

Bridgewater®

Daily Observations

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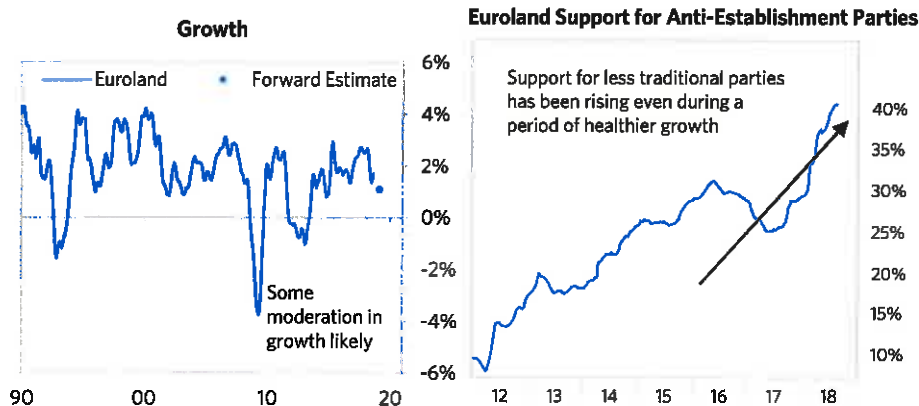
Jason Rotenberg
Melissa Saphier
Kate Dunbar

Weakening Economic Recoveries and Rising Political Risks in Europe Look Likely to Reinforce Each Other

We expect to see a moderation in growth across Europe, making it likely that the gradual recovery and improvement in unemployment rates across the depressed periphery will slow or halt. While monetary policy is still easy, it is becoming less so as the ECB winds down QE. In addition, global liquidity is being pulled back, spreads have widened a bit in some countries, asset prices have flattened off, and trade partner growth has moderated. These changes probably aren't big enough yet to cause a contraction, but they are likely to slow the expansion at a time when much of Europe remains depressed.

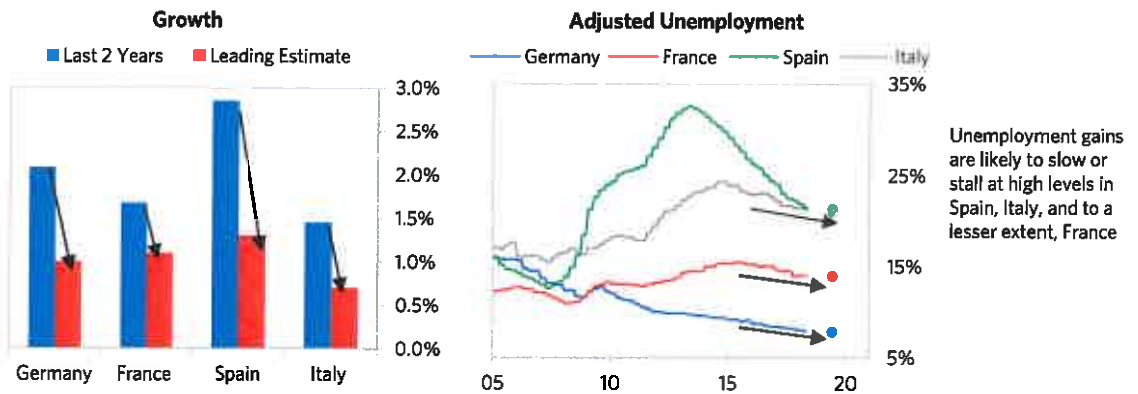
Effective political collaboration is only likely to get more challenging if the European expansion slows as we expect. Levels of support for anti-establishment parties have been rising in an environment where many depressed economies were improving, and they are more likely to continue to rise if this improvement stalls. The latest Italian elections have already brought in a more anti-establishment government, leading to a more aggressive confrontation with European institutions and a widening of credit spreads. Looking forward, the October negotiations over the Italian budget stand out as the likely next major source of confrontation. Recent political developments in Spain have also increased fragmentation and make an election as early as May 2019 more likely. And as we look ahead to 2019, some of the key posts at major European institutions will be up for grabs, including a new head of the ECB and a new head of the European Commission.

The charts below show a snapshot of Europe's economic weakening alongside its rising political risks. On the left, you can see how European growth has already slowed some along with our expectations for further moderation. On the right, you can see the continued rise in support for anti-establishment parties, which has been climbing to high levels in recent years even as economic conditions improved.



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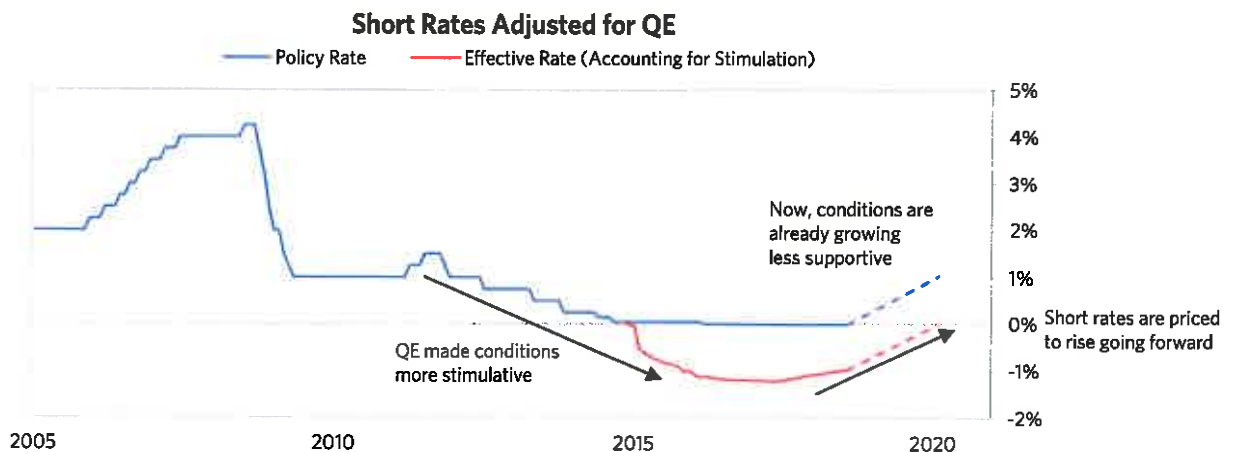
We expect that the transition from strong growth to weaker growth going forward will be broad-based across the major European economies, as you can see in the left-hand chart below. Prior strength allowed depressed economies to begin recovering from their severely depressed post-crisis conditions, while creating some risks of overheating in Germany. The risk today seems tilted more toward stagnation in the periphery, where there is still a long way to go to reduce unemployment and broader slack. The right-hand chart below helps put these very different levels of activity in context, showing our measure of unemployment across European economies, adjusted to make them more comparable across countries. By our estimates, unemployment is likely to stagnate everywhere, but Germany can easily withstand that, while other countries cannot. These stark differences in activity levels make it hard to set appropriate policy for Europe overall and increase the potential for economic and political tensions, as we are seeing.



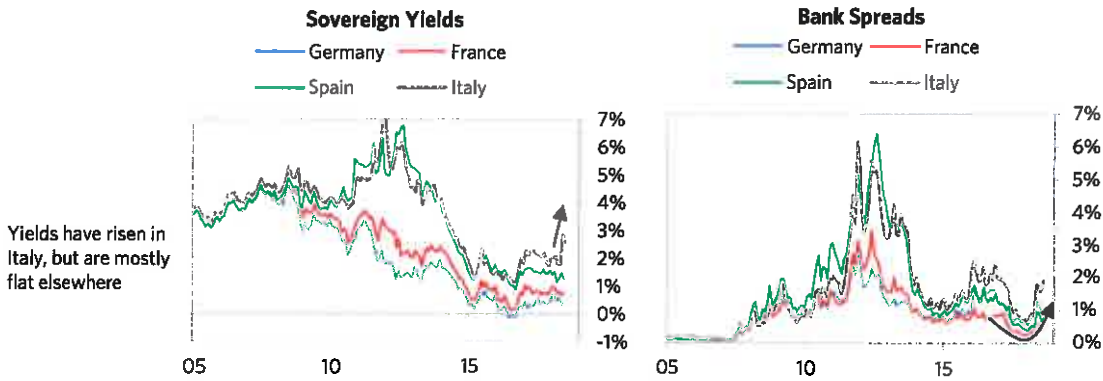
Domestic and External Conditions Are Becoming Less Supportive

Scanning across the drivers of growth, all look to be shifting from extremely stimulative to somewhat less so. So far, it doesn't look anything like a dramatic enough shift to derail the recovery, but the mix of conditions going forward will clearly be less supportive.

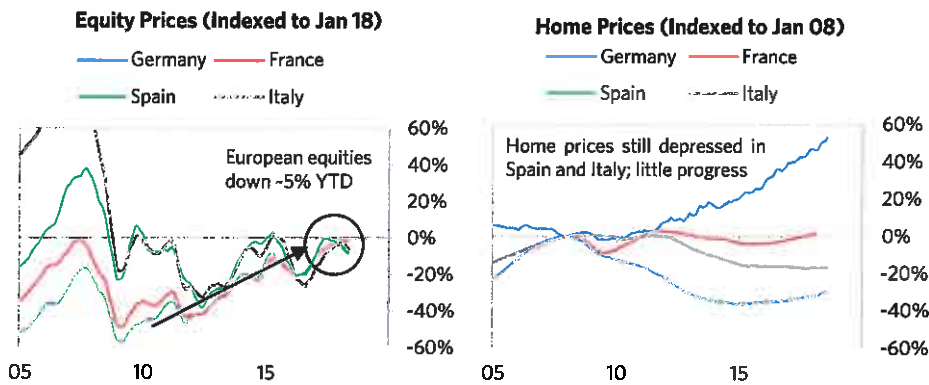
First, after years of all-out easing, the ECB is now pulling back very cautiously. They are on course to end QE in a few months and then begin raising rates in mid-2019. The chart below shows our combined measure of monetary policy, roughly translating QE into comparable terms with short rates, based on our understanding of how QE flows through. While by no means exact, it gives an approximate sense of how policy is becoming incrementally less supportive. And, of course, this domestic tightening is also occurring in tandem with a broader rollover of global liquidity as the Fed tightens simultaneously.



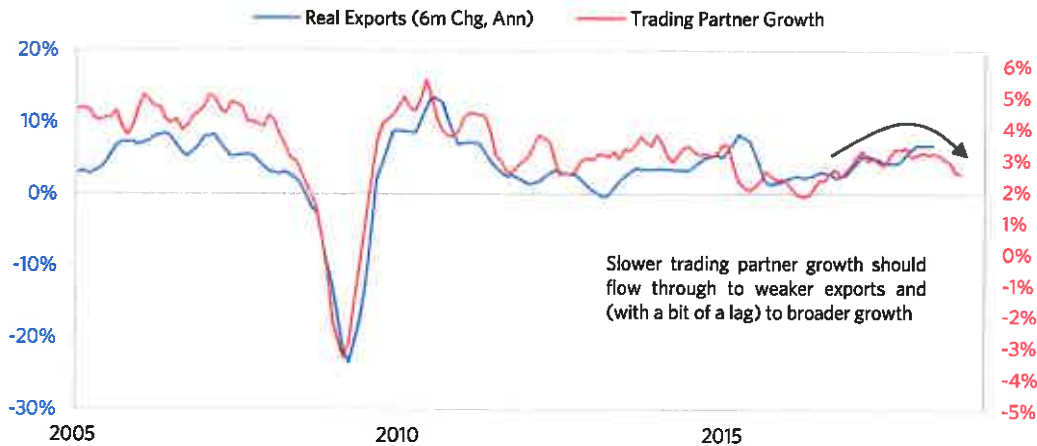
As tightening flows through, it is likely to put downward pressure on asset prices and upward pressure on rates facing borrowers. For the most part, the flow-through of tightening to rates facing borrowers is still ahead, but Italy in particular stands out as a pocket where the combination of fewer ECB purchases and rising political tensions has led to some tightening. Italian sovereign spreads have jumped to their highest levels since before the start of QE. Italian bank spreads have been affected on the margin, as well. The exposures of European banks (especially in Spain and France), even if not systemic, on the margin should make banks more cautious in extending credit.



Years of stimulation through QE (which works through asset markets) led to an appreciation in equities and home prices, creating or increasing the wealth effect. While the changes aren't big, since the beginning of this year, equities have started to flatten off and are on net down for the year. Home prices remain at a much earlier stage in their recovery, well below their pre-crisis peak in Spain and Italy, with only a very modest upward trajectory, and are hovering at pre-crisis levels in France. Home prices are most supportive in Germany, the country that needs stimulation the least.



Strengthening global growth has been a persistent support across Euroland over the past few years, but has moderated this year as global conditions have become less stimulative, and exports have started to flatten out along with it. As global liquidity tightens further, there's limited room for external growth to be much of a support. The flow-through to the economy more broadly happens with a bit of a lag, as incomes fall, leading to less spending. With exports accounting for 49% of GDP, Europe is particularly exposed to global growth, including material ties to EM economies.



Political Risks and Fragmentation Reinforce the Challenge

There are, of course, a lot of drivers to the rise in populism in Europe over the past decade, with economic conditions being one key driver. Populism has been rising even as all economies recovered, and it is likely to see even more support in an environment of somewhat softer growth and high and stagnant levels of unemployment. Challenging domestic politics in a number of countries and divergent economic conditions have already created ongoing risks in Europe, and this is happening at a time when a number of important decisions are about to be made over the next year or so—including who should replace Mario Draghi. To the extent that economic progress slows, that would only increase the challenge.

Abridged European Political Calendar

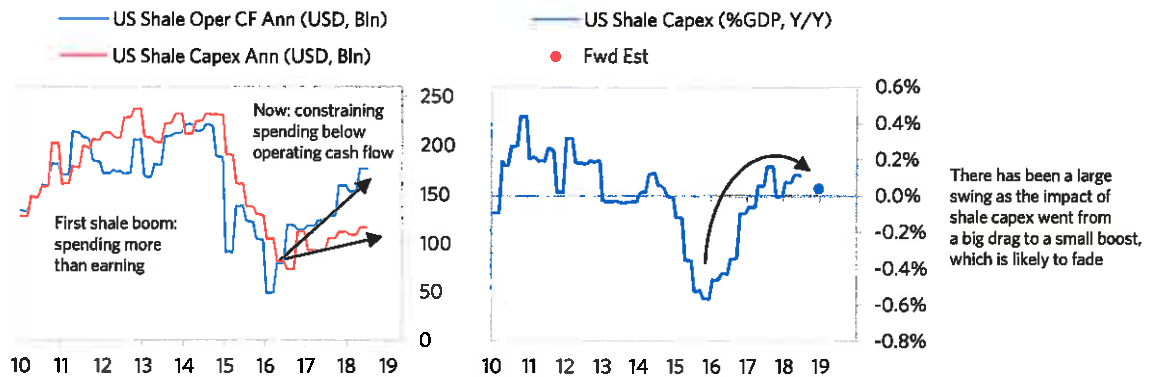
Date	Occasion	Key:
20-Sep	EU27 heads of state to discuss Brexit	Brexit
2018 15-Oct	Deadline for Italy to submit draft budget to EU	ECB Leadership Transition
31-Oct	EU self-imposed deadline for end of bilateral Brexit talks	Budget Decisions
31-Dec	Chair of the ECB Supervisory Board, Danièle Nouy, steps down	
29-Mar	UK exit from the EU	
2019 23-26 May	European Parliament elections	
31-May	Chief Economist Peter Praet ends his term at the ECB	
31-Oct	Mario Draghi's term ends; handover to new ECB president	

US Shale Capex Has Been a Boost to Growth That Is Likely to Fade

Sam Haber

Given their fast response times, US shale producers have had a large impact on US fixed investment and on oil production globally in recent years. As oil prices rebounded, production rebounded to new highs, while investment recovered as well, but to a lesser extent. The boost in production relative to investment is in large part due to efficiency improvements created during the previous low-price period, as well as producers' focus on the most productive shale basins. Equally important to producers' spending plans have been investors, who were burned by the highly leveraged shale growth of the last oil cycle and have since forced producers to focus on fiscal discipline and organic growth, constraining capex spending to be in line with current operating cash flow. Even so, this recovery in spending has had a substantial impact on US growth through investment over the past two years, going from a 60bps drag to a modest boost.

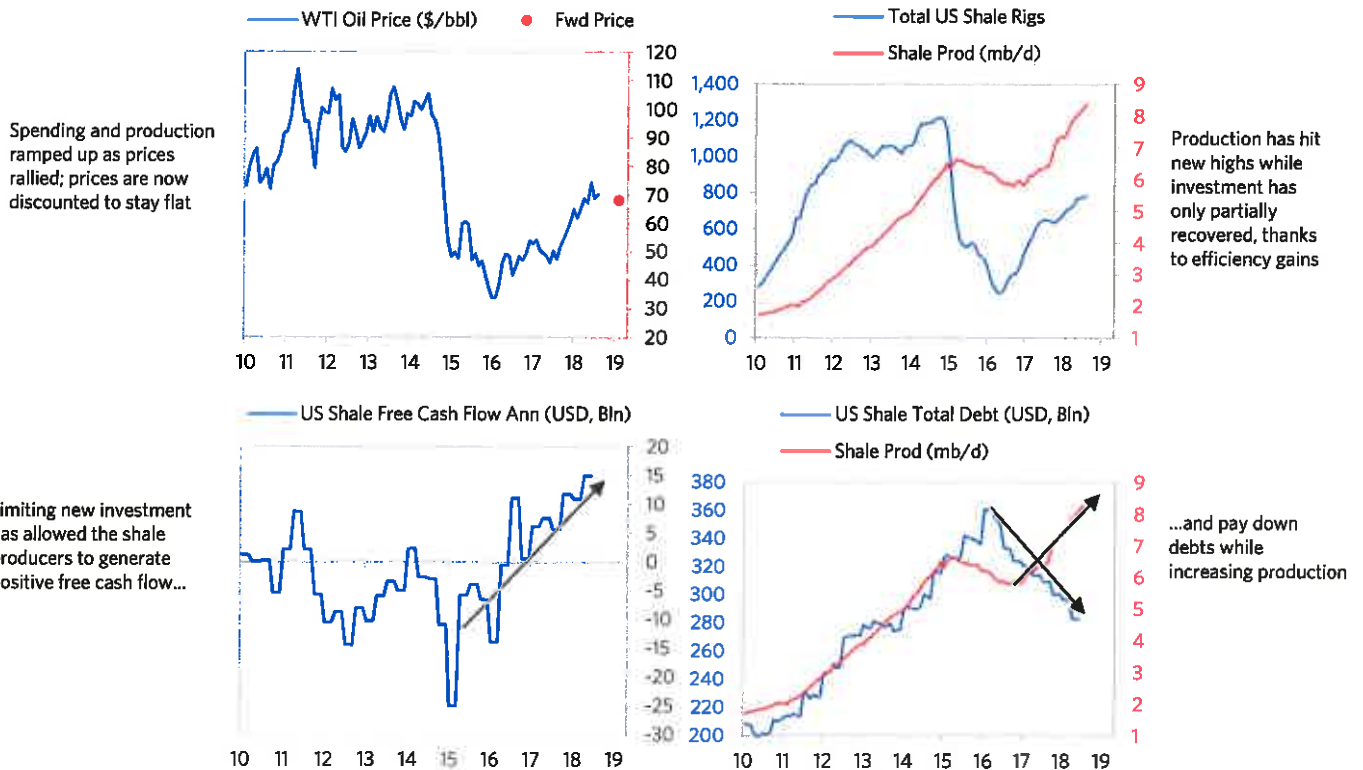
While the oil industry and oil prices impact growth in various ways, investment in new production is one of the most important ways and worth examining on its own. Looking forward, oil prices that are discounted to stay roughly flat from here, combined with an emphasis on fiscal discipline, mean that the boost to growth from shale capex is unlikely to be sustained in the next year. Additionally, this restraint on spending also puts a ceiling on how quickly shale can grow in the near term, at a time of already low spare capacity in the oil markets, and contributes to markets' vulnerability to a price shock.



Capex Has Picked Up as Oil Prices Have Rallied, but with More Restraint Than in the Previous Cycle

As mentioned above, the past two years have resembled a classic upswing in the oil investment cycle, particularly for the fast-moving shale producers, as higher prices (resulting from strong, synchronized global oil demand growth up against constrained supply growth due to prior capex cuts) resulted in increased investment and production. However, this cycle looks meaningfully different from the first shale boom from 2010 to 2014. During the first shale boom, most shale producers were significantly free cash flow negative (spending on capex in excess of their operating cash flow) even at \$100/bbl and were making up the gap through debt issuance, primarily in the high-yield debt market. Production growth was the primary goal at the time, and the breakeven cost of production for most was well above \$80/bbl.

When oil prices fell in 2015, in large part due to the unexpected growth in shale supply, most people at the time thought shale production would decline significantly. Instead, the industry radically improved its processes, focusing on efficiency and bringing down breakeven prices, such that while rig counts fell 85%, production only fell 15%. This has continued into this cycle—while shale production has reached new highs, rig counts and capex have only recovered to around 75% of their peak. The big change this cycle has been an emphasis on capital discipline—investors and producers are emphasizing sustainable growth and returning money to shareholders. For the first time in their history, shale producers are meaningfully free cash flow positive, and they have grown production to new highs while substantially paying down their debt. The flip side of this shift in behavior, combined with prices that are discounted to remain flat, is that capex growth has been meaningfully slower than in the last cycle and is unlikely to increase. Looking forward, this means that the impact on US growth will be smaller, and that limited investment will create headwinds for how fast shale production can grow in the near term.



The theme of capital discipline over investment has been consistently emphasized in shale producers' earnings calls this quarter:

Marathon: "Our outstanding operational execution coupled with our capital discipline and higher oil prices enabled us to generate about \$250 million of organic free cash flow during the second quarter, building upon our already peer-leading financial flexibility."

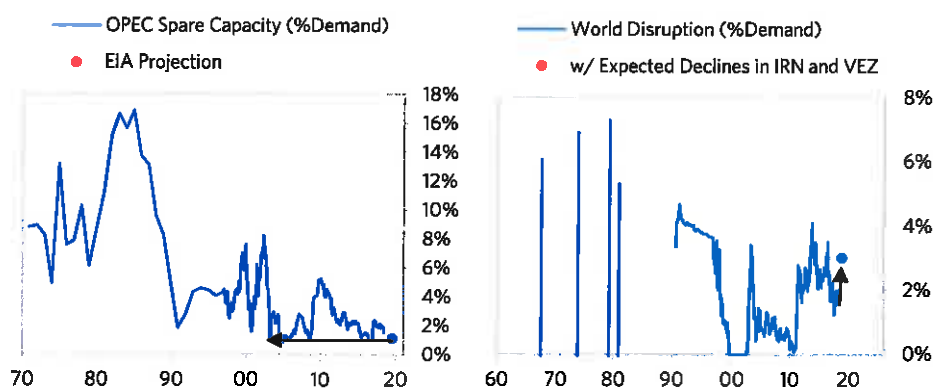
Devon Energy: "With our go-forward capital plans, I also believe it is worth highlighting that even with the recent rise in oil prices, we have no plans to add incremental activity in 2018...The management team at Devon is laser-focused on optimizing returns and ensuring capital efficiency for our shareholders. We will continue to attack costs and transition our product mix towards higher-margin barrels. We will be disciplined with our capital allocation and generate significant free cash flow."

Anadarko: "Anadarko's commitment to return value to shareholders was further evidenced by the completion of the first \$3 billion of share repurchases and the recently announced \$1 billion expansion. This is complemented by our announced plans to retire an additional \$500 million of debt as we attempt to shrink the balance sheet in a coordinated manner."

EOG: "The Board of Directors approved another increase to the common dividend. The current 19% increase, coupled with our previous 10% increase last February, brings our total dividend increase to 31% this year...We don't have any specific guidance for 2019 or forward. The methods and the way we're going to manage the company is we're going to stay disciplined, and we're going to stay focused on returns and not growth. So we'll spend and increase our capex only with discipline."

These Factors Also Limit How Quickly Shale Can Grow, at a Time When Global Spare Capacity Is Limited

The spending behavior changes, as well as capacity constraints and logistical issues, are headwinds for how quickly shale will be able to grow in the near future, and particularly how quickly it would be able to accelerate in response to shortfalls. This is especially important today, as spare capacity in the rest of the oil market is already too low to absorb meaningful unexpected supply disruptions and is likely to fall further in the coming months, as OPEC uses much of its remaining spare capacity to offset the expected declines in Venezuela and Iran. The lack of cushion in the oil market at a time of reasonably high geopolitical uncertainty elevates the risk of an oil price shock, even if the most likely outcome is flat prices in the near term.



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