

Bridgewater®

Daily Observations

September 6, 2018

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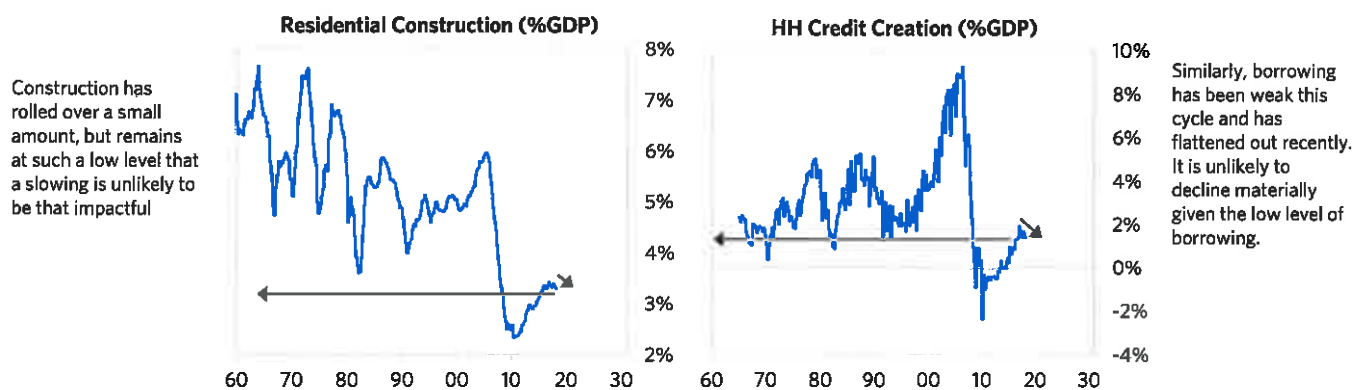
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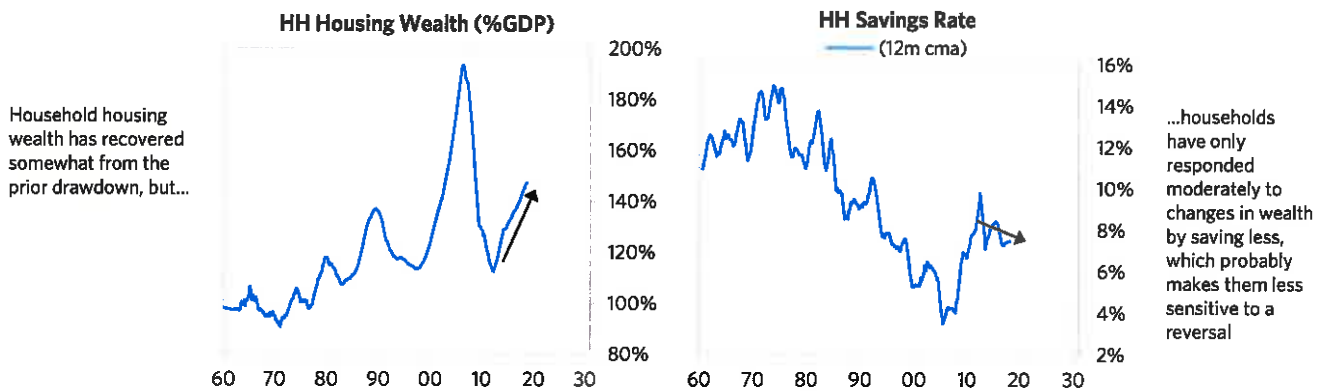
Housing's Weak Recovery and Unusually Strong (Late Cycle) Fundamentals Are Likely to Limit Its Downside

As we have communicated in previous *Observations*, as the Fed continues to tighten and the fiscal stimulus peaks, we see risks weighted to the downside for the US economy and more so for financial assets. Housing, as one of the most interest-sensitive sectors of the economy, and one that has an outside role in household wealth, borrowing, and spending, is a good sector to see the current and assess the future impact of tighter financial conditions. We are just beginning to see indications that rising rates are flowing through to a slowdown in housing activity. However, due to the strong fundamental conditions in the housing market, we would expect any downturn and the impact on household spending to be small relative to prior cycles. Housing has not contributed much to the current recovery, which is the flip side of there being few excesses in building or borrowing. The weak recovery also leaves the housing market with unusually strong fundamentals and few imbalances. Below, we walk through the dynamics of the current housing cycle and why we think the impact from the tightening will be small relative to other cycles.

- The most direct impact that housing has on the economy is through construction. The last several cycles experienced declines in construction of 2-3% of GDP over a period of a year or so. We would expect an order of magnitude less slowing this cycle, probably on the order of 0.5%. Due to a secular decline in housing relative to the economy and the slow cyclical construction recovery, residential fixed investment is only 3% of GDP. This is lower than the trough of every previous cycle and leaves less room for an adjustment.
- The indirect impact of housing is a bit harder to gauge but is also likely to be much more muted. In prior cycles, household borrowing fell between 2% and a maximum of 10%. That decline in borrowing included the monetization of housing wealth via cash-out refi loans that directly fueled spending. This cycle, mortgage borrowing is only running at 2% of GDP. And there have been few indications of the housing recovery fueling spending via cash-out refi loans or a decline in the savings rate.

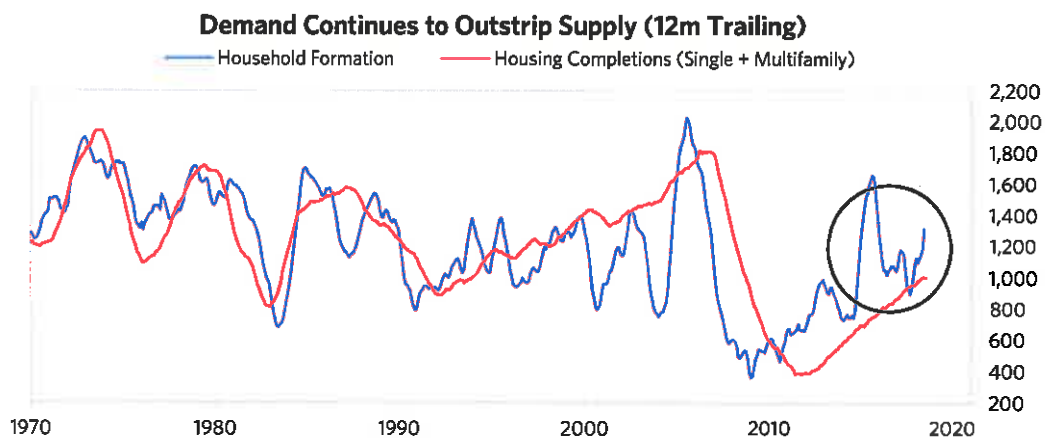


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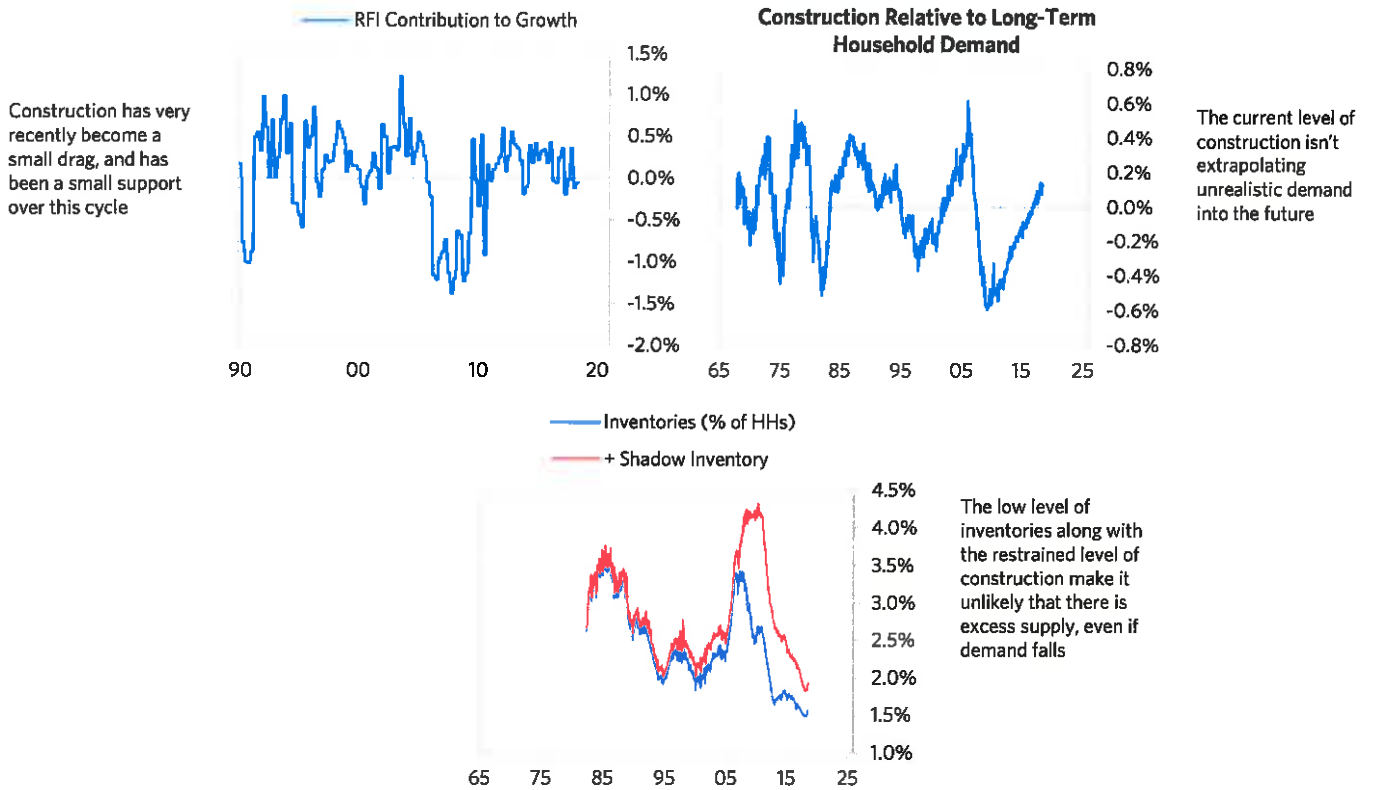
Direct Impact of a Housing Downturn Likely to Be Small Due to Secular Trends and Muted Cyclical Building Recovery

At a high level, the supply and demand for housing are the result of the number of households that want housing units (known as household formation rates) relative to the number of units (single and multifamily) built. As the chart below shows, housing construction has been low on both an absolute basis and relative to even the low levels of household formation.



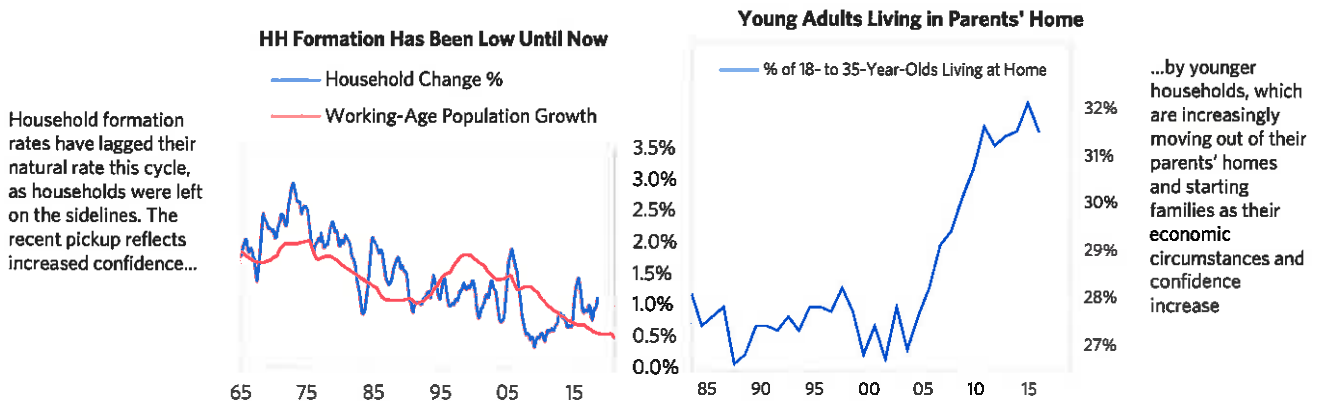
There Has Been Relatively Little Building This Cycle

Construction and the direct impact of that construction on growth have been modest. Only recently has construction reached the long-term trend demand for housing. This has translated to historically low levels of inventories. While traditional measures of inventories don't capture some important details, such as a shortage at the low end and more normal inventory at the high end, we don't think that materially changes the picture.

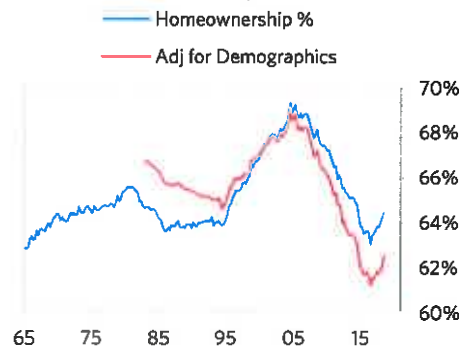


Latent Demand Is Likely to Be a Support

Above, we noted the limited building activity relative to household formation rates. Below, we note how depressed the household formation rate has been. Since the financial crisis, there has been a large drawdown in household formation rates, especially among younger households. This has begun to reverse as the continued economic recovery has allowed young households to move out of their parents' basement. In addition, home ownership rates are close to cyclical lows. Of course, a cyclical downturn would reduce demand for housing, but these signs of pent-up demographic demand should put a higher floor on the drawdown.



Homeownership Is Low

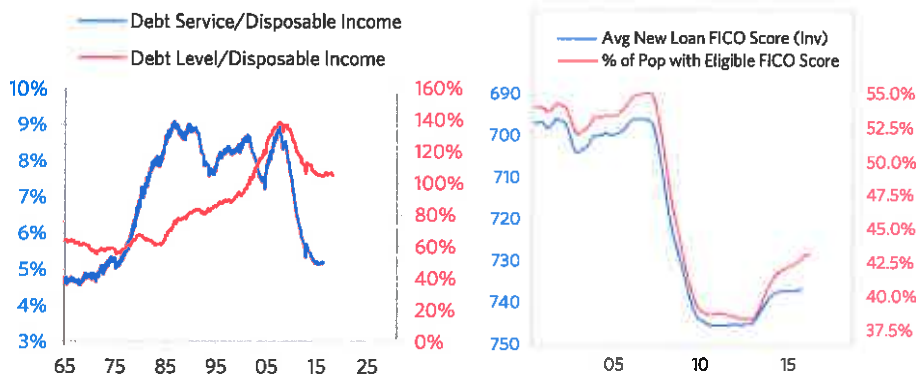


And along with fewer households, we have fewer homeowners, largely as a legacy of the last cycle. The recent rise shows this pent-up demand being a support, and we would expect this to continue since this isn't that risky from low levels.

The Indirect Impact of Housing Has Been Smaller Than Normal Because of Limited Excesses in Housing-Related Borrowing and Spending

Scars from the last crisis have contributed to much more restrained behavior by mortgage lenders and borrowers. As the largest storehold of wealth and the primary collateral for borrowing, housing wealth has historically been a big driver of household borrowing and spending. This cycle, borrowing both to buy a home and to equitize the wealth in a house has been very muted, in large part by tight standards. Households have largely delevered for the last eight years. This reduces the downside both to the amount that borrowing could potentially fall and to the financial repercussions from housing defaults.

Avg Mortgage Lending Standards



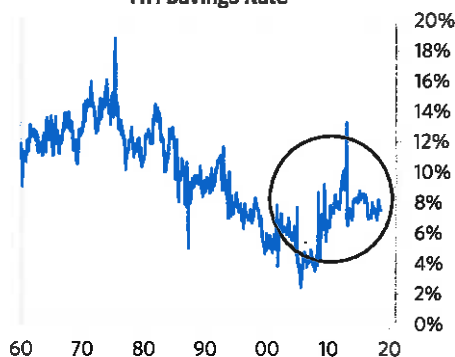
Debt levels and debt service have come down from prior peaks, leaving household balance sheets stronger this cycle...

...which, along with tight standards for loans, lowers the risk of the tightening causing defaults

And even with strong housing gains, we haven't seen significant household dissaving or borrowing against gains in home equity.

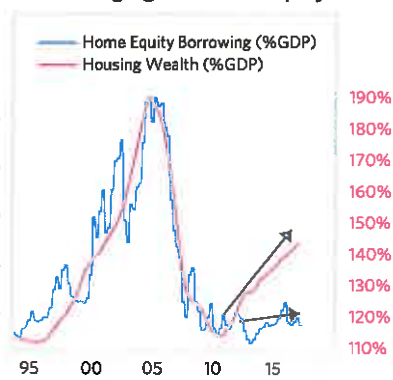
HH Savings Rate

Households have not dissaved this cycle, despite strong housing gains...



Borrowing Against Home Equity

...and direct borrowing against home equity has been really small relative to the past

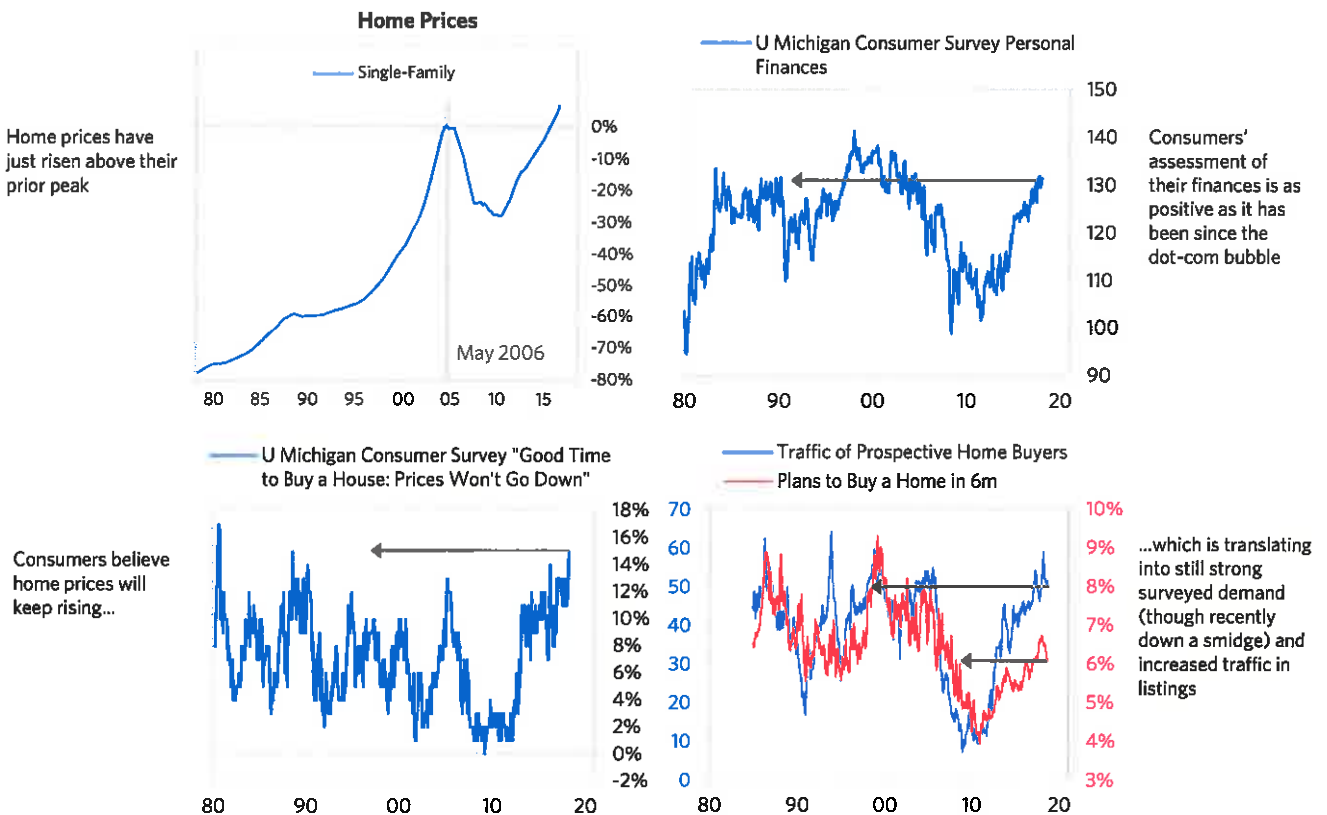


Prices Have Risen, but Affordability Looks Less Stretched Than in Previous Cycles

Even after the recent rise in mortgage rates and home prices, standard measures of housing affordability do not look overly stretched on a level basis. And furthermore, for those who can access credit, buying a home looks like a good deal relative to renting. This is unusual in general, but even more so later in the cycle.



Another lens is that home prices have not risen too much relative to the prior peak (though of course they were very high then, relative to incomes and interest rates). When one surveys consumers, they continue to plan to buy homes and believe their personal finances are the best they have been since the tech bubble. While there has been a bit of moderation in intentions to buy, the level of traffic and the number of consumers who believe prices will rise are near highs, triangulating a picture of strong demand driven by good economic conditions.



Large Adjustments Have Reduced Russia's Vulnerability to Further External Shocks

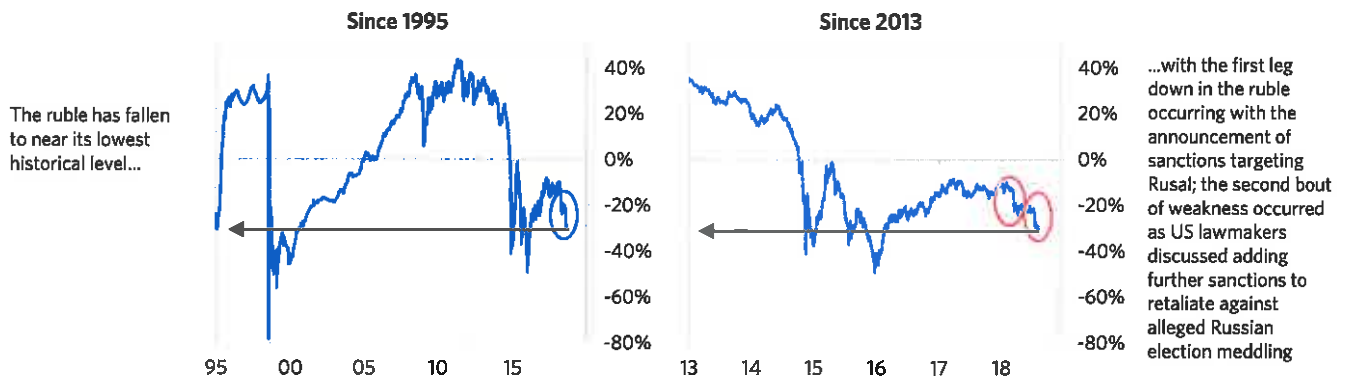
David Trinh | Allen Worth | Stuart Webber

The gradual pullback in dollar liquidity, combined with balance of payment strains in the most vulnerable economies like Turkey and Argentina, have had some impact across most emerging economies, but so far the effects have been much smaller than in prior crises. Looking ahead, with some exceptions, most EM economies look to be far better positioned this time than they were in the Asian financial crisis in the late '90s and the Latin American debt crisis in the early '80s. Despite the recent sell-off in its asset and exchange rate markets, coincident with the pullback in capital and with US sanctions, Russia—the subject of today's *Observations*—looks to be among the strongest of the pack at a time when significant further weakness looks to be discounted.

This increased resilience comes from a strong external position driven by Russia's substantial external surplus, ample reserves, and muted foreign investment, which provide a large buffer against undulations in trade or capital flows. Domestically, Russia's economy is also on a strong footing. The central bank tightened aggressively during its balance of payments crisis a few years ago, preventing inflation from substantially rising and bringing domestic demand in line with weaker exports. These actions should give the central bank a lot more flexibility to continue supporting Russia's gradual economic rebound, even in light of some balance of payment pressures. While further escalation of tensions between the US and Russia could result in punitive sanctions, as we discuss further below, the most likely measures look like they would have very manageable first-order impacts on the Russian economy.

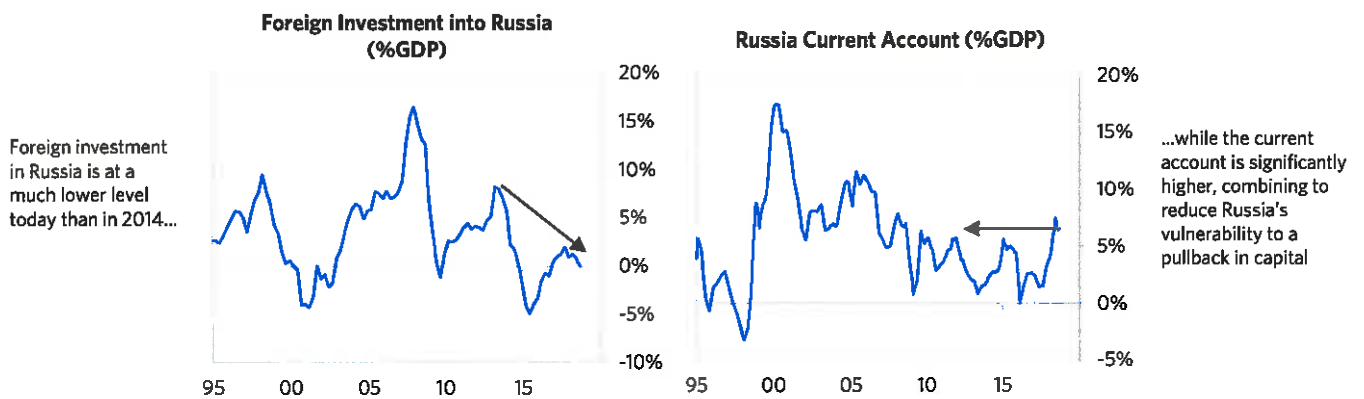
Russia's real exchange rate is close to as weak as it's ever been following the recent sell-off, although it remains at a higher level than in the 2014 depression.

Russia Real FX vs USD



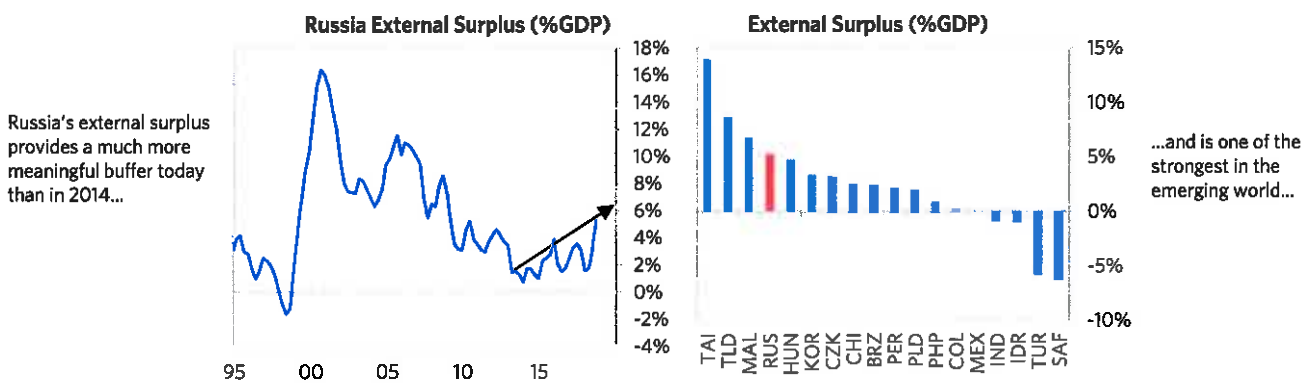
The Moderate Sanctions Path Would Only Have a Modest Impact on Russia; More Severe Sanctions Would Create a Material Though Likely Still Manageable Hit

Russia's adjustment after 2014 significantly reduced its vulnerability to sanctions pressure. In particular, its sharply improved current account and its reduction in external debt by 40% since 2014 (short-term rolls are down by 50%) meaningfully reduce the potential for the sort of squeeze that occurred when the US previously imposed sanctions. Of course, if the US pushes for really extreme sanctions, like those imposed on Iran, the economic impact would be much more disruptive. But, as is discussed in more detail later in today's *Observations*, the currently considered measures should have manageable, if potentially painful, first-order economic impacts.

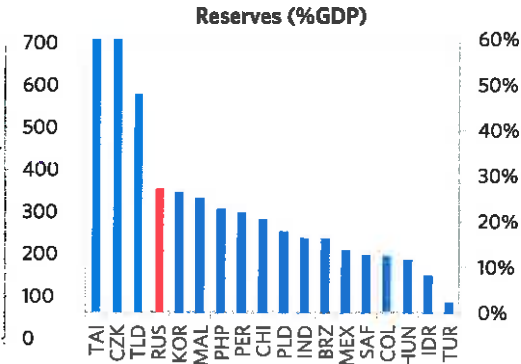
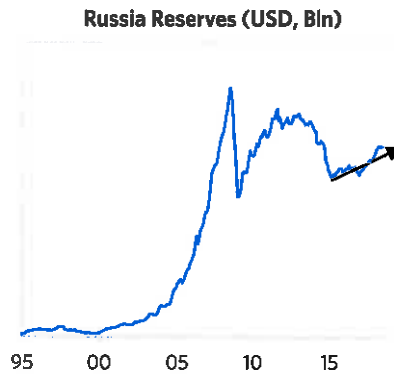


Relative to Other Emerging Market Economies, Russia Has a Relatively Strong External Position

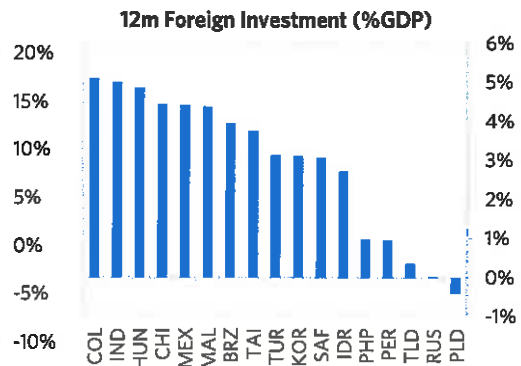
As discussed above, Russia looks much less vulnerable to a pullback in capital flows and/or a fall in external income than other peer economies do. Russia has a substantial external surplus, as seen through its very positive basic balance, substantial reserves to blunt any external pressures, and recently has received only very modest foreign investment, leaving it less susceptible to a pullback should foreign investment retrench.



...at a time when the Russian central bank has more dry powder than during the 2014 crisis...



...with reserve levels also very strong compared to peer economies

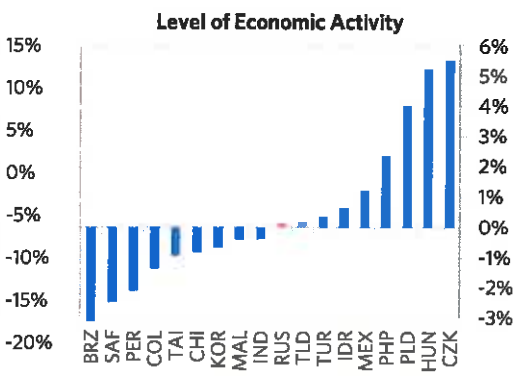


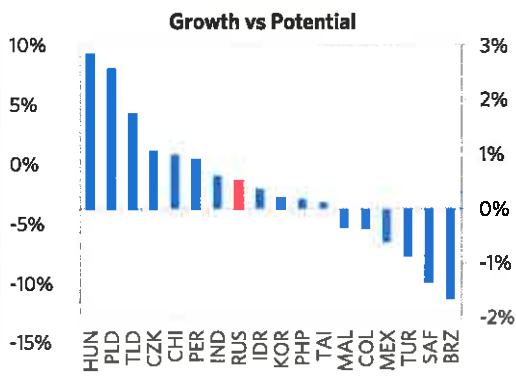
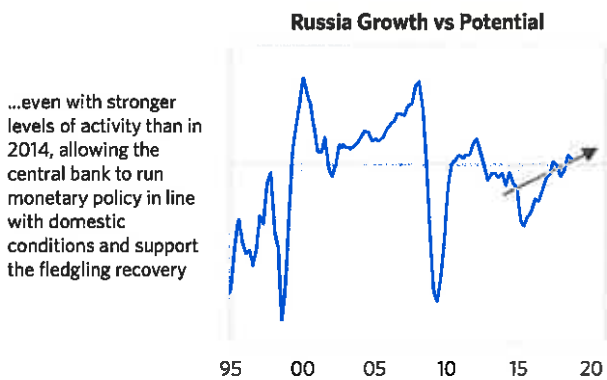
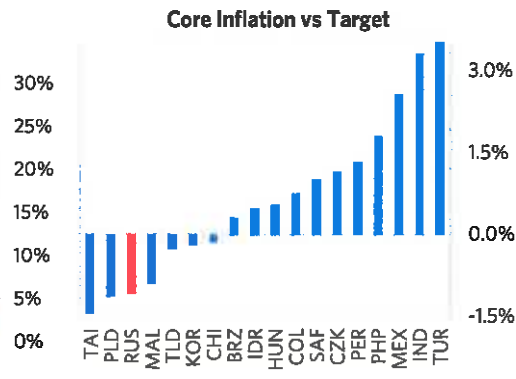
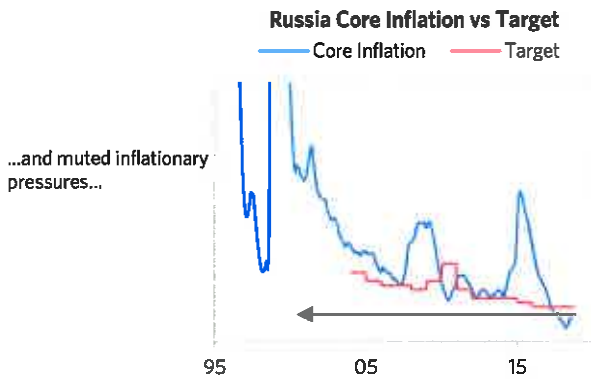
The muted level of foreign investment creates less room for a big pullback than was the case in 2014, and is also low versus the rest of the emerging world

Muted Inflationary Pressures Give the Central Bank Room to Run Accommodative Monetary Policy

Internal conditions in Russia show few signs of pressures that would force policy makers to tighten and derail the fledging domestic recovery. As shown below, levels of Russian activity are roughly at neutral, and inflation remains below trend, representing a more stable set of conditions than existed during the 2014 crisis. This gives Russian policy makers latitude to run relatively more accommodative monetary policy, supporting domestic activity and asset prices.

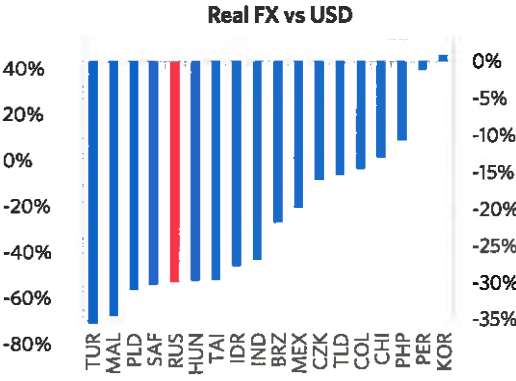
The Russian economy looks like it has room to run, with neutral levels of activity, lower than when the 2014 crisis hit...

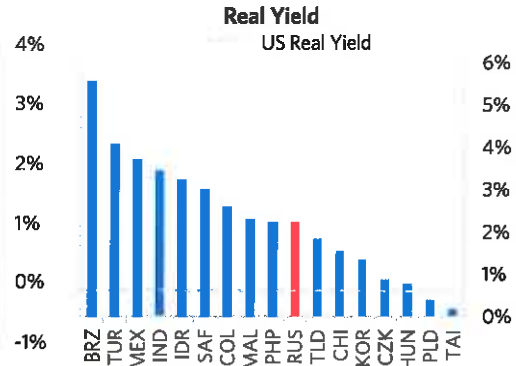




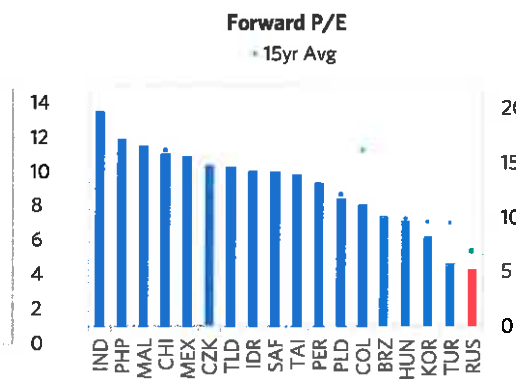
Asset Markets Have Sold Off, Discounting Weaker Russian Conditions

While we won't go into our views in detail, Russian asset prices are discounting meaningful weakness. The recent currency market action has brought the real exchange rate to historically low levels. Russian real yields imply that further currency weakness relative to the dollar is likely, and Russian stocks are trading at lower multiples relative to both their own history and to most emerging economies.





...with higher real yields than the US, implying further real currency weakness...

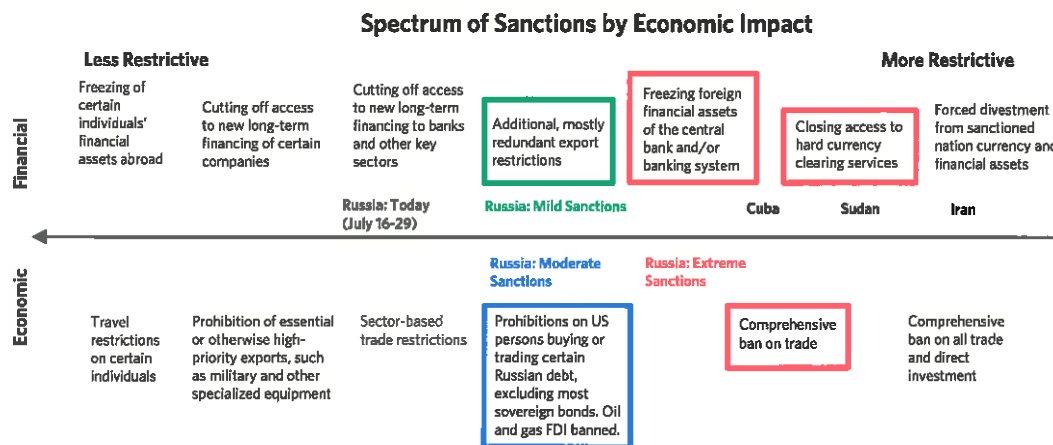


...at a time when P/Es remain low relative to history and to other countries

Sanctions Pose a Real but Manageable Risk to the Russian Economy

While the Russian economy is on relatively sound footing, the potential for an escalation in sanctions between Russia and the rest of the world does present a real downside risk for the Russian economy. That said, while fresh sanctions would certainly have a negative impact, the most likely measures look like they will have a relatively contained impact, and even the more severe measures look like they would be manageable, albeit painful, for Russia. Below, we show the spectrum of possible sanctions that could be imposed. Currently, the only restrictions imposed cover exports to Russia of goods or technologies with national security concerns, which were largely already banned before the recent measures. In the upcoming weeks, President Trump or Congress could decide to impose bans on US persons holding certain Russian debt (right now, most sovereign bonds would be excluded, but that could change), restrictions on US entities participating in Russian oil and gas projects, or even a comprehensive ban on trade. Additionally, the president has wide latitude to impose restrictions on Russia at any time, meaning that sudden escalations to more extreme measures are a possibility.

Below, we give a rough perspective on the economic impact of sanctions currently under consideration, and work through the measures and their likelihood in more detail.



Mild Sanctions (Very Likely): These sanctions have small direct economic effects and are very likely to be imposed or are already in effect. Examples include:

- Banning the sale of arms and other technologies with military applications (i.e., dual-use goods).
- Restricting foreign aid assistance (both currently in effect from violating the Chemical and Biological Weapons Act).
- Possible diplomatic sanctions.

Moderate Sanctions (Somewhat Likely): Congress is considering a range of legislation that would force Trump to impose sanctions against Russia. While it's unlikely to pass as introduced before the midterms, the contemplated measures are indicative of what may eventually be imposed. We consider these or similar measures to be somewhat likely and of moderate economic impact. Examples include:

- Prohibition of US persons buying or trading newly issued debt from the Russian Treasury, National Wealth Fund, or Central Bank. Interestingly, it doesn't seem like this includes the Russian Finance Ministry bonds, which are the principal vehicle for Russian sovereign debt issuance (i.e., OFZs).
- Prohibition on investment in any new project where Russian state or parastatal firms have invested more than \$250 million. This would affect all countries, not just investments by US persons or projects in Russia.
- Prohibition on US persons buying or trading newly issued financial instruments from a list of seven Russian banks (e.g., Sberbank).
- Blocks and prohibits all transactions in property and interests in property by one or more of seven Russian banks listed in the bill if the property (and interests in property) are in the US (come within the US), or are or come within the possession or control of a US person.

Severe Sanctions (Not Likely): These measures are at the extremes of contemplated or threatened legislation or action by the executive branch. The below measures are not exhaustive—Trump has wide latitude in this area—but represent a material escalation of economic impact from the more likely moderate sanctions within the parameters of current legislation. Examples include:

- US persons barred from holding any Russian debt or lending to the Russian government/banks.
- US bars anyone from financing the Russian government or banks with dollars.
- US cuts off all imports and exports with Russia.

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