Bridgewater®
Daily Observations
September 18, 2018

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We noticed some of our readers had trouble opening the attachment for today's Observations, so we are resending in a smaller file.

How the Tightening Cycle Is Reverberating Across Assets and the Economy

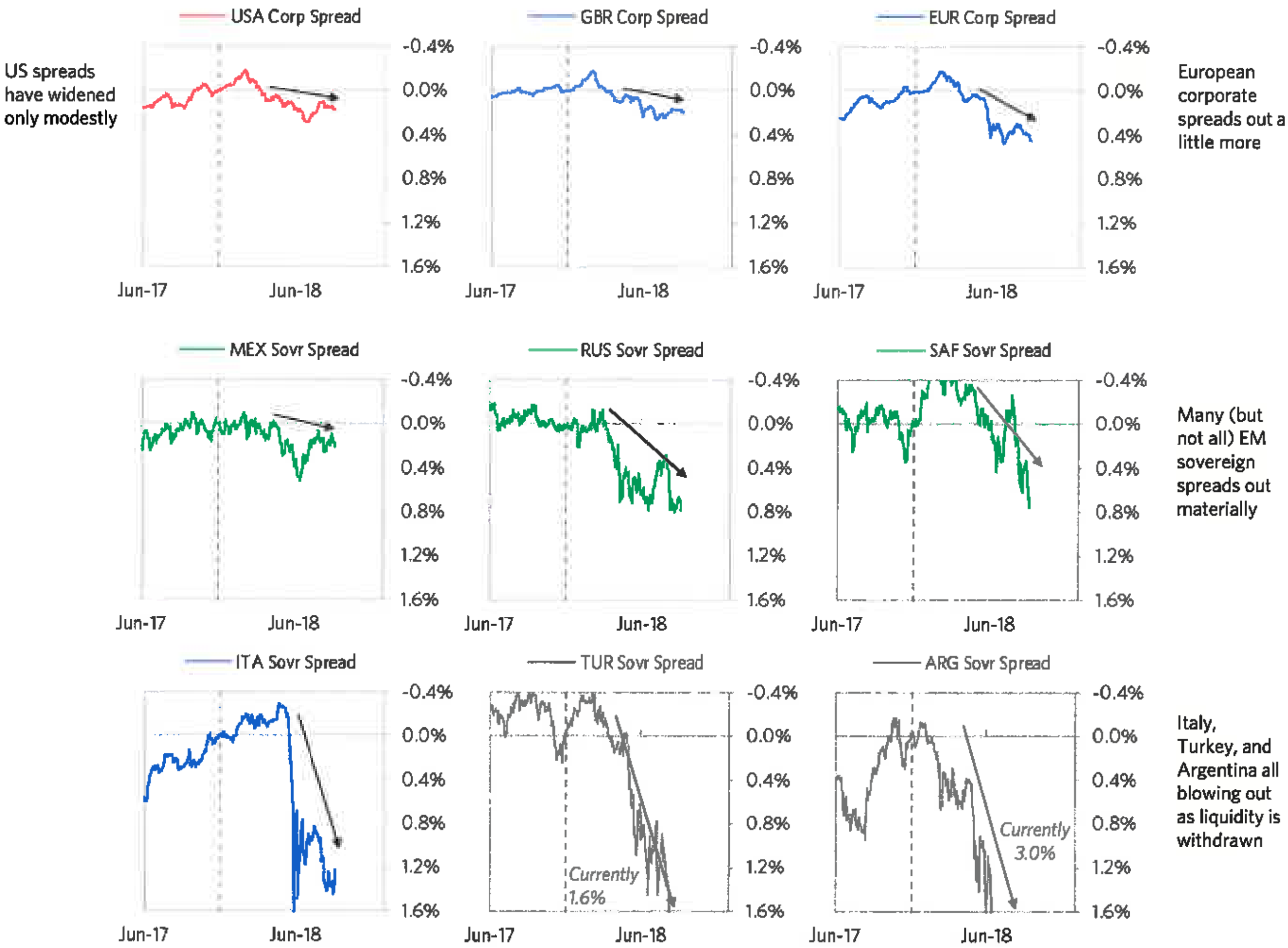
The global tightening cycle is proceeding gradually but is now well underway, reverberating through the global financial and economic system with gradually mounting effects on assets and economic conditions. While most of the tightening has come from the US, the impact has been global given the dollar's role as a funding currency. As you'd expect, across the world the entities that are most sensitive to liquidity and interest rates are seeing the greatest impacts. Scanning across the globe:

- Within the US, tightening is weighing on the most interest-rate-sensitive sectors, such as housing and autos. But overall, economic conditions have remained strong, as monetary tightening is being meaningfully offset by fiscal stimulus, with government leveraging pumping liquidity into the hands of businesses and households. This support will abate next year, even as the monetary tightening cycle is set to continue.
- Dollar liquidity has also tightened globally, and with the dollar still serving as the world's most important funding currency, foreign players who are most reliant on ongoing access to dollars but unable to print them have acutely experienced the pullback in liquidity. Adding to these challenges, regulatory changes since the financial crisis regarding bank funding and capital have made it a bit more expensive for banks to send US dollars abroad. And tax policy changes are incentivizing businesses to repatriate capital back into the US, removing it from the global banking system.
- Other central banks in the developed world are tightening more gradually than the Fed, but this tightening is taking place in an environment of tightening global liquidity and without an offsetting fiscal stimulation as in the US, leading to weaker spending and asset prices. In Euroland, for example, growth has slowed moderately, and Italian spreads have widened as the ECB has gradually pulled back. Although the ECB's withdrawal has been more modest than the Fed's tightening, there has been less ample global liquidity to fill the gap and no fiscal stimulation to offset the impact.
- China's central bank, after tightening to bring down financial leverage and move spending toward more sustainable sectors, is now the only major central bank that is taking steps toward easing. Past tightenings and trade tensions are reverberating through Chinese asset markets and its economy, although the impact on the real economy has been modest relative to the significant decline in credit, as policy makers have been successfully targeting frothy financial lending. It looks like policy makers have the tools and the desire to offset this by providing more support.

Looking ahead, we expect the withdrawal of dollar liquidity to continue, as sustained strong US growth and high levels of economic activity encourage the Fed to push ahead with tightening. We expect the dollar to continue rallying against most developed currencies. As tightening continues to ripple through the global economy, most bond and stock markets look vulnerable to us. US risky assets are especially vulnerable, as fiscal stimulus will peak and then become a drag on growth in the coming months, and asset prices are likely to lead the downturn in the economy and remain weak until an economic downturn is sufficient to lead to a slowdown in dollar tightening.

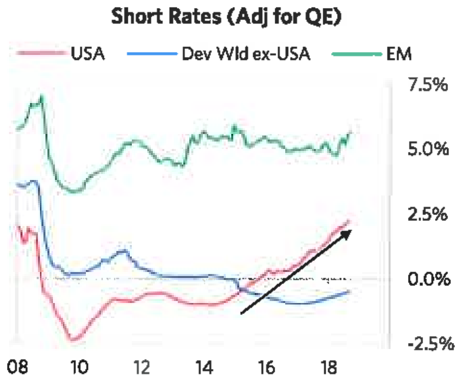
Below, we scan the impacts of the global tightening cycle around the world, highlighting these themes. We start with a scan of credit spreads, which are a good measure of risk premiums around the world. The effects of the pullback in liquidity are manifesting in widening spreads across the world. The most acute impacts are being felt outside of the US, driven by the dynamics of the US dollar as a driver of money and credit globally, as well as the interaction of that with other more transient fiscal and tax policy levers being employed in the US this cycle.

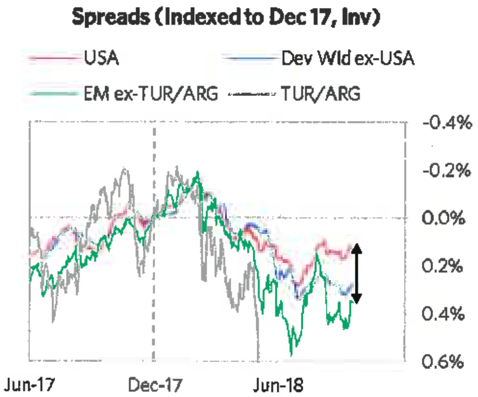
Scan of Global Credit Spreads (Indexed to Dec 2017, Inverted)

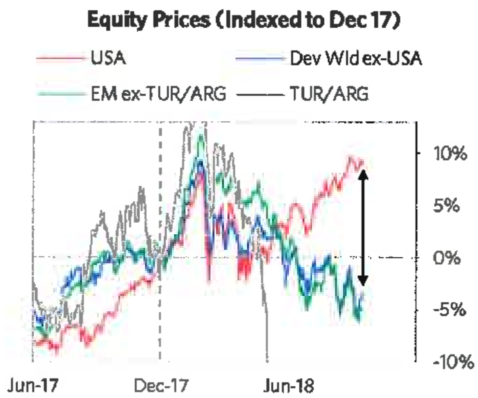


Give Feedback

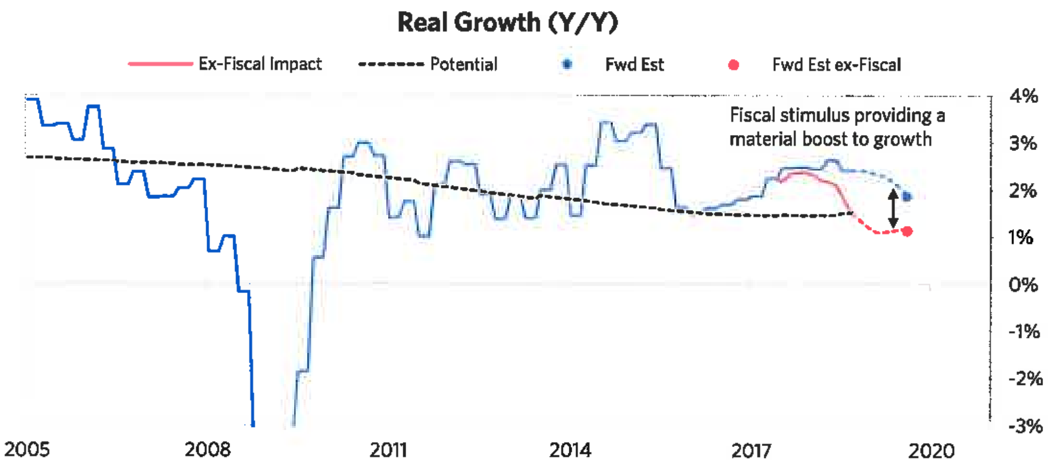
Aggregating asset performance across regions, while the Fed has been the epicenter of the pullback in liquidity, the US has outperformed as the pullback in liquidity has rippled globally, as the charts below illustrate. This outperformance of US assets has been supported by relatively stronger domestic economic conditions and cash flows, and we explore the drivers of this next.





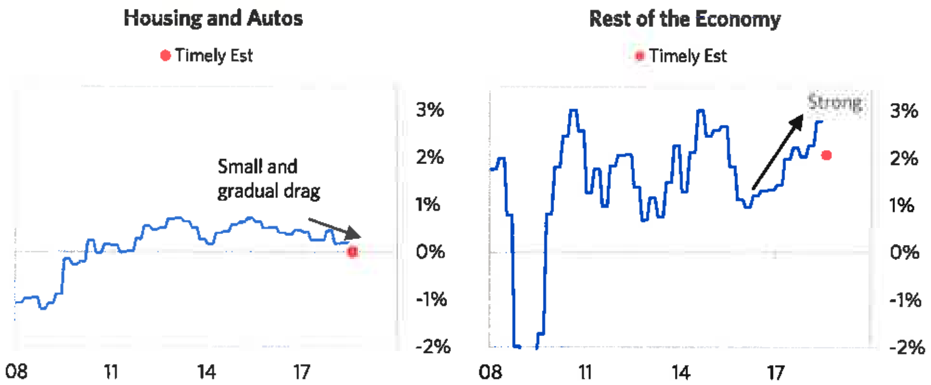


In the US, the domestic impact of Fed tightening on US growth is evident in the most rate-sensitive sectors, but is being meaningfully offset by other factors. Most importantly, fiscal stimulus passed by Congress at the end of 2017 has put more money in the hands of households and businesses. The chart below shows our rough estimate of the impact that fiscal stimulation has had on US growth. This offset to Fed tightening will start unwinding in the coming months as the impacts of the fiscal package peak.

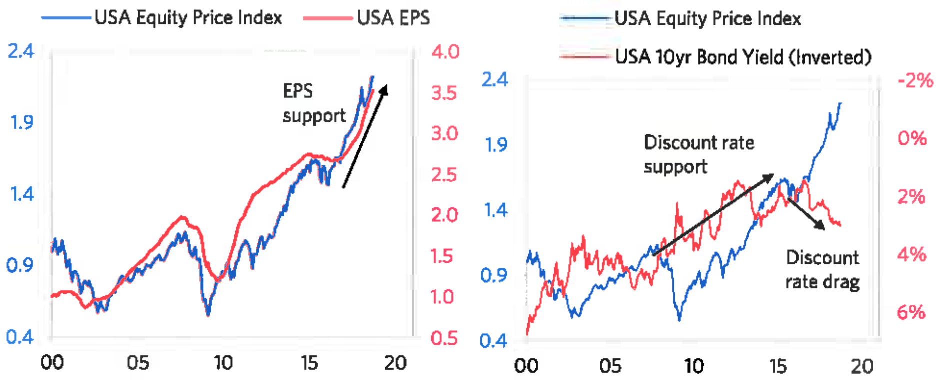


As shown below, the Fed tightening is certainly hitting US domestic growth. Interest-rate-sensitive sectors like autos and housing have been declining for some time. But the drag on the overall economy hasn't been that big, both because of the offset of fiscal stimulation and because the economy's reliance on credit is still low relative to prior cycles.

Contribution to Real GDP Growth (Y/Y)

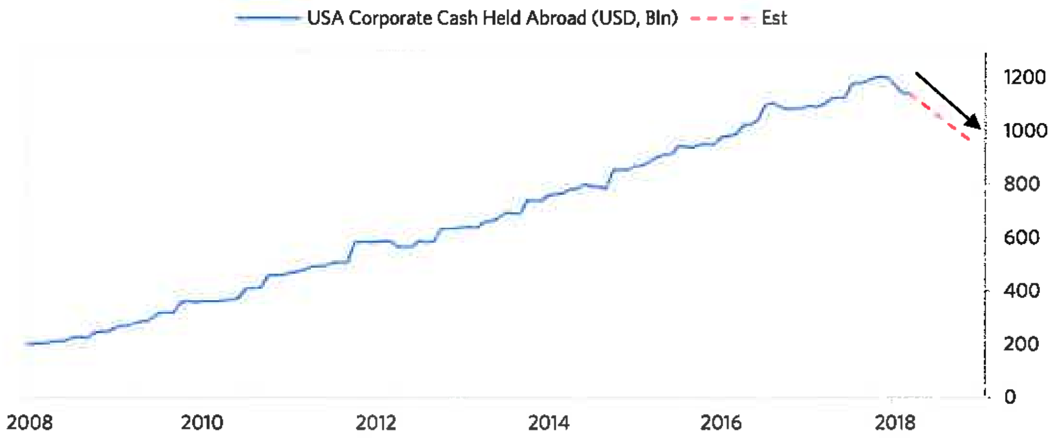


As the economy has held up, this has mitigated the impact of tightening on financial assets. In the stock market, the drag from rising discount rates lowering the present value of future cash flows as the Fed has tightened has been offset by strong earnings.

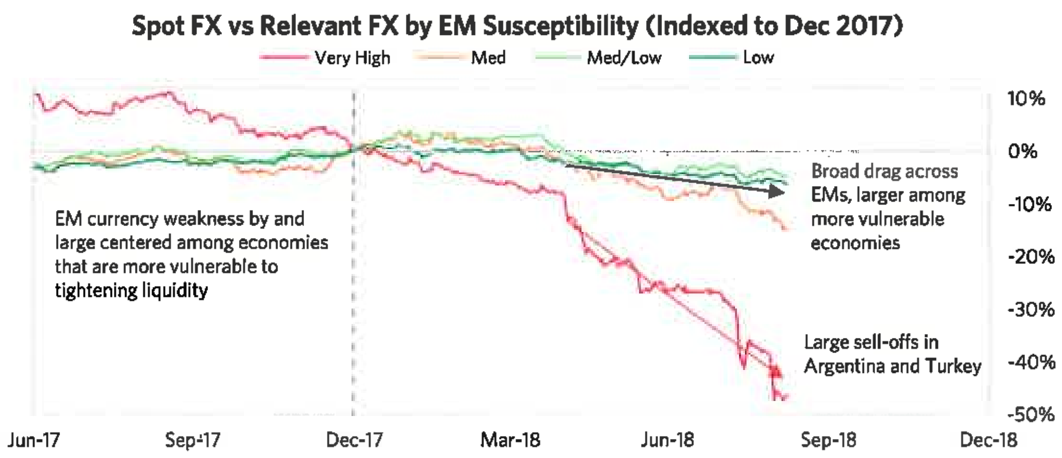


Give Feedback

The impact of tax-policy-driven corporate profit repatriation is on the margin more supportive of US domestic liquidity than of global dollar liquidity. Tax policy changes have encouraged US corporations to repatriate the cash they had accumulated and held offshore. US companies have amassed a significant war chest of cash held abroad for tax purposes, roughly $1.2 trillion. This war chest effectively moved US dollar cash out of the US and into foreign banks. Companies' desire to repatriate this cash following recent tax reforms moved US dollar liquidity from abroad into the US credit markets and banking system. And the new rules on capital and liquidity enacted after the financial crisis make it marginally more expensive to move the liquidity back out of the US than it used to be.



The dollar is a global funding currency, so it is typical that when US dollar liquidity tightens, those outside of the US who are most reliant on ongoing access to dollars through the capital markets and global banking system—because they cannot print dollars themselves—experience the largest impacts. We've seen the same in this cycle (e.g., Turkey). The chart and table below split the world into economies with high, medium, and low reliance on continued access to US dollar funding. Turkey and Argentina, which have a high funding need, high levels of debt, and low levels of reserves, have performed worst. The handful of others that are moderately exposed (e.g., South Africa and Brazil) have underperformed as well. Across the EM, performance has been much stronger than what we have seen in past cases of broad EM contagion because of stronger underlying conditions, as we discussed in more depth in our August 23 *Observations*.

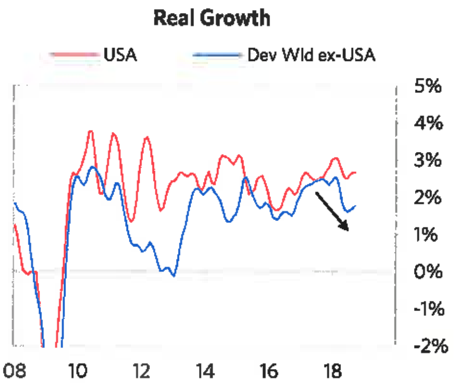


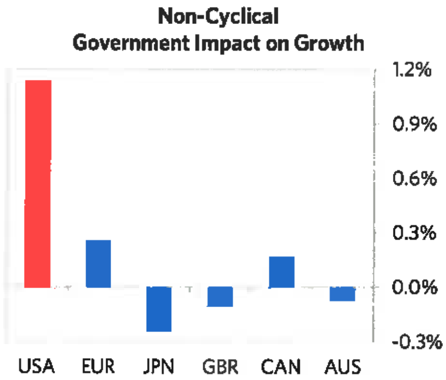
Give Feedback

Today: Emerging Market Susceptibility

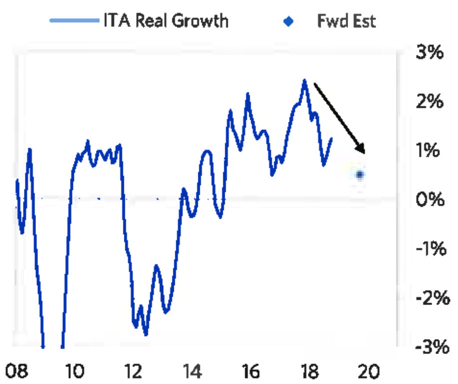
	Reliance on Foreign Capital				Ability to Manage				Market Action
Country	Current Account (%GDP)	Financial Inflows (%GDP)	Hard FX Ext Debt (%GDP)	ST Ext Debt (%Total Ext)	FX Peg / Heavily Managed?	Net Reserves (%GDP)	Ext Debt in Local FX (%Total)	Aggregate Susceptibility	Spot FX Chg Since Dec17
Argentina	-5%	9%	31%	10%	No	3%	13%	Very High	-51%
Turkey	-7%	3%	45%	16%	No	1%	6%	Very High	-43%
Chile	-1%	4%	54%	14%	No	19%	8%	Med	-11%
South Africa	-3%	7%	19%	--	No	11%	59%	Med	-19%
Indonesia	-2%	1%	25%	8%	No	6%	15%	Med	-9%
Brazil	-1%	1%	28%	6%	No	14%	4%	Med	-20%
Hungary	3%	-2%	59%	25%	No	8%	23%	Low	-8%
Poland	0%	-1%	49%	11%	No	13%	--	Low	-6%
Malaysia	4%	4%	55%	24%	No	17%	15%	Med/Low	-2%
Czech Republic	1%	-1%	68%	32%	Yes	51%	--	Med/Low	-4%
Taiwan	14%	4%	26%	23%	No	58%	--	Med/Low	-4%
Mexico	-1%	2%	25%	7%	No	10%	25%	Med/Low	1%
India	-2%	5%	13%	5%	No	12%	36%	Med/Low	-11%
Philippines	-1%	0%	17%	5%	No	19%	3%	Low	-7%
Peru	-1%	1%	27%	7%	No	19%	--	Low	-3%
Thailand	12%	2%	19%	13%	No	40%	35%	Low	-1%
Russia	3%	-1%	22%	6%	No	21%	27%	Low	-17%
South Korea	5%	2%	20%	8%	No	26%	27%	Low	-5%

Other central banks in the developed world are tightening more gradually than the Fed, but this tightening is taking place in an environment of tightening global liquidity and without the kind of offsetting fiscal stimulation that there is in the US, leading to some moderation in spending and asset prices. As the charts below illustrate, the level of US fiscal stimulus stands out relative to the fairly neutral policy stances taken by other major developed world governments, and growth has slowed more in these economies.



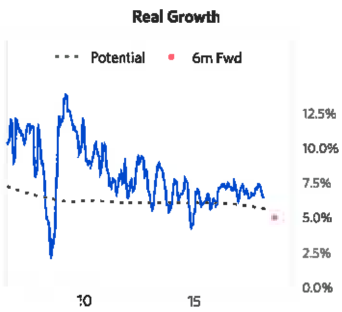


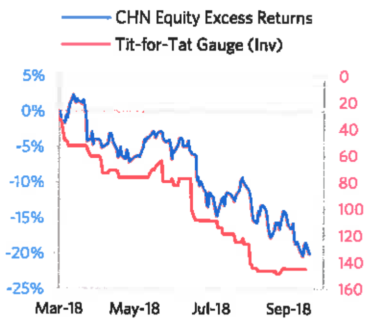
For example, in Euroland, growth has slowed moderately, and Italian spreads have widened as the ECB has started to gradually pull back. Although the ECB's withdrawal has been more modest than the Fed's tightening, there was less ample global liquidity to fill the gap and no fiscal stimulation to offset the impact.

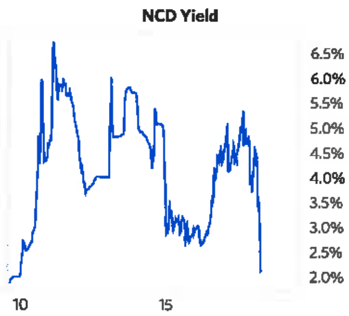


Give Feedback

China, after tightening to bring down financial leverage and move spending toward more sustainable sectors, is now taking steps to mitigate the impact of prior tightenings and the risks of trade tensions. As the charts below convey, past tightenings are leading to downward pressure on economic activity (left chart), although the decline in growth is modest relative to the decline in credit, as policy makers have mostly been successful in targeting frothy financial lending relative to credit for real economic activity. Additionally, Chinese markets have fallen sharply alongside rising trade tensions. This is shown below (middle chart) utilizing our "tit-for-tat gauge," which shows our aggregate reading of global trade threats and actions, weighted by our assessment of the probability of implementation and the direct impact of those measures. As trade tensions have ratcheted up, as asset markets have come under pressure, and as growth has slowed, policy makers have begun to ease monetary and fiscal policy. Thus far, these easing steps have been relatively small and targeted, consistent with policy makers' dual mandate of creating acceptable levels of growth and reducing financial risks. Rates sensitive to easing liquidity, such as short-term financing instruments (e.g., negotiable certificates of deposits, or NCDs, shown on the right below) and policy bank bond spreads, have compressed in response.

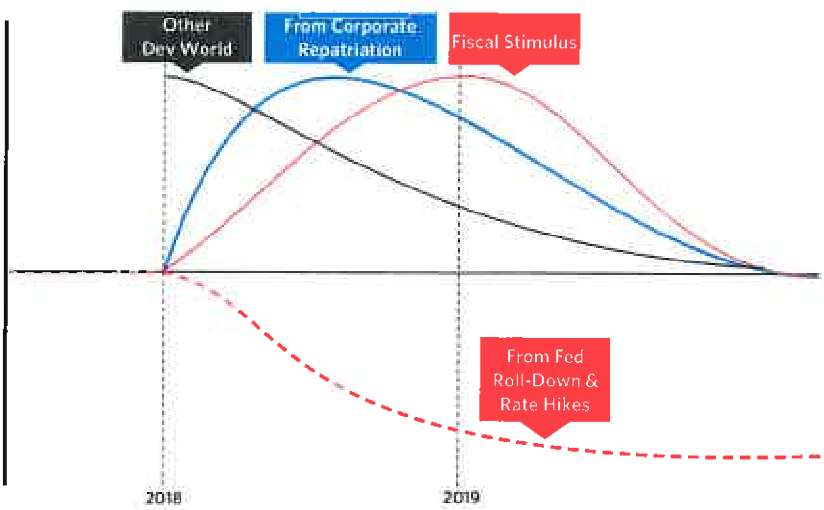






Looking ahead, the Fed, which has been the epicenter of the global tightening, is likely to continue to pull back as strong US conditions put the US even further along in its cycle. At the same time, tax cuts and corporate cash repatriation are transient policy changes, and by this time next year we expect both forces to have rolled off. Taken together, the fading impacts of these policies, combined with the lagged effects of monetary tightening, will create ongoing ripples globally and a particularly risky situation in the US for 2019-20.

Liquidity Impact



Give Feedback