Bridgewater®
Daily Observations
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Markets Are Discounting Extreme US Outperformance

After almost a decade during which the US has been ahead of the developed world in its recovery and its monetary policy, markets are pricing in that US outperformance will continue for many years. Over the last several months, pricing has become more extreme, as US yields have risen on a relative basis, US stocks have outperformed, and the dollar has rallied. At this stage, pricing is sufficiently stretched that this discounting of relatively extreme US strength is vulnerable to even a modest reversal in relative conditions. And going forward, we see growing pressures for the US's economic outperformance to fade. The Fed's ongoing tightening is weighing on growth as the boost from fiscal stimulation is set to fade, and further upside surprises are likely to be met by further tightening given already elevated levels of economic activity. In contrast, in other developed economies years of easy monetary policy have allowed significant healing to occur, while markets are pricing in many years of weak conditions ahead. As we look across markets:

- In the bond markets, US real yields are at their widest levels in decades relative to the rest of the world. Higher US short rates today are sensible given that the US is much further along in its cycle than the rest of the world, with tighter levels of activity and higher inflation rates than most of the developed world. What makes less sense is that this huge differential is priced in to remain in place long-term.

- In the stock markets, US economic outperformance over the last decade has led US earnings to grow significantly faster than earnings in other countries. At this point, forward analyst expectations are for a continuation of secularly strong relative US earnings growth at a time when the US economy is facing tighter liquidity from Fed tightening, US companies are more likely to experience wage pressures, and the fiscal boost is set to be behind us soon. In contrast, earnings in other developed economies have significant room to outperform as those economies continue to recover.

- The dollar, in contrast, does not appear to be as stretched. Even if US economic outperformance moderates going forward, the dollar should continue to benefit from tighter liquidity for the foreseeable future given where the US is in its cycle, with this support coming as the dollar is broadly priced to depreciate versus developed world peers.

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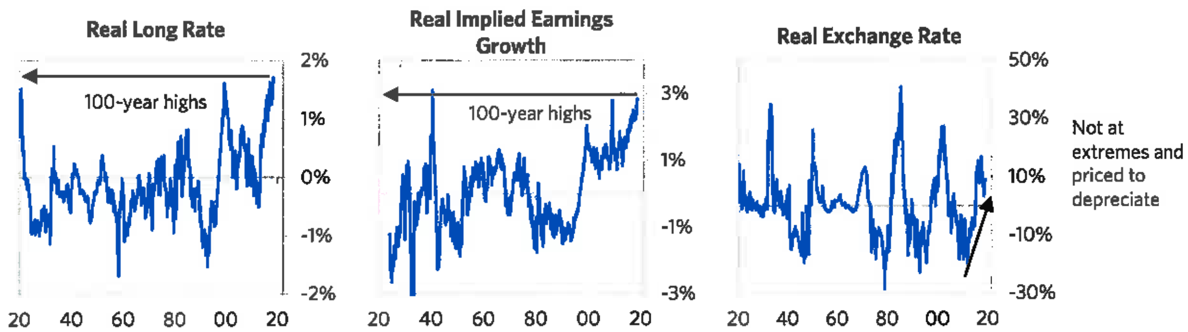
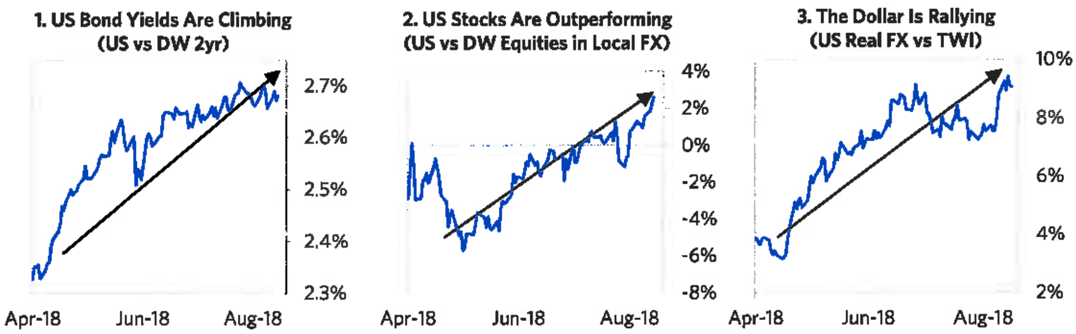
The charts below highlight how extreme the pricing is for bonds and equities, with both as wide as at any time in the last century. For bonds, we compare real interest rate differentials. For equities, we look at a rough measure of how quickly earnings need to grow to break even on holding equities relative to bonds. Our rough valuation for the dollar is closer to normal, and one important implication of higher relative yields against a backdrop of economic outperformance is that it will help incentivize investment into the US, providing a support to the exchange rate at a time when it is priced to depreciate.

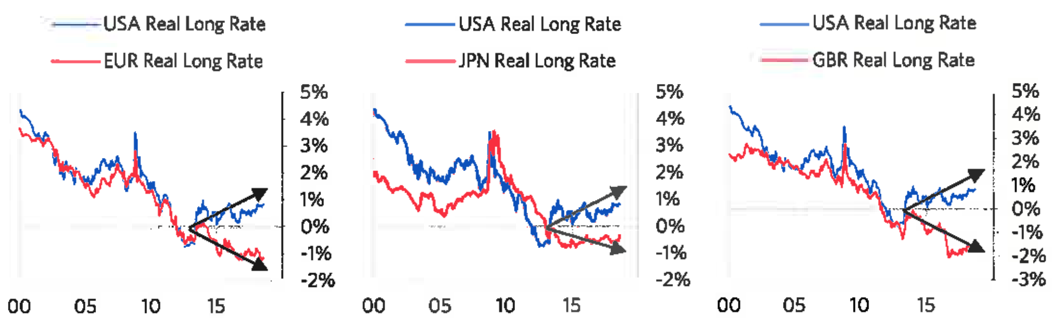
USA vs Rest of Developed World



US yields, stocks, and the dollar have all reflected the strength in US conditions over the past several months, pushing the pricing of relative economic performance to even more extreme levels versus the developed world.



In the bond markets, this reflects that markets are discounting the US to continue to run historically tight monetary policy versus its developed world peers for many years. As shown below, there exists a divergence in longer-term pricing between the US and every major developed world economy. The US is priced to tighten over the next several years, while other major economies are priced either to increase only very modestly or to remain flat. This pricing looks pessimistic to us given that monetary policy remains extremely easy outside of the US while other economies have also made significant progress in their recoveries.



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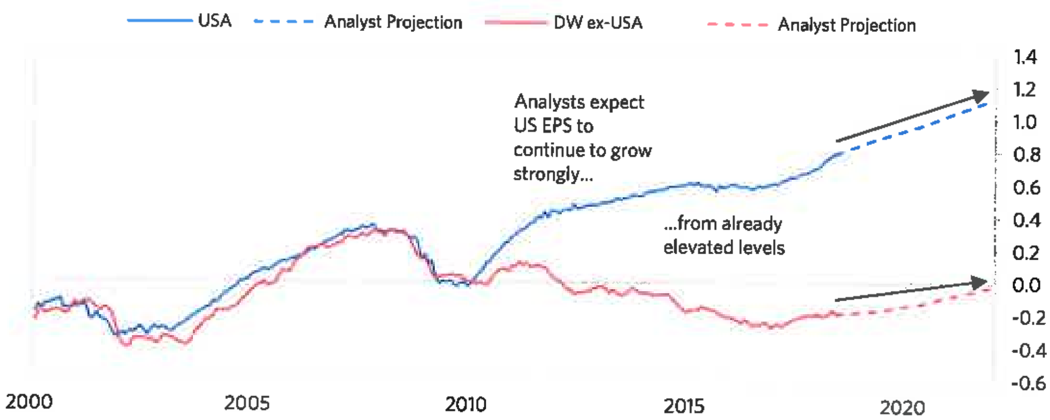
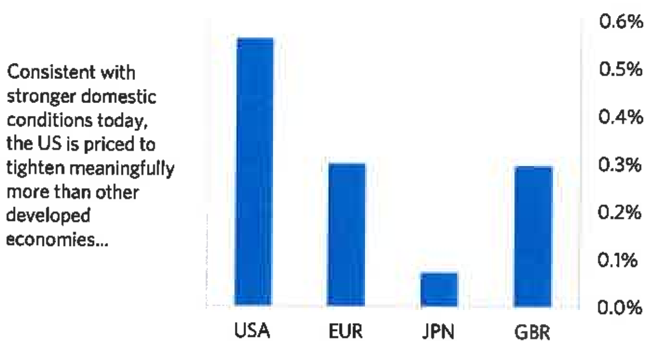
In the equity markets, following a period of significant outperformance, expectations are for US equities to continue seeing strong relative earnings growth relative to developed world peers, widening a divergence that has already reached quite extreme levels. As shown below, analyst forward expectations are for US EPS growth to continue significantly outpacing other developed world economies.

Equity EPS (ln, Indexed to 2010)

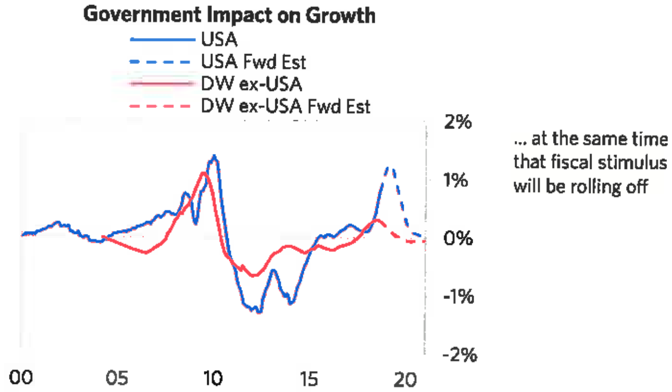


Given that markets are already pricing in the US to continue outperforming for many years to come, US assets are particularly vulnerable to marginal changes in conditions. US growth will continue to be weighed down by the Fed's ongoing tightening, at the same time that the boost from fiscal stimulation is set to fade. As shown below, the US has run more expansive fiscal policy than the rest of the developed world over the past year, supporting US growth relative to other economies. But going forward this impact will fade, creating a drag on growth of about 1%.

2yr Discounted Tightening



Government Impact on Growth



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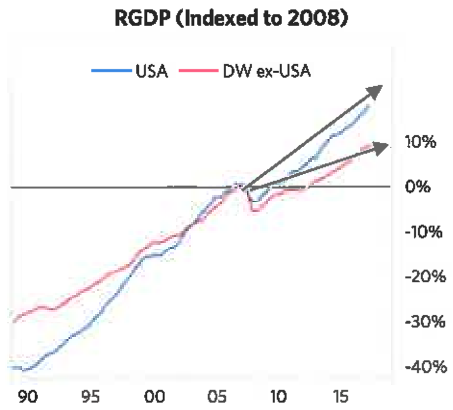
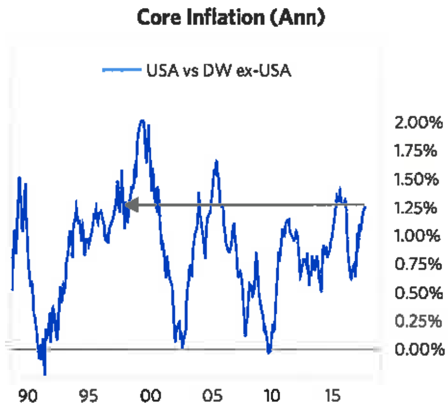
Additionally, already elevated levels of economic activity means that any upside surprise to US growth will be met by further tightening. After years of strong relative growth, the US economy is the furthest along in the developed world in its cyclical expansion. The overall level of economic activity is elevated, and core inflation is higher in the US than elsewhere.





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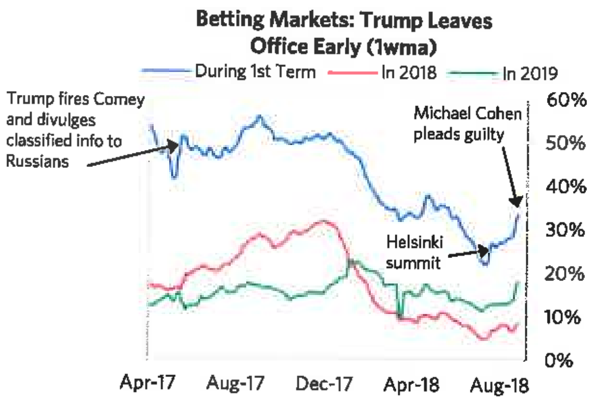
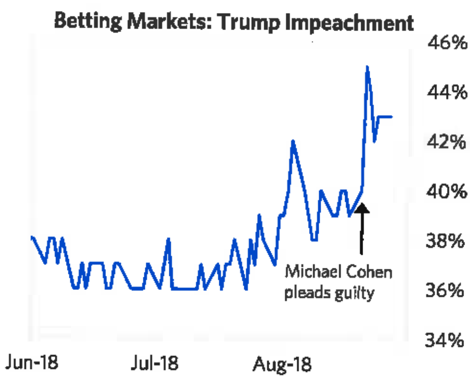
Betting Market Implied Odds of Trump Leaving Office Early Rose Last Week but Are Still Pretty Modest

***Jason Rotenberg | Matthew Karasz** | Jordan Nick*

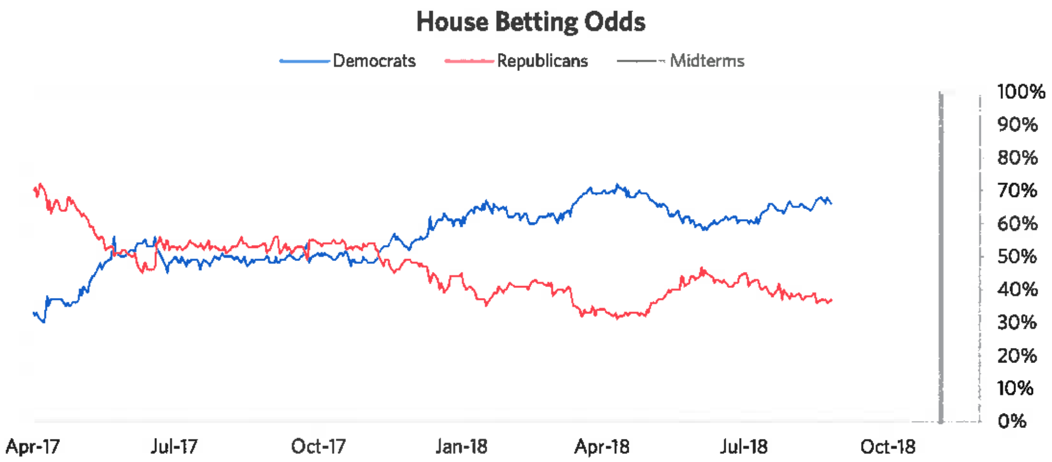
We are not political experts and don't form market views on political events, but we need to stay on top of major political events in the markets we trade so that we can make sure we're adequately diversified against the potential outcomes and incorporate the estimated impacts once they've become clear. Looking at how political betting markets are pricing political events and how asset markets more broadly react to changes in these probabilities is one way we find useful to triangulate whether a political event is becoming a major market driver. Last week's news increased the priced-in odds of Trump leaving office early, but they are still pretty modest, with odds of an early exit rising to 34% and odds of impeachment in the House rising to 43%. The market action was muted as the most recent news broke. More generally, it's unclear to us how much a Trump impeachment or early exit would move markets, and if so, in which way. For example, the events leading to Nixon's resignation added some short-term volatility to markets, but they were overshadowed by economic drivers like the oil shock and a meaningful rise in interest rates. Below, we show the modest changes in betting markets and financial markets in the wake of the most recent Trump news, and we also take a quick look at the market action during the events leading to Nixon's resignation.

An impeachment vote would only require a majority in the House of Representatives, and the recent rise in the odds of impeachment in part reflects the rising probability of the Democrats taking the House. Actually removing Trump from office would be much more challenging. The legal bar for bringing criminal charges to a sitting president is extremely high, and it would take a two-thirds majority in the Senate to remove Trump.

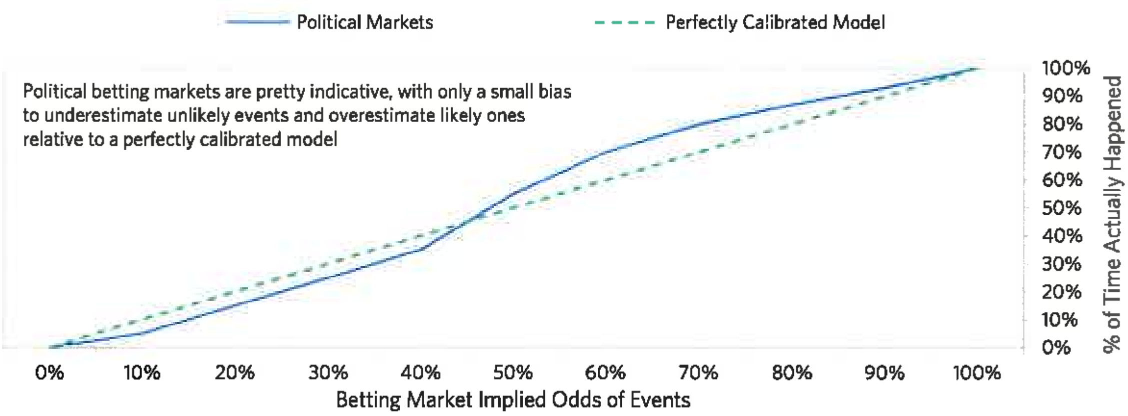




It's also notable that the Democrats' chances of winning the House have been picking up a bit and now stand at 66%, which is a key driver of the odds of impeachment but would only be a first step in removing Trump from office.



Political betting markets are small and relatively illiquid, and as a result they are likely to be much less efficient than the financial markets we trade. That said, the research we've seen would suggest that they are still pretty well calibrated and generally indicative of what the odds of various events are. We show one example below, from a chart from a paper published by Page and Clemen in 2013 that looked at 300 political betting markets. This analysis would suggest that events with 10% odds in betting markets happen roughly 10% of the time, events with 20% odds happen roughly 20% of the time, and so on. It showed some bias for these markets to underestimate unlikely events and overestimate likely ones, but one that's small relative to how indicative they tend to be.



[1]

[1] Page & Clemen, 2013, "Do Prediction Markets Produce Well-Calibrated Probability Forecasts?" *The Economic Journal*.

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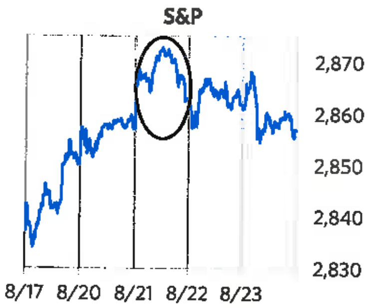
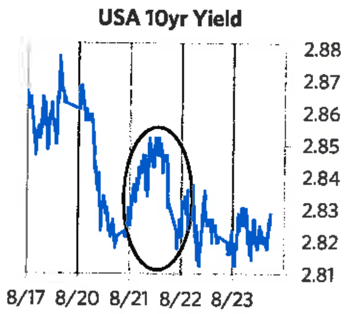
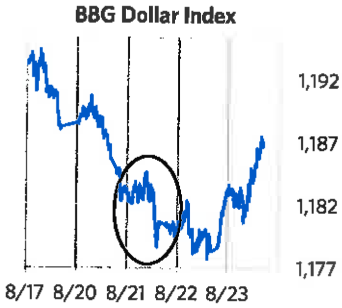
Muted Market Last Week on Trump News

More broadly though, financial markets remained relatively quiet when the news on Cohen broke. The fall across US assets was small and does not stand out that much relative to the moves across the week.





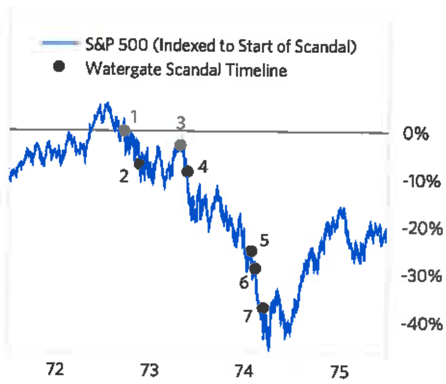


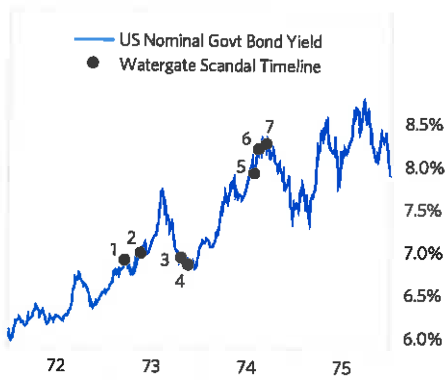
The Nixon Analogue Suggests the Potential for Some Volatility, but It Was Not the Key Market Driver

Even if Trump does get removed from office, it's unclear that it would necessarily cause major market moves. The resulting market action would depend on a variety of factors, including how long the process took to play out (i.e., a protracted, paralyzing battle versus something swift), who Trump's potential successor would be, and the differences in their economic policies. One example we've given in previous *Daily Observations* was the market moves around the Nixon Watergate scandal; it's a good case study where politics probably did matter to markets, causing some short-term volatility but not nearly as much as the economic environment.

The following charts show the equity market through the Watergate years, along with oil prices, bond moves, and the dollar. The US equity market was down materially from the time of the Watergate break-in to Nixon's resignation, but this likely overstates any potential impact of the scandal, as the environment was very bearish for equities. While Nixon's problems did not help, the oil shock and the large rise in interest rates were responsible for the majority of the decline in the equity market during the Watergate period.

Events:
1. Watergate burglar McCord admits to govt involvement
2. Senate begins hearings
3. Saturday Night Massacre
4. "I am not a crook"
5. Supreme Court orders Nixon to release tapes
6. Nixon resigns
7. Ford pardons Nixon





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