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Daily Observations

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The Lead Time Between Asset Prices and the Economy May Be Long

In the last two cycles, the equity market peak was about coincident with the economic peak. That experience is not the norm—markets tend to lead the economy by about a year—and we expect a longer lead time this cycle. In this cycle, asset prices were driven up faster than economic conditions due to excess liquidity and extremely low discount rates, and the reversal of those factors is also likely to affect asset prices more directly than the economy. Partly as a result of this, it is our rough guess that asset prices may have topped for this cycle, while we view global growth as slowing but still healthy.

The table below compares equity market peaks in tightening cycles since 1960. In 2000 and 2007, the equity market didn't peak until the economy was peaking. That happened, in our view, because you had big bubbles in both cases where asset prices and the real economy were entwined. In 2000, it was the equity bubble directly financing capex, and in 2007, it was the housing bubble directly financing household overspending. When those things started to crumble, they hit the economy very quickly. That's not the normal phenomenon, however. Typically, the equity market peaks well before the economy, because it's monetary tightening, not the economy, that's driving down assets. As you can see, in most of the cases prior to 2000, asset prices peaked well before the economy and economic cash flows (i.e., earnings). Earnings growth continued, but the monetary tightening weighed enough on discount rates, risk premiums, and growth expectations to outweigh strong earnings growth. Without the more direct linkage between financial markets and spending that occurred in the last two bubbles, this is how we expect cyclical asset peaks to play out. You can also see that the market today looks more like the prior cases since the stock market peak in January, with earnings growth staying strong while asset prices have flattened out.

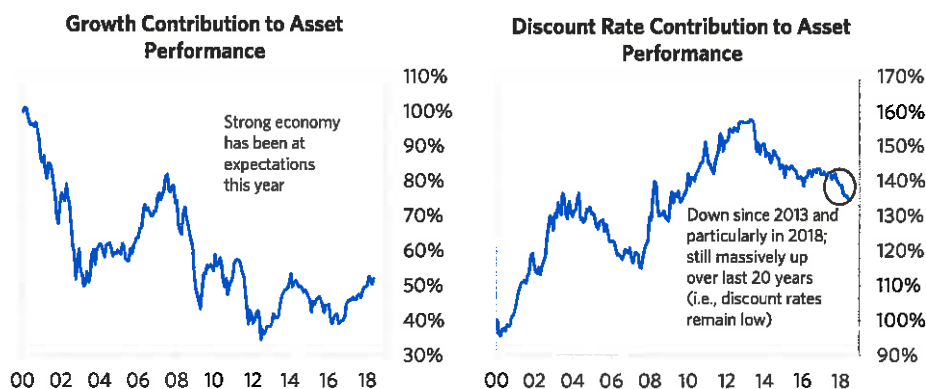
Equity Market Peaks in Tightening Cycles

Equity market peaks are often followed by many months of continued economic strength and earnings growth—but also tightening monetary policy

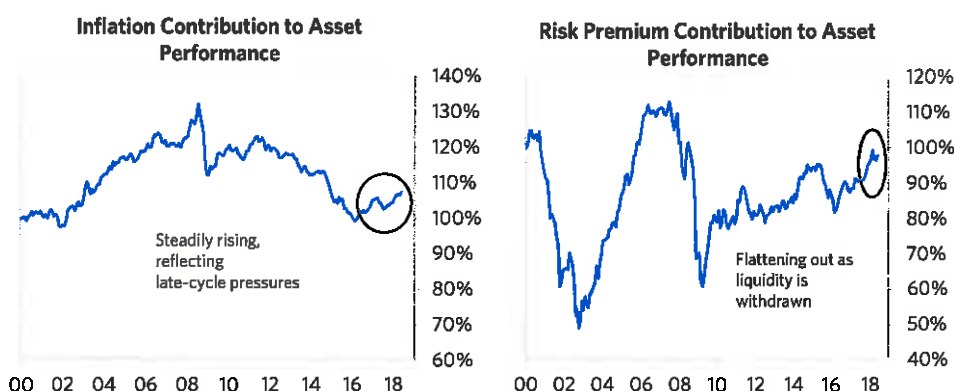
Year of Equity Peak	Months until Economy Peaks	Next 12m Equity Excess Return	Next 12m Earnings Growth	Next 12m Chg in Bond Yield
1966	12	-15%	6%	-0.2%
1968	9	-8%	-2%	1.4%
1972	11	-24%	20%	0.3%
1980	9	-13%	4%	1.4%
1983	No Turn	-13%	16%	2.1%
1987	19	-16%	23%	-0.1%
2000	1	-19%	-25%	-1.0%
2007	4	-12%	-12%	-0.5%
Since Jan 26	No Turn Yet	-1%	10%	0.3%

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Another way to illustrate these dynamics is through the impact of the four big-picture drivers of asset performance: growth, discount rates, inflation, and risk premiums. To construct these, we look at the returns of asset classes with opposing structural biases. Central bank tightening has been weighing on all risky asset classes in 2018 through rising discount rates, while the still-strong economy has been performing about at expectations, leaving flat returns from the change in growth relative to expectations. The net has been an equity market down about 5% since its peak in January. It's also worth noting that while returns due to rising discount rates have been negative this year and for a few years, the level of discount rates, especially on the long end, remains extremely low.



Rising inflation has also hurt equities somewhat, and risk premiums have flattened out.



This dynamic is what you see around the market peaks of most of the tightening-driven turns over the last 60 years other than the last two. The table below compares the cases in the first table through the lens of four big-picture drivers of asset performance. As you can see, the economy tended to stay strong for at least a year after the equity peak in most cases, with the poor equity returns owing to rising discount rates and risk premiums outweighing healthy growth conditions. The most recent two cycles were notably different, with weakening growth driving the market weakness, which was to some extent cushioned by falling discount rates.

¹ This analysis is based on the All Weather Lens, which is an analytical approach to assess the behavior of the major drivers of asset performance and their impact on markets during any given period, based on Bridgewater's understanding of global financial markets. Information shown is the result of analyses of actual and simulated market data.

Equity Market Peaks in Tightening Cycles

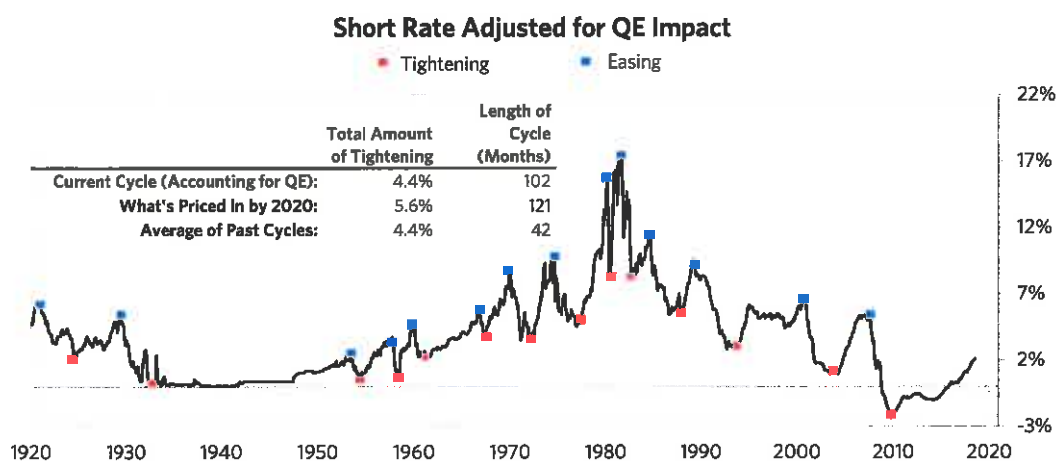
Year of Equity Peak	Months until Economy Peaks	Next 12m Equity Excess Return	Growth Contribution to Asset Performance	Inflation Contribution to Asset Performance	Discount Rate Contribution to Asset Performance	Risk Premium Contribution to Asset Performance
1966	12	-15%	-14%	-3%	2%	-10%
1968	9	-8%	10%	36%	-9%	-3%
1972	11	-24%	2%	34%	-2%	-4%
1980	9	-13%	12%	6%	-4%	-31%
1983	No Turn	-13%	11%	-9%	-14%	0%
1987	7	-16%	-8%	6%	0%	-7%
2000	1	-19%	-19%	-1%	17%	-20%
2007	4	-12%	-14%	13%	11%	-9%
Since Jan 26	No Turn Yet	-1%	-1%	1%	-3%	-3%

Continued economic strength tends to cause ongoing tightening in monetary policy and risk premiums, which offsets that strength in the late cycle

12 Months after Equity Peak

This Tightening Cycle Has Been Cautious but Long, and, Including the Roll-Off of QE, Reasonably Large

Including the removal of QE as part of tightening, we are already in the longest tightening cycle since the recovery from the Great Depression, and the amount of tightening the Fed has done so far is roughly as much as it took to tip over prior expansions. While QE and interest rates are different, we have worked out a rough rule of thumb to compare the impact of the two. On this very loose basis, we think that during the maximum QE period in the US, QE had roughly the equivalent stimulative impact of a -2% short rate. Very roughly speaking, by removing QE and raising short rates, the Fed has already tightened by the equivalent of 400 basis points, and they are likely to raise rates another 1% by the end of 2019 and to roll off a further \$700 billion of balance sheet. In the chart below, you can see the current tightening cycle so far and what's priced in, compared to the 14 tightening cycles in the past 100 years.

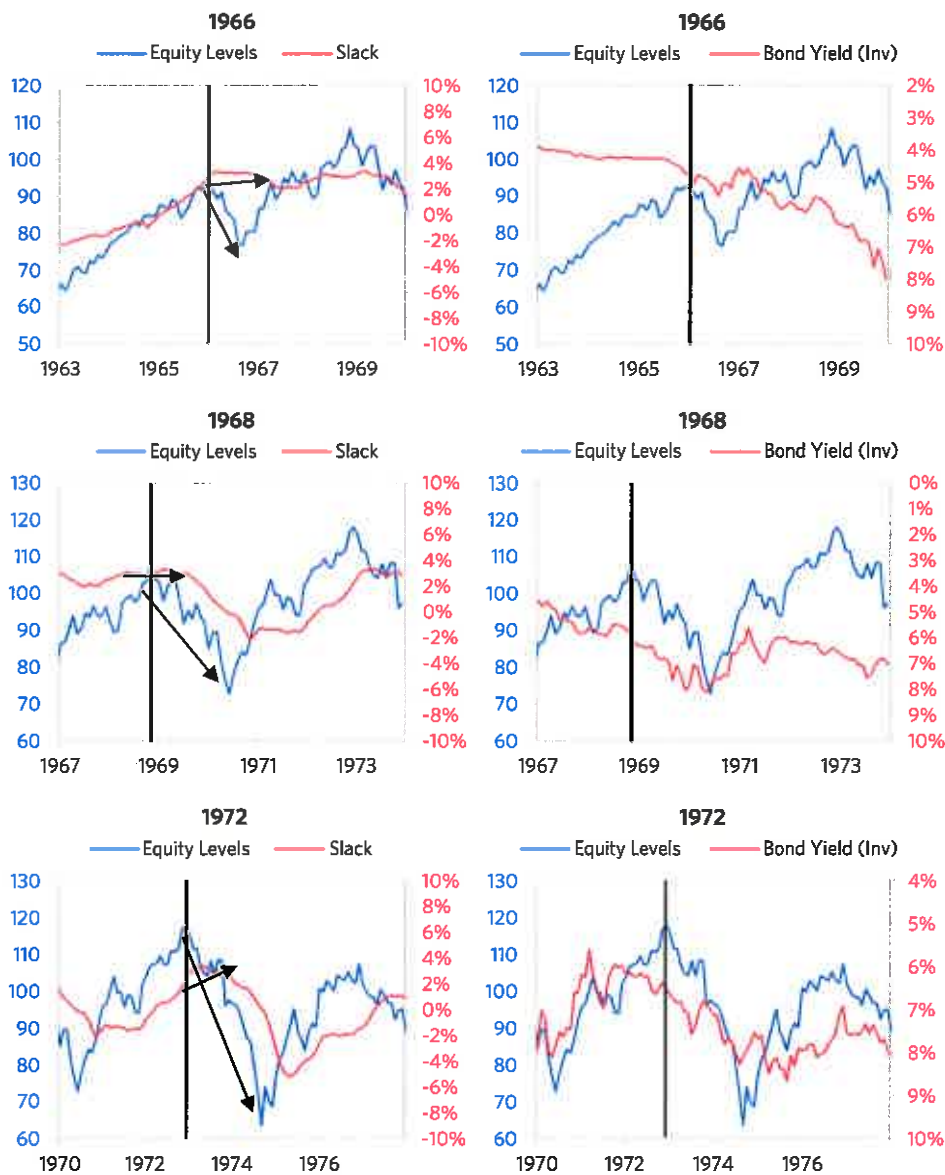


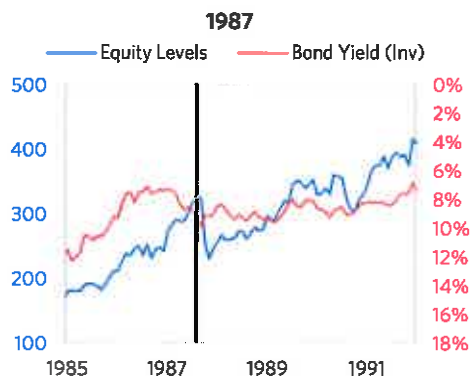
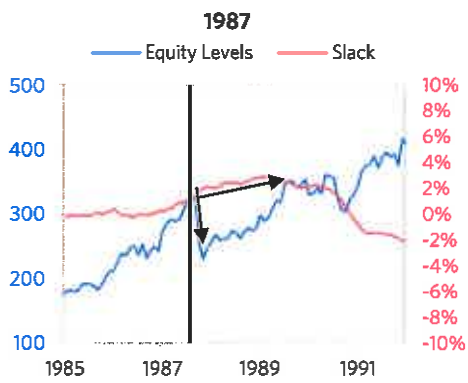
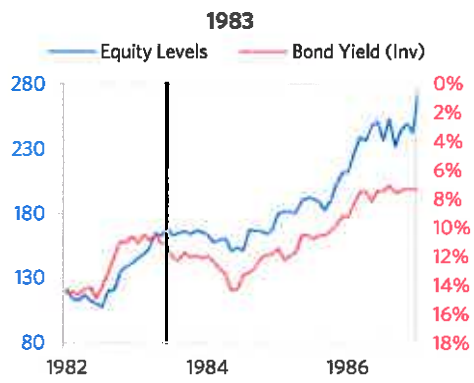
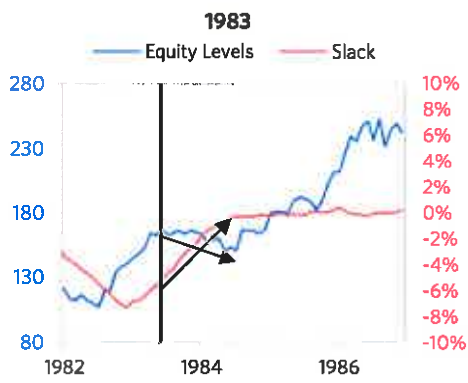
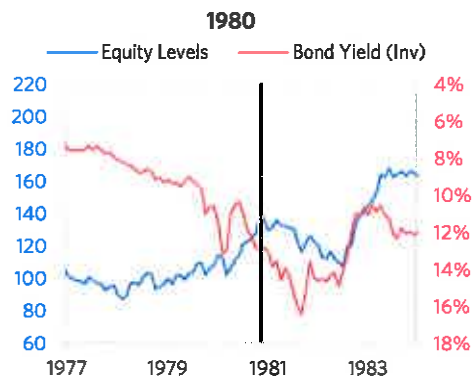
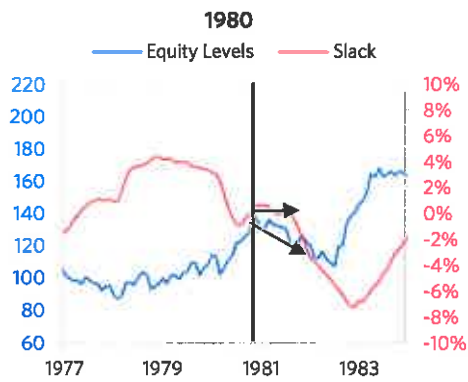
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Appendix: The Cases

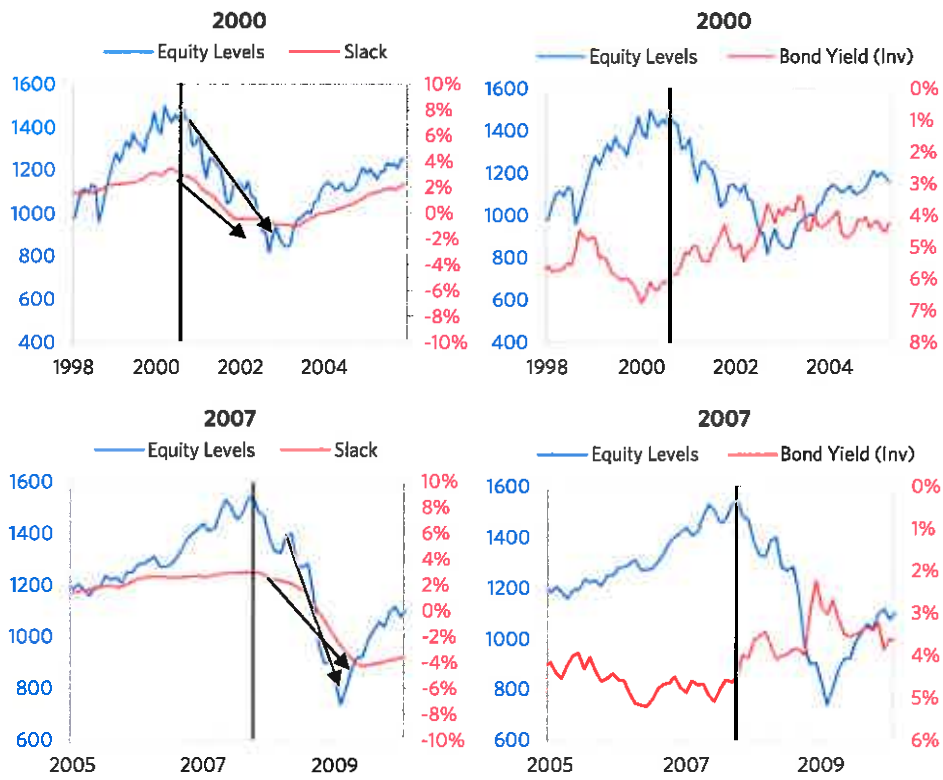
Below we show quick snapshots of each case we examine. We show equities relative to both the economy and the bond yield.

As we can see more directly here, for essentially every cycle until 2000, the turn in the equity market substantially led the turn in economic activity (measured by slack). In those cases, bond yields typically continued to rise as more tightening was needed to slow down the economic momentum.





The more recent cases (and as a result, the ones closest to investors' minds) work somewhat differently—with the equity market peaking mostly coincident with the economy itself.

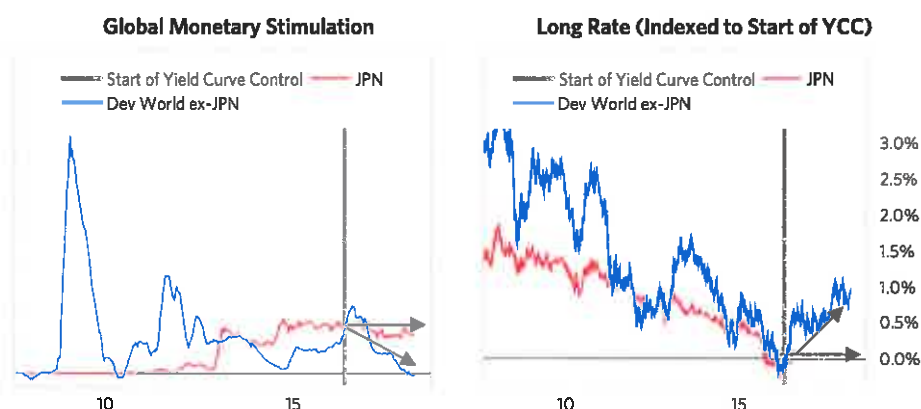


Ignore the Tweaks: The BoJ Reiterated Its Commitment to Easy Policy in Tuesday's Meeting

Matthew Karasz | Jordan Nick

The Bank of Japan has been extraordinarily accommodative in recent years, and in its Tuesday meeting it both kept policy easy and signaled its intention to continue on this policy path until it reaches its inflation target. This commitment to easy policy contrasts with the broad shift toward tightening we've seen across the rest of the developed world. The BoJ did make several tweaks to its policy on Tuesday that will allow for modestly higher rates and somewhat slower asset purchases, including allowing more flexibility in JGB yields around its 0% peg, adding more flexibility to its ETF program, and reducing the number of bank reserves impacted by negative rates. However, these moves don't change the overall picture much; they're small moves aimed at alleviating some of the second-order consequences of such a prolonged period of very easy policy (such as reduced liquidity in the JGB market and lower bank profitability), which will allow the BoJ to stay easier for longer. With inflation stuck near 0%, it'll likely take years of easy policy for the BoJ to reach its 2% inflation target, at best. The latest BoJ decision is essentially an acknowledgment of that reality.

The first set of charts shows how easy the BoJ remains, even as the rest of the developed world has shifted toward tightening. At this point, the BoJ is the only major central bank that is still printing large amounts to buy bonds as well as stocks, and it has kept 10-year interest rates pegged at 0% through its yield curve control policy (YCC) even as yields have risen elsewhere.

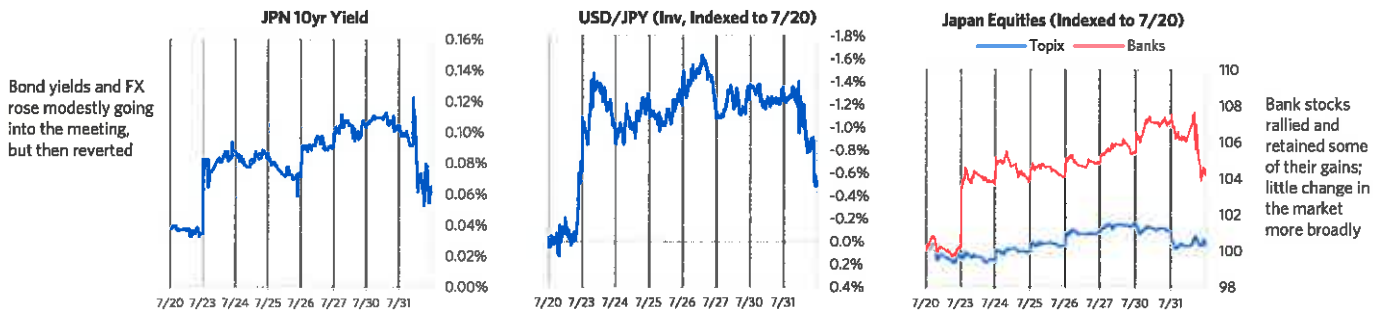


The BoJ made a couple of changes to its policy program in Tuesday's meeting, but they are small and don't signal a change in the overall very accommodative stance of BoJ policy. The table below goes through the suite of easing measures the BoJ is currently employing.

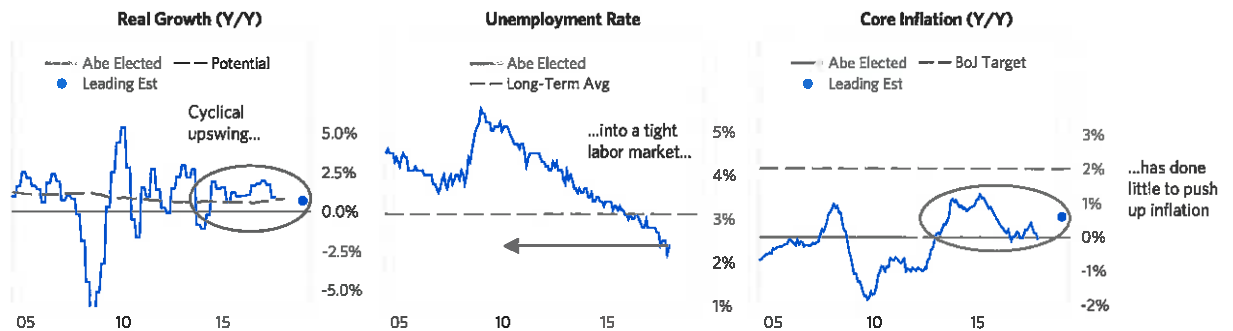
BoJ Policy Package

	Description
Yield Curve Control	The BoJ is targeting 10yr yields at around 0%. They will now tolerate yields moving up or down 0.2 percentage points from the target, up from around 0.1 before.
Forward Rate Guidance	The BoJ had previously committed to easy monetary policy but gave no timetable. It is now saying interest rates will remain extremely low "for an extended period of time."
ETF Purchases	The BoJ's policy has been to buy 6 trillion yen worth of stock ETFs a year. At the meeting, the BoJ gave itself more flexibility to increase or decrease purchases, potentially reducing the need to buy during rallies and giving itself more flexibility to support the market during downturns.
Negative Rates	The BoJ has targeted short-term interest rates at -0.1 percent. It will keep that target but reduce the number of reserves eligible from 10 trillion yen to 5 trillion yen, reducing the negative rate burden for banks.

Over the past week, the market action in Japan was consistent with expectations of the BoJ allowing modestly higher rates. Yields on 10-year bonds rose to the top of the range that the BoJ was allowing under its 0% peg, consistent with a rising likelihood of higher rates going forward. Bank stocks rallied, reflective of the impact a likely steeper yield curve would have on their profitability. Following the meeting, however, the moves by and large reverted, as the changes were on the small side of expectations.



Continued easy policy is consistent with Japanese conditions. Over the last couple of years, easy BoJ policy has contributed to the pickup in Japanese cyclical conditions, but policy makers have a long way to go to reach their inflation target. Japanese growth has been above potential for about five years, and this has led to the tightest labor market in years. The latest batch of Japanese stats (including employment and industrial production) was somewhat weaker, but these statistics tend to be choppy, and so were likely overstated. Even with this strong economic momentum, inflation has remained near 0% and far from policy makers' 2% target, as secular disinflationary pressures have offset this cyclical strength. Looking ahead, it'll likely take years of easy policy for the BoJ to reach its 2% inflation target, at best.



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