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**Daily Observations**
September 27, 2018 ©2018 Bridgewater Associates, LP
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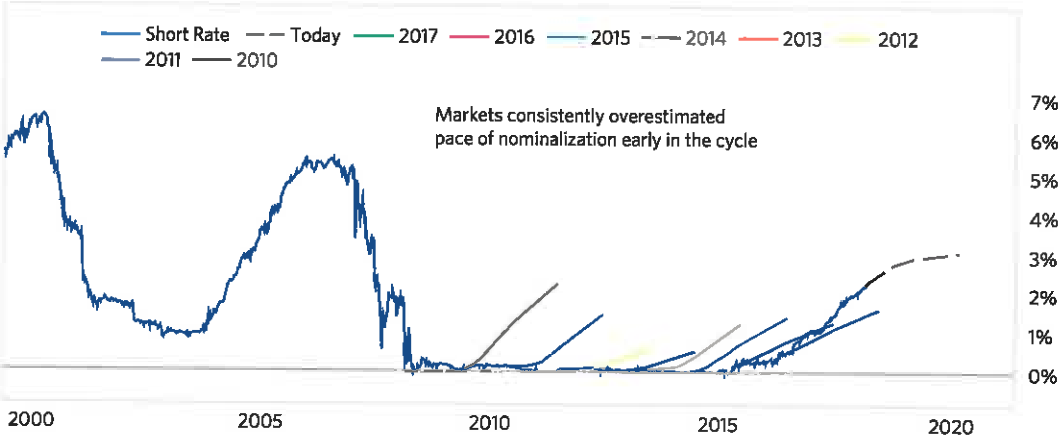
# The Important Thing Is What the Fed Does Relative to What's Discounted

Wednesday's Fed rate hike was fully discounted, the Fed's statement didn't impact the discounting of the future path of monetary policy, and the market action around the announcement was modest. In today's *Observations*, we'll give some perspective on how we're interpreting the Fed's tightening cycle to date and how we see it playing out going forward. In short, while the Fed's rate increases do weigh on the real economy by gradually decreasing incentives to borrow and spend, what matters most to financial markets is how policy evolves relative to what is discounted. For much of the expansion, the Fed tightened much slower than discounted, the expectations for future policy changes were revised lower, and as a result rate increases weren't enough to slow the economy and were supportive for asset prices. Over the last year or two, the Fed has been tightening a bit faster than what had been discounted, in large part as a response to US fiscal stimulation and overall strength. This tightening was enough to weigh on the currencies and assets of some of the most vulnerable foreign dollar borrowers; however, it still was not enough to slow the US economy, profits, and asset prices, as it was offset by other tailwinds. Looking ahead, markets are discounting another 50bps of tightening and then relatively stable monetary policy. The Fed expects to raise rates somewhat more than this, but will ultimately react to how conditions evolve. We have previously expressed our concerns about the longer-term downside risks to the US economy, so we won't repeat them here. But based on the more normal cyclical linkages, we think the odds remain tilted toward somewhat faster tightening than discounted.

The chart below shows how actual monetary policy has evolved over the course of the expansion relative to what had been discounted, highlighting the way it consistently undershot in prior years and gradually overshot more recently.

**US Short Rates**

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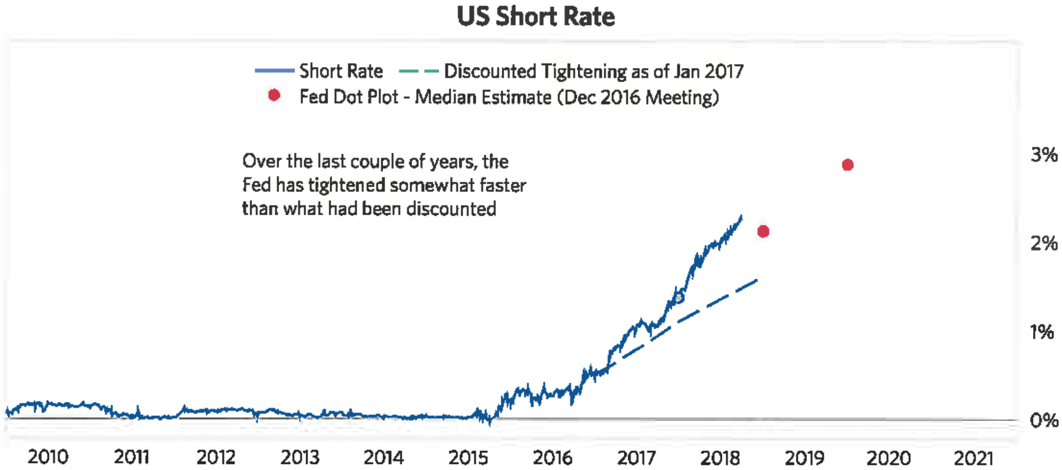
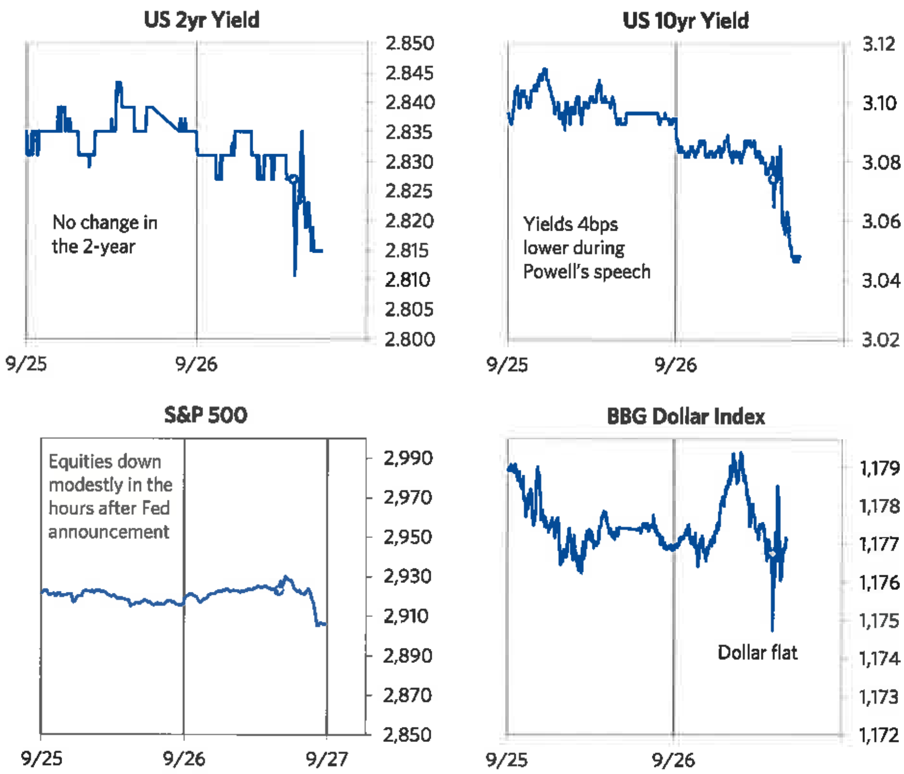
Next, we take a closer look at the more recent period, when the Fed tightened faster than markets had been discounting (and closer to the Fed's own expectations). Looking ahead, they expect to continue to tighten a bit faster than priced in, but this will ultimately depend on conditions.




The market action around the Fed meeting yesterday was muted. The moves on the actual announcement were tiny. Bond yields fell about 4bps during Chairman Powell's speech when he highlighted among other things that the Fed "might need to move along a little bit quicker if inflation surprises to the upside. [But that] we don't see that."



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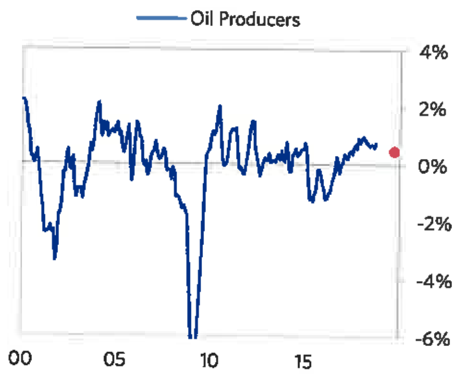
## *Perspective on the Winners and Losers from the Rally in Oil Prices*

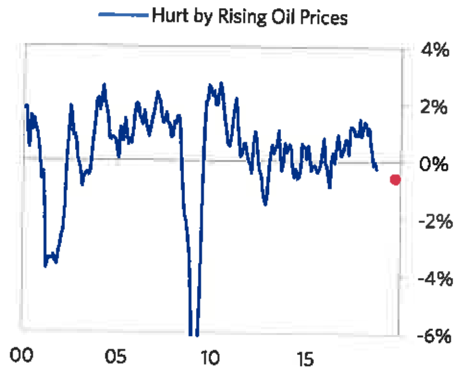
***Sam Haber***

The move up in oil prices since the beginning of 2016 (from $35 to $80) is equivalent to about 1.5% of global income, creating some winners and losers. In these *Observations*, we give some perspective on how these moves have impacted different countries and sectors. As prices have risen, consumers worldwide have felt disposable income being squeezed, particularly in countries whose currencies have become less competitive over the same period and are large net importers. On the flip side, producers have captured the benefits, but not uniformly. While all producers gained the benefits of higher prices, only the faster-moving US shale saw significant increases in production, allowing those producers to capture more of the gain than in prior cycles. And across the board, investment has remained constrained, both in shale (which has focused on capital discipline over investment) and in the rest of the world.

The chart below on the left shows growth rates for producers rebounding on average and remaining above potential, and the chart on the right shows growth in net importing countries softening somewhat. These moves haven't been huge, but have been a notable driver of economic performance.

**Growth vs Potential**




**Consumers Are Feeling the Pinch of Higher Oil Prices, with Material Effects in Some Countries**

Households are generally the first to feel the impact of a change in oil prices, as this flows through to consumer prices relatively quickly. While the rally over the last few years was significant, when looking at current prices compared to the recent history the change in dollar prices isn't huge, and most consumers are facing similar conditions as they have over the past five years. However, for a few countries, the local real price of oil has shot up dramatically, due to large devaluations in the currencies. Some of these countries, like Russia, are large oil exporters that are able to offset some of the pain facing consumers by subsidizing consumption or increasing social spending. Others, like Turkey, are facing higher local oil prices at a time when the rest of their economy is struggling, and do not have the same means to blunt the pain of higher oil prices as they did during other high price periods.

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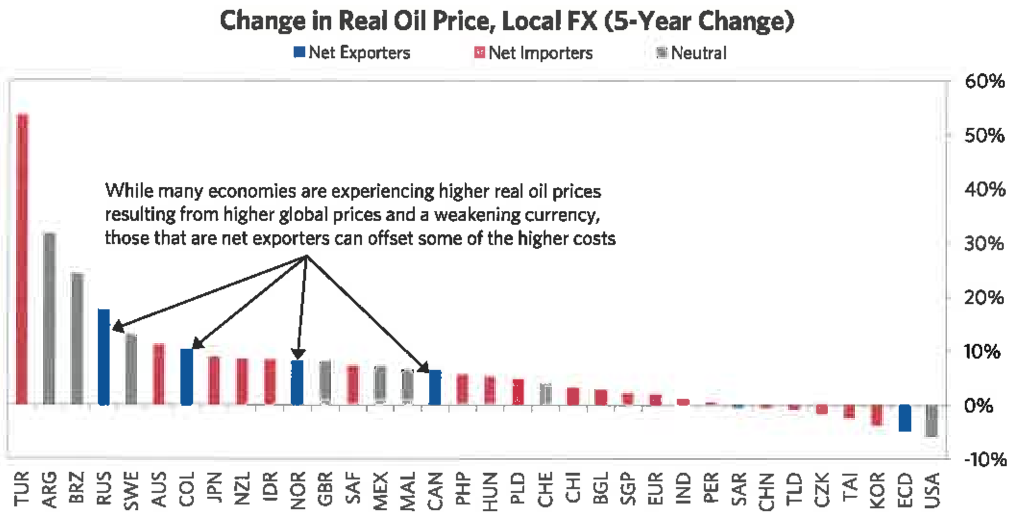
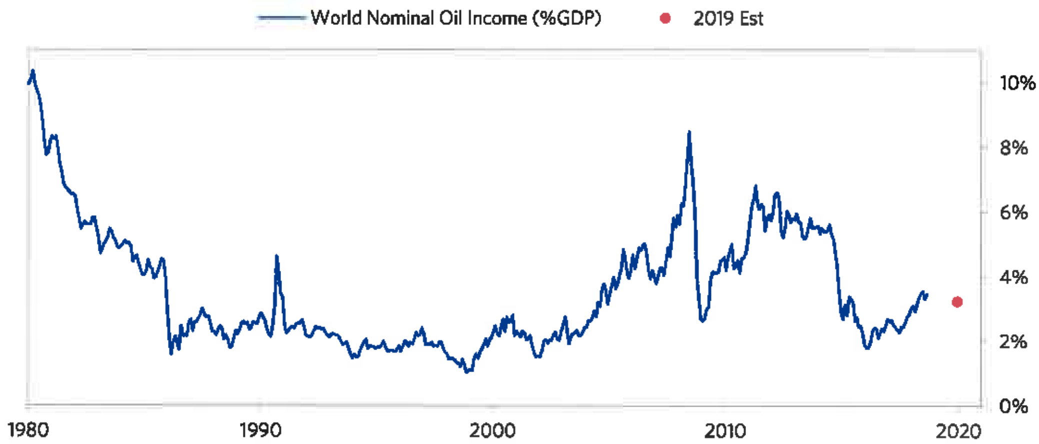



**All Producers Are Benefiting from Higher Prices, but Only Shale Has Benefited from Increased Production**

On the opposite side from consumers, producers have been able to capture the benefit from higher prices. The immediate impact of rising prices is higher oil incomes for oil producers, at the expense of consumers. The upswing from the 2016 lows to the present amounts to 1.5% of world GDP being redistributed, focused in the hands of only a couple of large oil producers.



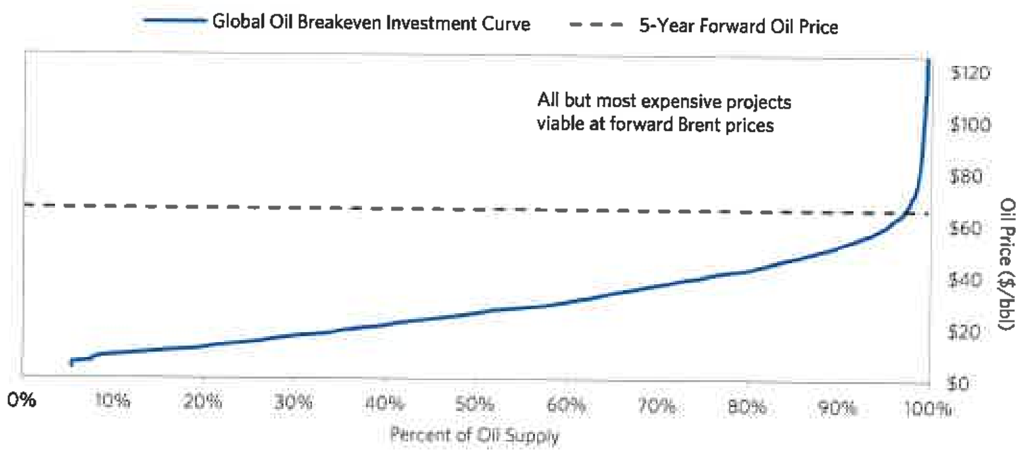
The change in wealth is also shifted by changes in production, not just price. By and large only the US, led by shale, has increased production over the last year, in large part thanks to improved well efficiency (as opposed to ramping up investment). This allowed US producers to capture a disproportionately large share of the rally in oil prices, as the US share of total oil production increased as prices rallied.

**Change in Oil Supply (Last 12m)**

| | Change (mb/d) |
|---|---|
| World | 1.30 |
| USA | 1.82 |
| Shale | 1.69 |
| OPEC | -0.35 |
| Saudi Arabia | 0.47 |
| Iran | 0.03 |
| Venezuela | -0.73 |
| Rest of OPEC | -0.12 |
| Non-OPEC ex-US | -0.17 |
| Russia | 0.30 |
| Canada | 0.00 |
| Brazil | 0.06 |
| Mexico | -0.14 |
| China | -0.03 |
| Other | -0.36 |

**Prices Have Finally Now Risen to Levels That Will Incentivize Investment, but This Impact Is Felt over Time**

Furthermore, at this point in the rally, an increasingly large share of global oil investment has become economical, with virtually all but the most expensive supply now viable at forward Brent prices. However, this flows through to investment much more gradually and the impact on growth is distributed across a longer time frame. This is because of the long lead that traditional producers face—it can take 5-10 years to bring new wells online, so investment only occurs once forward prices are sufficiently high to make new projects worthwhile, and even then, producers this time around are more cautious given the pain they felt in the last bust. So far, the only segment of investment that has recovered has been the faster-moving shale, which can come online on the order of months, and even that is only to around half of peak levels.



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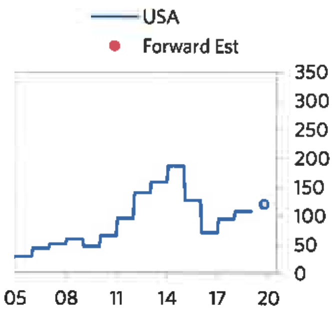
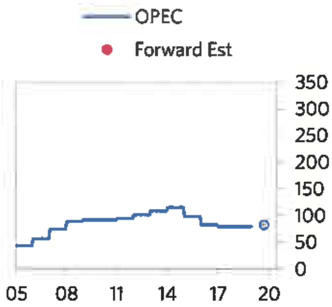
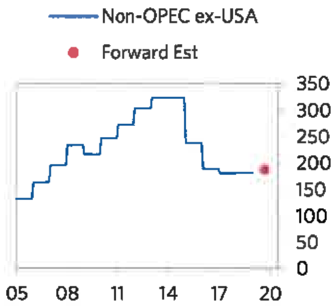
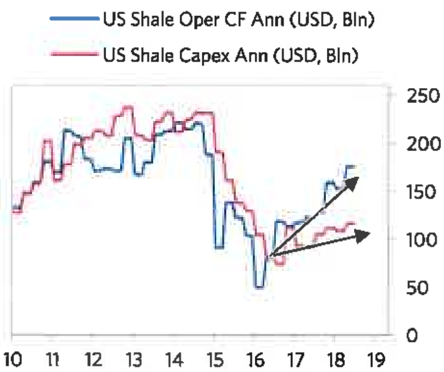
**Oil Capex (USD Bln, Ann)**

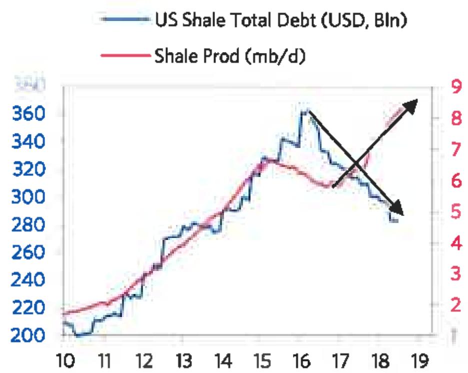



While shale capex has recovered the most of any sector, shale producers have shown meaningful capital discipline in the last year, instead growing at a sustainable rate (investing in line with their operating cash flow) while paying down debt, which had grown substantially during the prior shale boom. While this has been a headwind to both production and investment over the recent recovery, it puts shale producers on much stronger footing to handle any eventual downturn in oil prices and/or to take advantage of further increases.



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