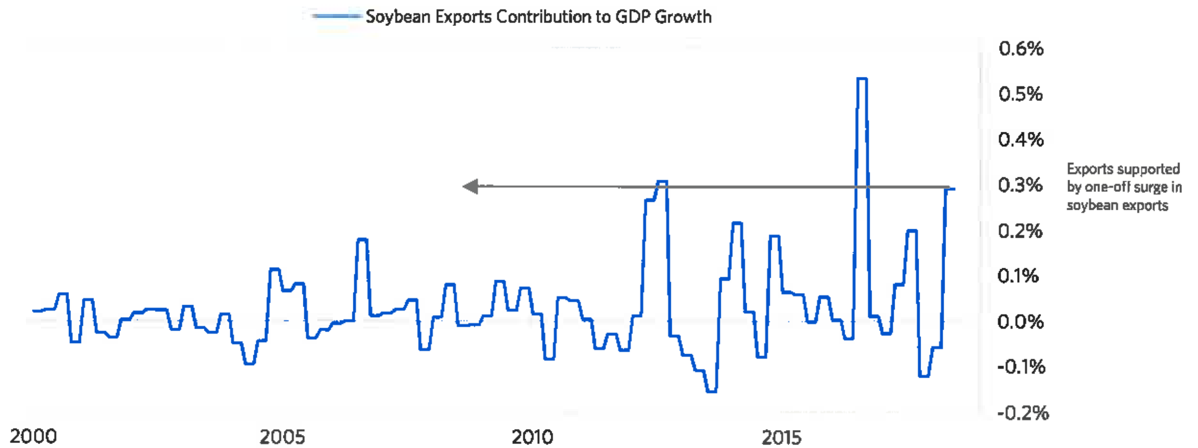
While exports have been strong in recent years, the notable strength in the second quarter was likely overstated. It seems like this pickup was driven in large part by producers front-loading shipments in anticipation of the new tariffs, a one-off boost that will become a drag going forward. One example that made news was the surge in soybean exports—in May and June, before the tariffs went into effect—which grew at a pace of about 200% year over year in May and, as we show below, added about 30bps to overall growth. This was approximately the second-biggest pickup in nearly 20 years, only beaten by the temporary pickup in 2016 due to weak foreign harvests. We'd expect soybean export growth to keep slowing, now that the tariffs have gone into effect.



Looking at the underlying drivers of exports gives us further confidence that the Q2 strength was a one-off fluke, as opposed to a reflection of a broader economic trend. As the charts below show, the underlying drivers of external demand haven't moved enough to explain the surge we saw in the second quarter: trading partner growth has been strong, but hasn't accelerated like exports have, and the dollar hasn't been supportive (rallying so far this year and reversing much of the prior fall). The stability in these underlying drivers—along with the signs of front-loaded exports—makes us think that, while external demand is strong, the surge in exports in the second quarter likely overstates this strength.

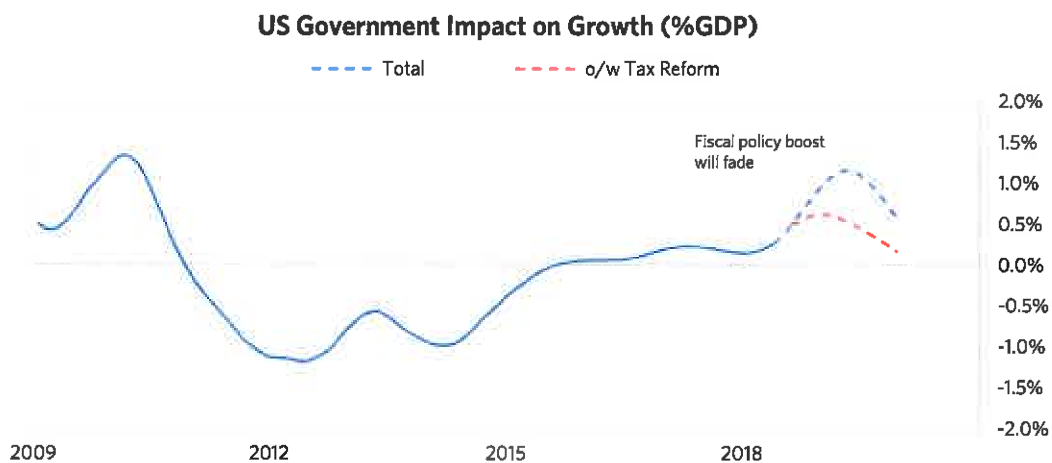
Give Feedback

Government Spending and Broader Fiscal Policy Have Been Supportive but Are Set to Peak

Direct government spending picked up in the second quarter, and fiscal policy more broadly was an even bigger support by boosting the spending of both households and corporates. However, as we've said before, we think the boost from fiscal policy is likely to peak toward the end of this year, as the drag from the Fed's tightening becomes more meaningful. This creates risks for the economy.

The chart below shows our rough estimate of the impact of the fiscal easing on growth over time. While there is no precision in the timing shown below, we think fiscal policy will add about 1% to GDP growth this year, and that this support will then fade over the course of next year.

US Government Impact on Growth (%GDP)



On a backward-looking basis, most forces, including global conditions and the stimulus, have lined up to support strong US growth. Looking ahead, we see these supports gradually fading, even as the Fed continues to tighten monetary policy. We expect growth to moderate as a result, and we see more downside than upside risks to growth.

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