

# Bridgewater®

## Daily Observations

August 16, 2018

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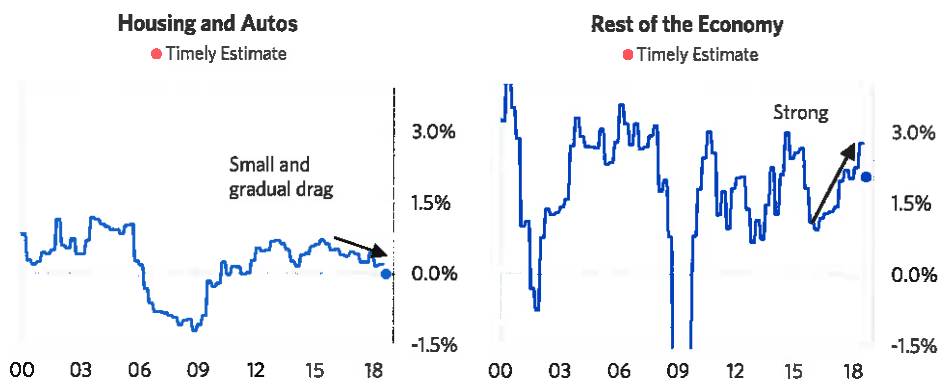
Karen Karniol-Tambour  
Matthew Karasz

### Fed Tightening Is Weighing on the Most Interest-Rate-Sensitive Parts of the US Economy, but Overall Growth Remains Strong

The Fed has been tightening gradually for some time, and this tightening is gradually flowing through and creating a steady drag on US growth. Rising interest rates weigh on the economy most directly by making it more expensive to buy on credit, and as rates have risen, household spending that is typically financed by borrowing—such as big-ticket items like autos and housing—has slowed. But since household borrowing has remained modest coming out of the financial crisis, the impact of fewer debt-financed household purchases has been moderate. Meanwhile, the rest of the economy has remained strong, supported by the fiscal boost and strong external conditions. Thursday's stats reflected this picture: industrial production continued to pick up in line with supportive business conditions, while retail sales were weak for big-ticket items, which are typically credit-financed, and strong for other items, and housing activity slowed. Looking ahead, the Fed is planning to continue tightening while the fiscal boost is approaching its peak, and external conditions are set to slow. The combination is likely to weigh on asset prices and the economy.

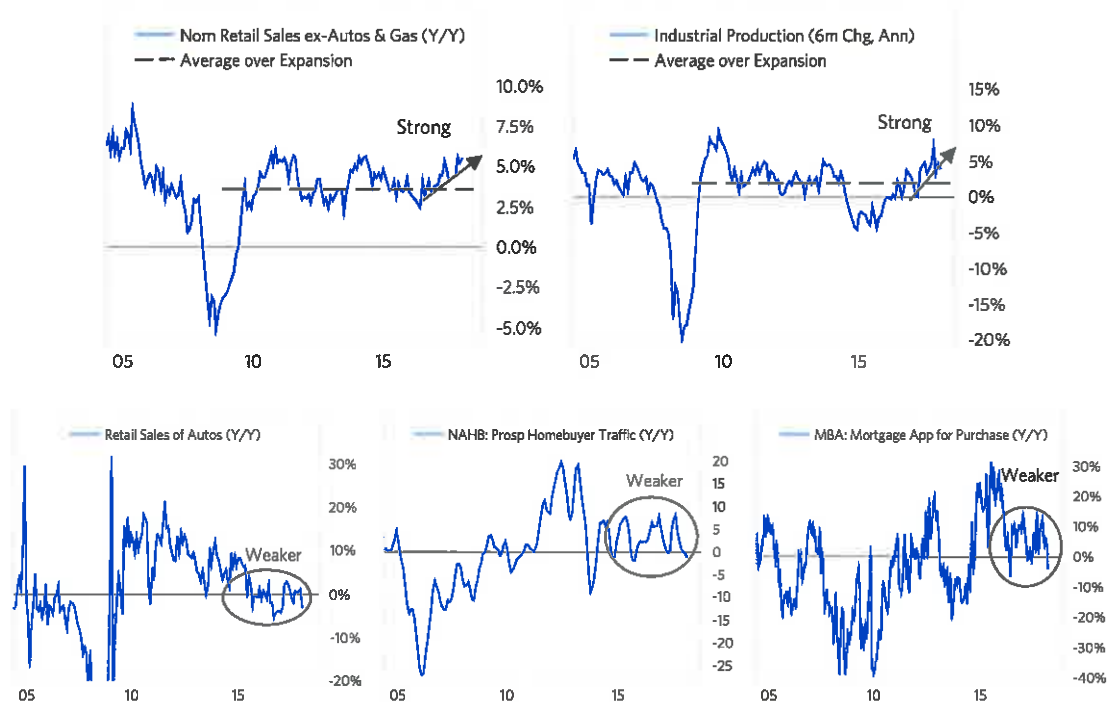
The first charts below show the offsetting pressures on the US economy. While the Fed tightening has been weighing on interest-rate-sensitive sectors for some time, the drag on the overall economy hasn't been that big. Plus, it has been more than offset by the pickup in the rest of the economy.

#### Contribution to Real GDP Growth (Y/Y)

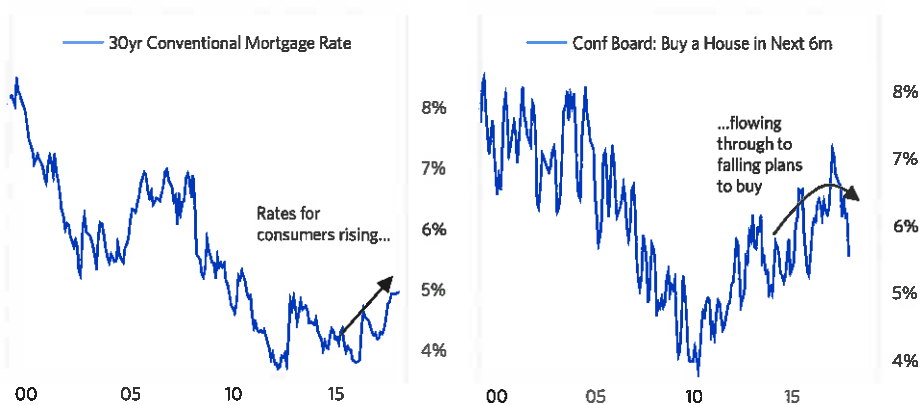


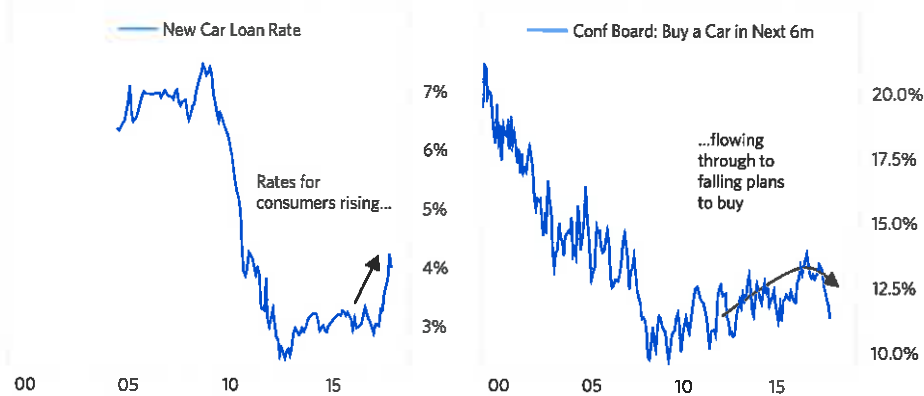
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Wednesday's stats provide a good, timely illustration of the Fed's tightening weighing on the most exposed sectors, but the rest of the economy holding up. The retail sales and industrial production reports suggested that household and business activity across most items continued to pick up through August. Meanwhile, we got various signs of slowing in interest-rate-sensitive sectors: auto sales continued to slow, the NAHB survey pointed to slowing home buyer traffic, and the MBA survey pointed to a continued slowing in mortgage applications.

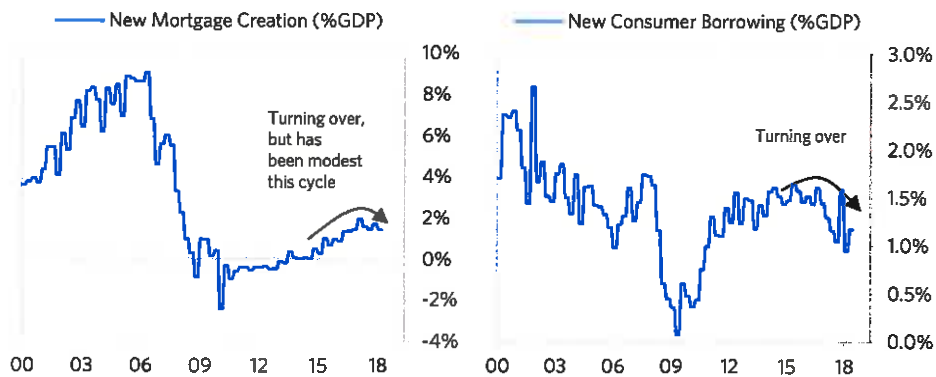


Taking a closer look at the household and auto sectors gives us more confidence that the slowing there is symptomatic of the Fed tightening. Over the past couple of years, rates facing households for these types of purchases have clearly risen and, in line with that, spending plans have turned over. This has knock-on effects for home construction, which has also been weak.

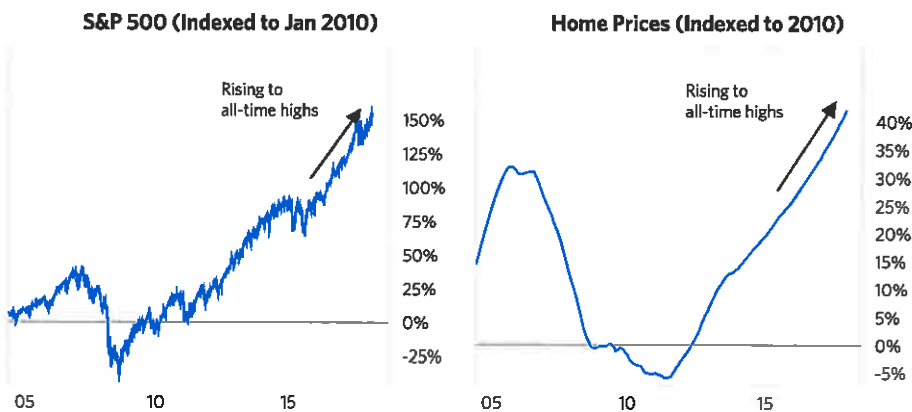




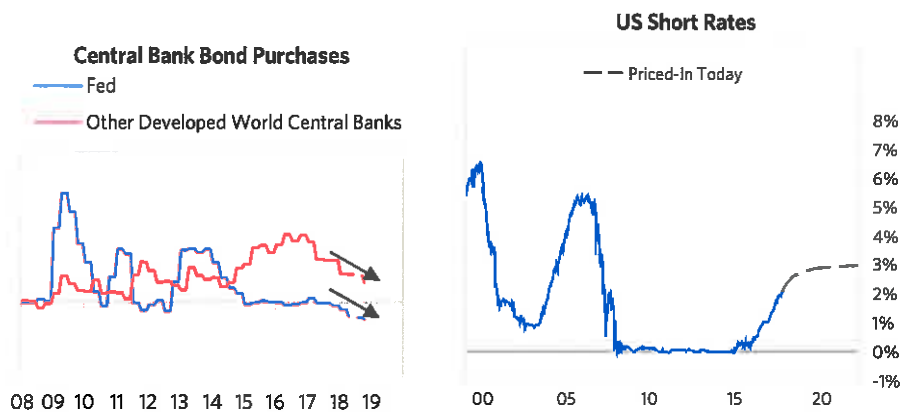
Another place we have seen the tightening beginning to bite is in household borrowing. However, since household borrowing has remained modest coming out of the financial crisis, the impact of fewer debt-financed household purchases has been moderate. This is particularly true of mortgages, which have historically been the main way households have borrowed.



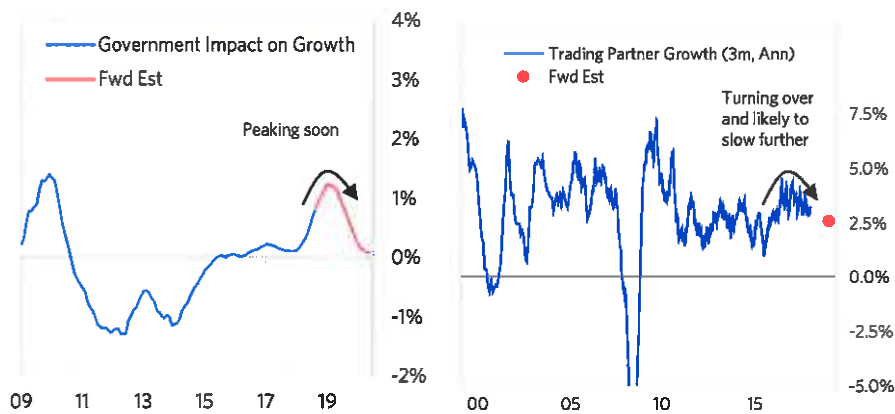
While the Fed's tightening has begun to hit interest-rate-sensitive spending and borrowing, so far it has been offset by other factors, like the strong economy, and so it hasn't led to a broader tightening of financial conditions. As we show below, home and stock prices, which tend to be more sensitive to growth, have continued to rally. However, as we'll describe below, we see conditions becoming much less supportive, and this is likely to weigh on asset prices and the economy more broadly.



Over the next year, the drag from the Fed's tightening is likely to increase. Tightening typically flows through with a 6-12-month lag, and so the tightening to date is likely to become more of a drag. In addition, the Fed is planning to continue winding down its balance sheet; it is discounted to raise rates about 70bps over the next year, including at its next meeting, and this tightening is set to occur in the context of a broader pullback in central bank liquidity. Taken together, these pressures will increase the headwind to asset prices and the economy.



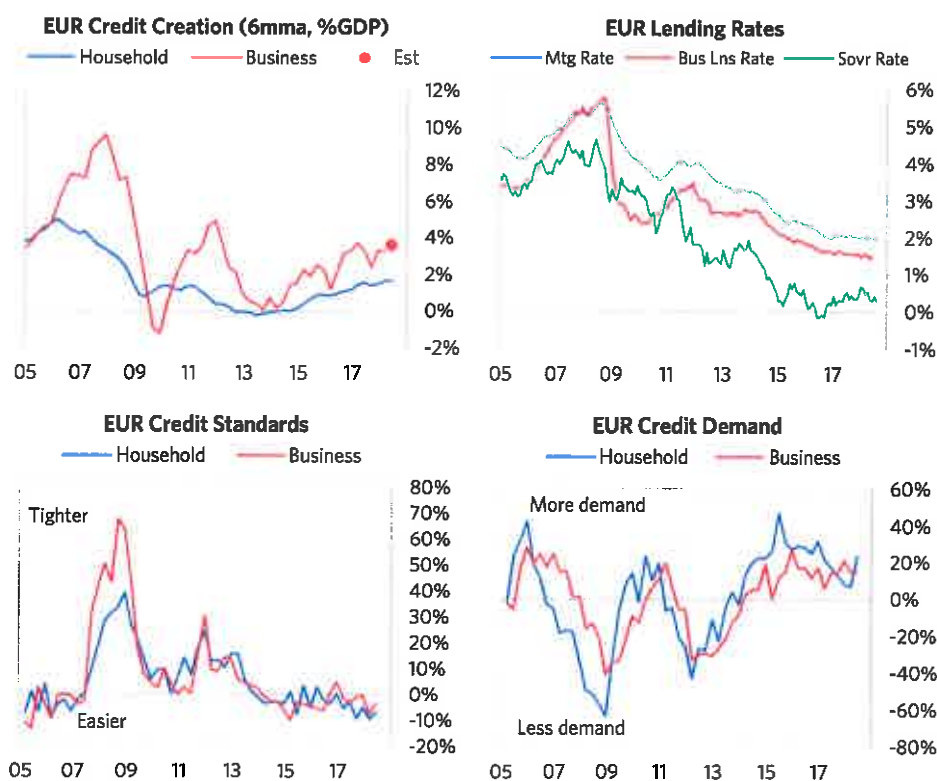
In addition, this tightening is set to hit at a time when the fiscal easing peaks and global growth slows. In particular, we estimate that fiscal policy will add about 1% to GDP growth this year, and this support will then fade over the course of next year. Growth in US trading partners has already begun to turn over, and it is set to slow a bit more over the next year.



## European Credit Conditions Are Continuing to Improve Even as the ECB Gradually Pulls Back

Melissa Saphier | Jake Peabody

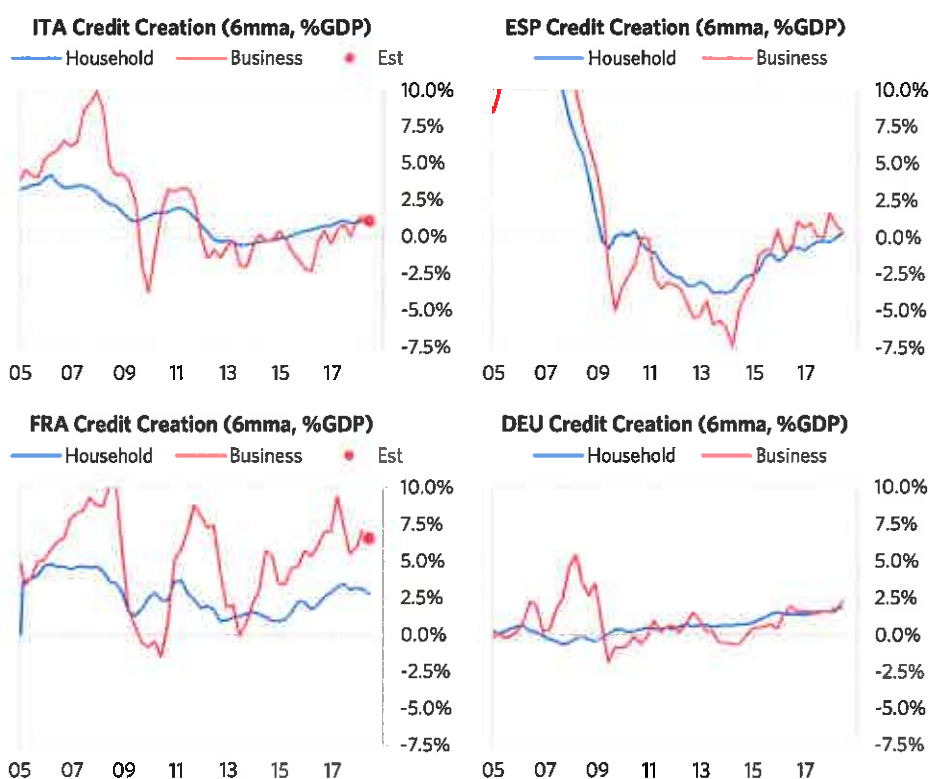
Over the past several years, the ECB's easing efforts have helped mitigate deleveraging pressures, ushering in a broad-based cyclical recovery aided by modest credit creation. Now and looking forward, the question is how well the recovery will hold up as the ECB removes its support—in particular, the degree to which the recovery in credit can replace the withdrawal of central bank money printing. Looking across Europe, the answer is essentially, "so far, so good." Since the ECB halved its printing at the start of the year, credit creation has continued to inch up, and both credit supply and demand dynamics remain supportive. In contrast to the US, which is much further along in its tightening cycle, the ECB's modest and gradual tightening to date has yet to hit rates facing most borrowers; European rates remain at lows. And because the ECB is currently tightening only by slowing its asset purchases, promising to wait a year or so before raising rates, the impact is likely to be more concentrated in the financial markets and to pass through less to real economy borrowing conditions. European banks are continuing to ease lending standards, and after substantial healing, their balance sheets look quite healthy. Banks also report that both household and business demand to borrow is rising, consistent with and reinforcing the ongoing cyclical recovery. So, our base case is that the gradual credit recovery should be sustained in the coming months as the ECB continues cautiously dialing back its stimulus, moving incrementally in line with how conditions evolve. The main risk is in the periphery, where the credit recovery is less entrenched and more vulnerable going forward. Periphery banks remain exposed to renewed sovereign stress, as we've seen recently in Italy, while Spain's banking system is particularly exposed to Turkey. So far, these problems aren't big enough to hamper the ability of these countries' banking systems to extend credit, but they represent an ongoing risk as the ECB gradually reduces its support.



### The Improvement in Credit Has Been Broad-Based across Countries and across Households and Businesses

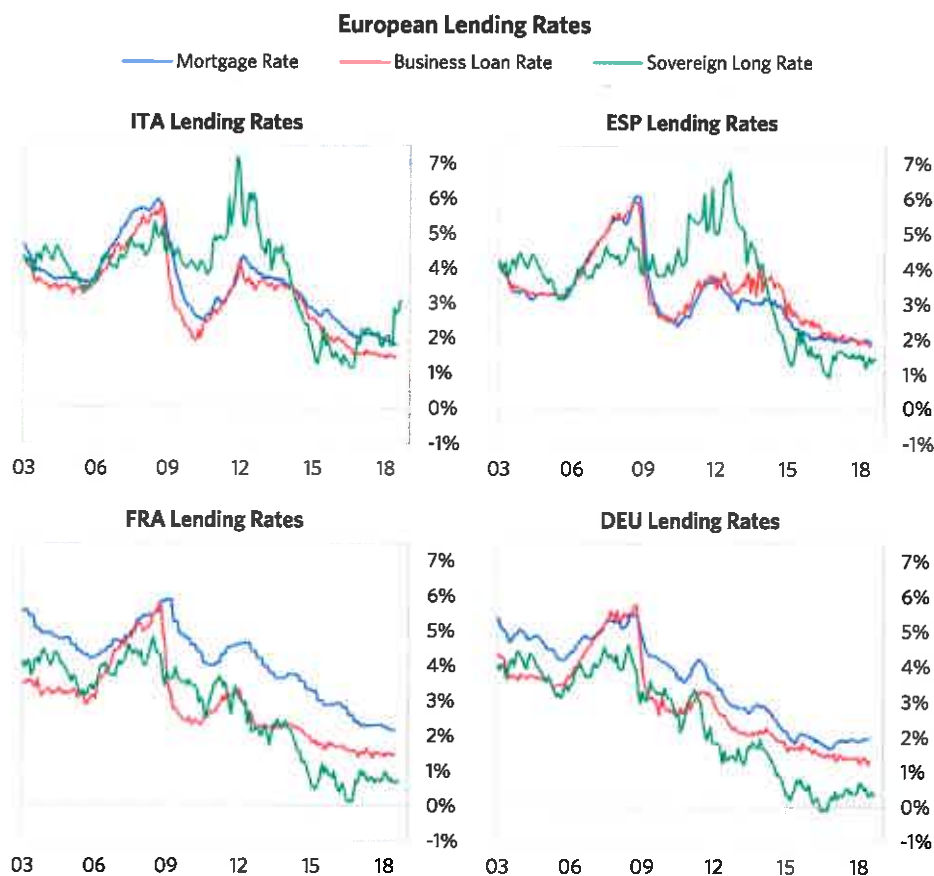
These improving credit dynamics through Q2 have been broad-based across the Eurozone, though the recovery in the periphery is at an earlier stage, with Italy the most vulnerable to tightening. French conditions are stronger overall, but credit-reliant French businesses in particular are also a source of vulnerability.

- In Italy, even with the rise in spreads that began in May and ongoing political uncertainty, household and business borrowing alike have been able to sustain their trajectories of slow but steady improvement to a modest pace. The Italian economy is muddling along for now, though its ability to withstand tightening is the most in doubt given its mediocre cyclical position and its longer-term economic and political problems (including high sovereign indebtedness and the lack of structural reforms to improve long-term growth prospects and outgrow the debt).
- In Spain, the prior deleveraging and overall economic contraction were the most acute, but with those adjustments behind it, the economy has made significant strides back toward more normal levels of activity. Thanks to this progress, households have very recently stopped deleveraging on net, and businesses have begun borrowing a bit.
- France is something of an outlier, with credit running much faster than overall growth, particularly in the corporate sector. The risks of overtightening are not as significant as in places like Italy, because French conditions overall are stronger, but France's reliance on credit does make the recovery susceptible to a slowing as the ECB pulls back.
- In Germany, where conditions stand out as very tight and low debt levels leave room to borrow, the private sector has nevertheless been slow to lever up throughout the expansion. But borrowing is gradually inching up to moderate levels as continued income and spending gains motivate further activity and borrowing.



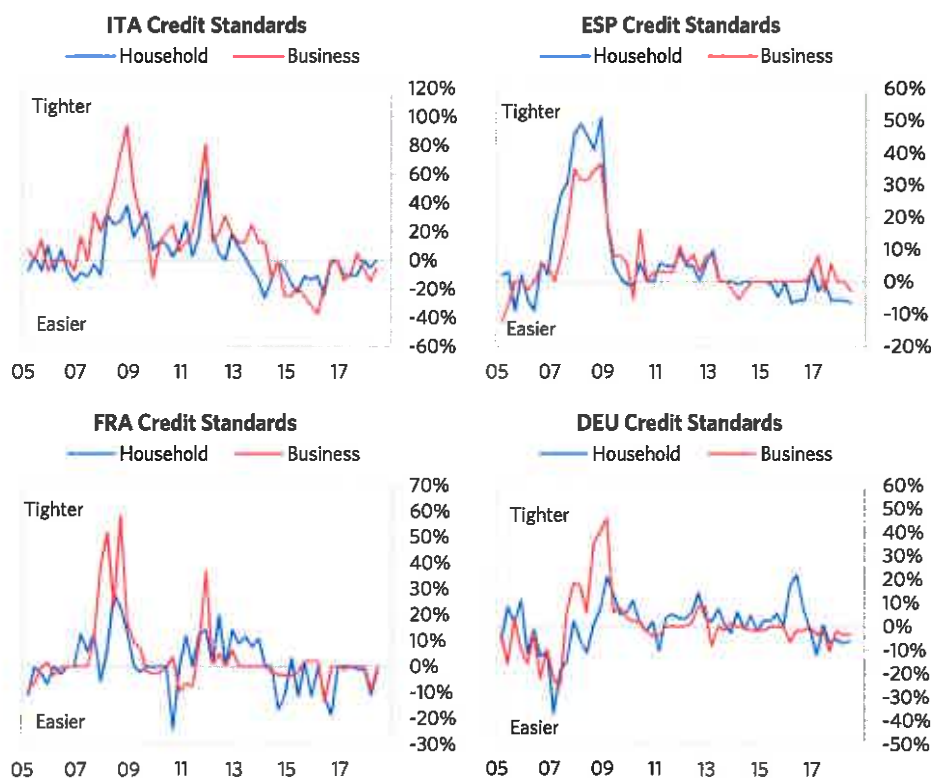
### So Far, the ECB's Gradual Tightening Has Not Flowed Through to Rising Rates Facing Borrowers

The ECB's tightening trajectory is extremely gradual, and so far, it hasn't flowed through to a rise either in sovereign rates or the rates facing borrowers. At this point, rates facing borrowers are at lows, while conditions are as strong as they've been in years—a stimulative combination. Even in Italy, where sovereign rates jumped up in May given the political situation, at least through June private sector rates have been largely unaffected, as you can see in the upper left-hand chart below. This is similar to what we saw in the early years of the euro crisis, when rates facing private sector borrowers in the periphery did not jump as much as those facing the stressed sovereigns. (Note that while looking at the rates side by side to see how they move together is helpful, the levels aren't directly comparable since the lending is at different maturities.) Of course, these real economy rates only capture interest charged on loans that were actually taken out, but taken alongside the continued easing of standards discussed below and the pickup in credit overall, this suggests pricing remains easy for broad swaths of borrowers. Going forward, we do expect the pullback of liquidity to flow through to rising rates, but there's plenty of room for this to happen and yet still have rates remain stimulative relative to conditions. And the ECB is calibrating its tightening to move in line with the improvement in the economy, not to get ahead of it.



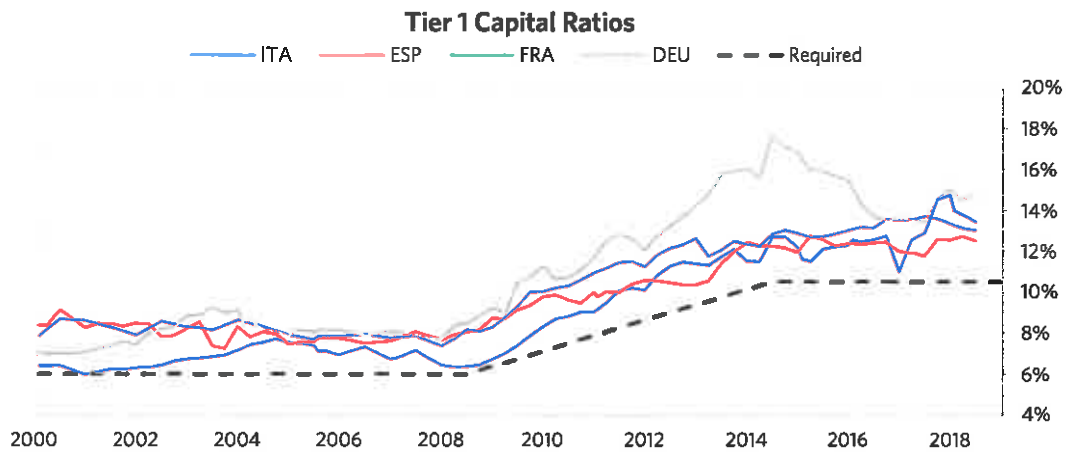
## European Banks Are Willing and Able to Lend, Even in the Periphery

After being hurt first by the financial crisis and then the acute phase of the euro crisis, European banks have healed substantially and stand ready and willing to lend. Especially since banks are the dominant credit channel in Europe, surveys of banks' senior loan officers are helpful triangulation points on credit supply conditions. The surveys through Q2 (conducted in June) show that even as the ECB's QE has begun to wind down, banks haven't begun passing on the tightening through raising their credit standards. That's the case even in Italy.

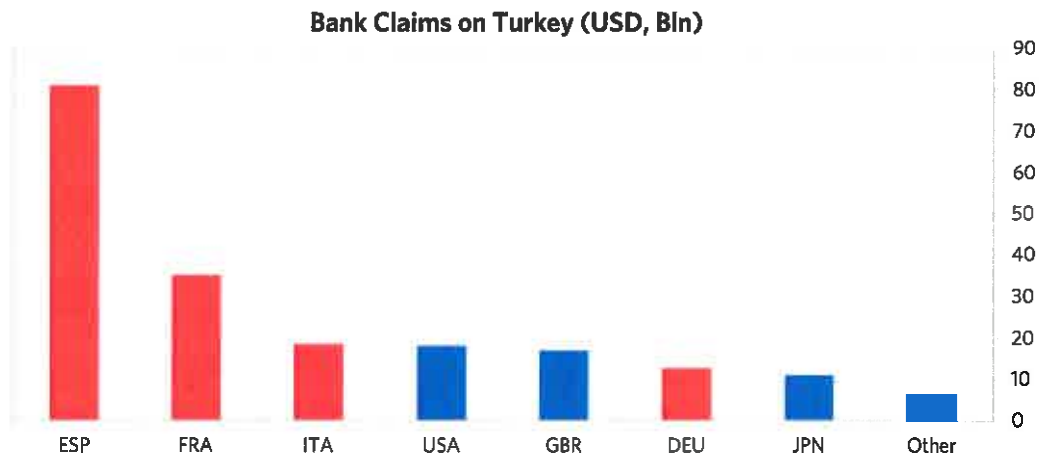


Part of the improvement in bank lending conditions stems from the fact the European banks have deleveraged and raised additional capital over the past few years, improving the system's solvency and reinforcing the banks' ability to provide credit. Even the weaker banks have raised capital in recent years, through both private and public sources. At this point, most banks hold capital in excess of requirements, as well as large liquidity buffers, and have room to expand their balance sheets. Crucially, though, the sovereign-bank linkage has not yet been severed, leaving the periphery banks exposed to renewed sovereign stress. The case of Italy today provides a reminder of this, though the recent rise in Italian spreads is small enough that Italy's banking system still enjoys a solid capital buffer, and there has not been a material adverse impact on its ability to extend credit.



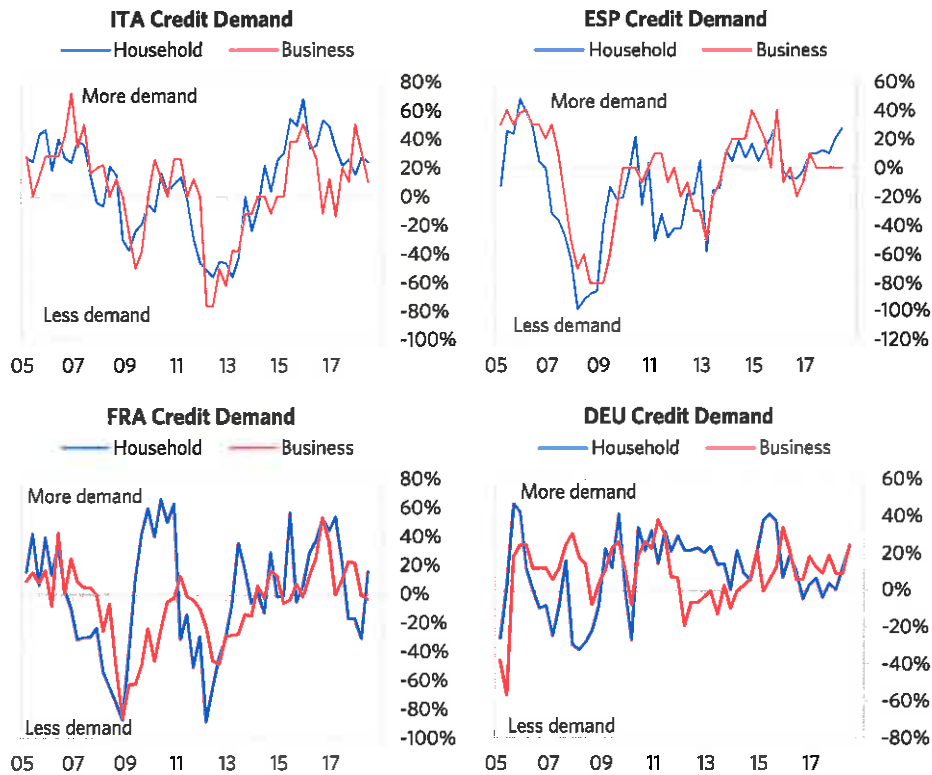


One additional risk is around European (especially Spanish) banks' exposures to Turkey. While these exposures are large enough to cause some pain in the form of reduced revenues and potential hits to capital, the potential for systemic problems is limited. The exposures are relatively small in size and are mostly held through ownership stakes in separately capitalized subsidiaries, capping the potential downside at the size of the ownership stake. Spanish banks are the most exposed, though even in the case of the single most exposed bank, BBVA, a complete write-down of their ownership stake in Garanti Bank would keep them far in excess of their capital requirements.



### Demand to Borrow Is Improving, Consistent with (and Reinforcing) the Solid Cyclical Recovery

As the European recovery has increasingly taken hold and become more broad-based, the private sector's appetite to borrow has gradually returned. Across Europe, banks are reporting increasing demand from borrowers (with the main exception being France, where borrowing is already running hot). This, combined with a banking system that is able to extend credit as described above, should allow the European credit recovery to be sustained even as the ECB gradually steps back.



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