

Bridgewater® Daily Observations

September 26, 2018

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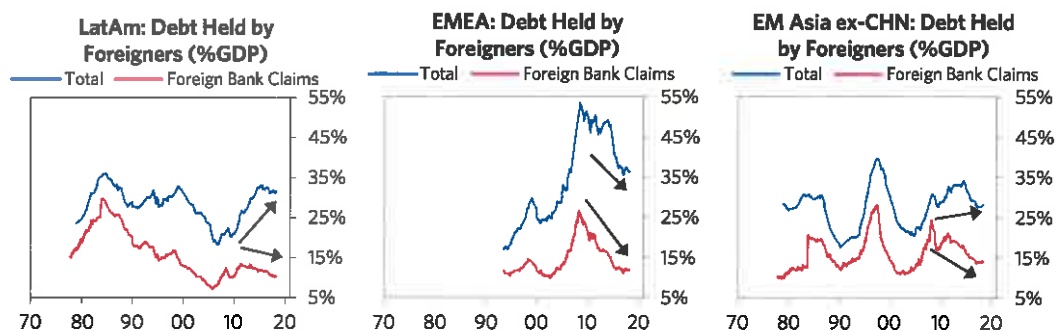
Larry Cofsky
Vini Pecora
Charlie Woodlief

Emerging Debt Cycle Fueled by Bonds Not Banks Translates to Less Contagion

As the withdrawal of dollar liquidity puts strains on borrowers reliant on that liquidity, the borrowers' problems become their lenders' problems. The response of the lenders then flows through to other economies and markets, aka contagion. Prior *Observations* have noted that there are fewer excesses and imbalances in this emerging debt cycle, which reduces expected strains and losses relative to prior cycles. We also expect less contagion from strains that do arise because this debt cycle has been primarily financed by bonds, rather than bank lending. Capital markets investors can of course experience losses. But it is the banks, with their 10x leverage, where losses can ripple through economies and markets by impairing the ability of banks to supply credit. Their role has been smaller in this cycle, reducing this vulnerability.

In prior cycles, much of the lending to emerging economies came from developed world banks. Since the exposures were large and the losses big, the losses caused banking problems. These impairments in turn caused the banks to cut back on the supply of credit at home and abroad. The Latin American debt crisis exemplifies this dynamic well. This cycle, the direct lending from banks was relatively small, reducing the likelihood of a ripple from emerging market debt problems to a material cut in the supply of credit. Within the developed world, European banks have more exposure to risky emerging borrowers than other lenders do. But even there, we expect losses to be more of an earnings problem than a capital problem, reducing the contagion impact. The one place that concerns us is Italy, as its weak recovery and fragile debt markets remain a big problem, and the ECB's monetary policy for the aggregate of Europe is increasingly at odds with what Italy needs.

Relative to prior cycles, banks have played a much smaller role in the current emerging debt cycle.

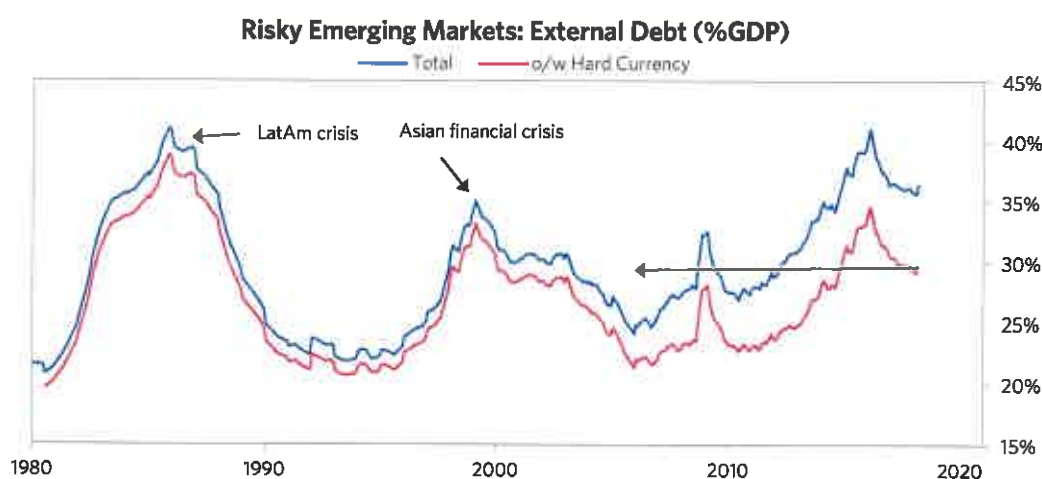


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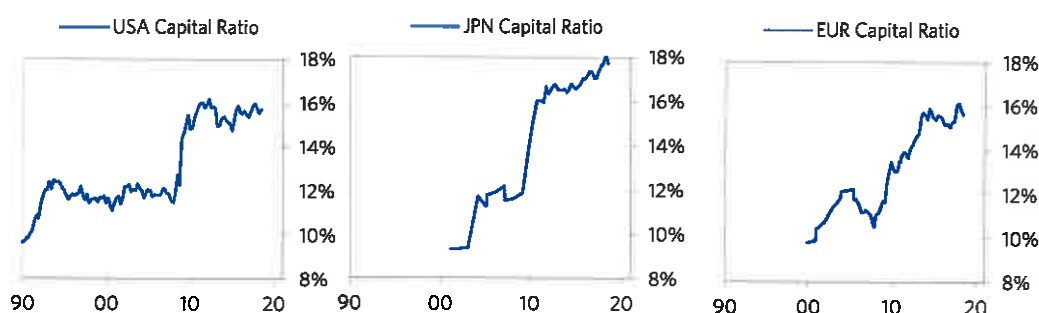
The Current EM Debt Cycle Looks Less Extreme Than Previous Cycles, So the Losses to All Investors Are Likely to Be Smaller

The post-crisis stimulation by central banks helped fuel a classic buildup in external debt by global borrowers. As we have noted in previous *Observations*, there are fewer excesses today. The chart below highlights two points:

- 1) Although total debt levels are near prior peaks, borrowers have reduced their reliance on hard currency funding, lowering their asset/liability mismatch compared to past cycles.
- 2) Over the last couple of years, most borrowers have moved from borrowing to paying down debts.

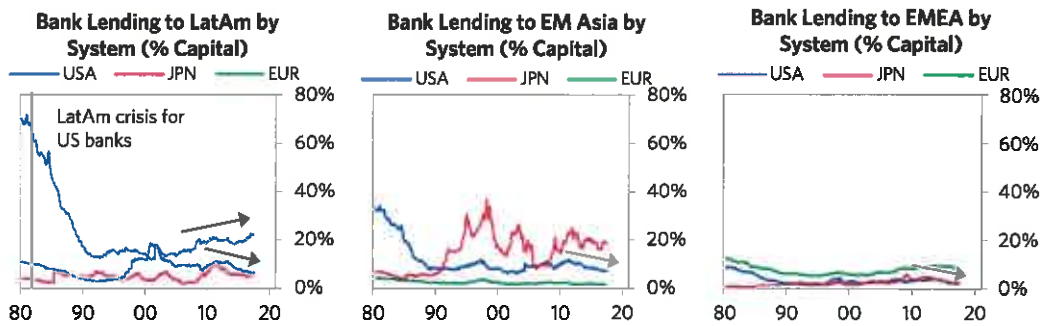


The size of the debt buildup relates to the first-order consequences of a rollover, but the impact on the banks is what matters most for contagion. As we will walk through below, relative to prior cycles, the developed world banks have a smaller market share in what we see as a smaller than average emerging debt cycle. And it is important to keep in mind that the developed world banks are unusually healthy at this stage of the economic cycle. This is because of 1) the extreme tightening of the regulatory environment since the financial crisis, and because 2) central bank money rather than bank credit has fueled developed economies as well as emerging ones.



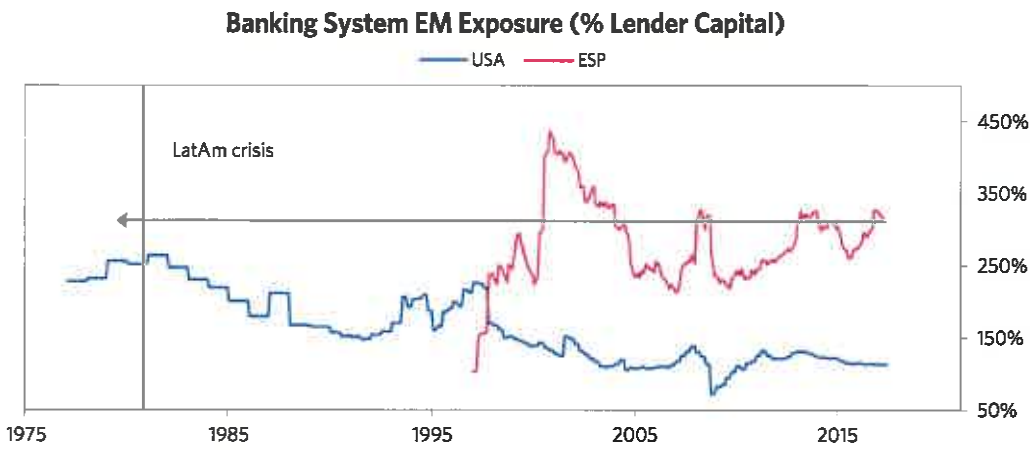
In Developed World Banking Systems, European Banks Have the Largest Exposure to Emerging Economies

Relative to US and Japanese banking systems, Euroland banks have increased their exposure more and lent to riskier borrowers (Latin America, Turkey, South Africa). But the exposure is still small relative to other cycles, notably the LatAm exposure by US banks in the 1980s. Most of the growth in US and Japanese banks' lending since 2000 has been to EM Asian countries that we assess to have relatively low levels of indebtedness and vulnerability to a decline in dollar liquidity.

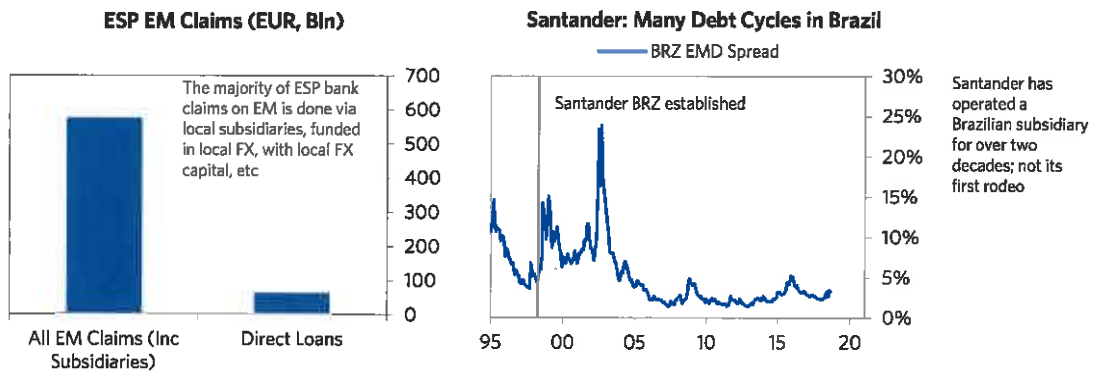


Spain's Exposure Is the Largest in the Eurozone, but the Type of Exposure Makes It More Likely That the Risk Is to Earnings Rather Than to Capital

Spain is the only EU banking system with material exposures to EMs, mostly from Santander and BBVA's ownership of Brazilian and Mexican banks. In a pure balance sheet accounting sense, Spanish bank exposures look comparable to the US's bank exposures in 1980s during the LatAm crisis (which had a materially negative impact on the US banking system). But understanding the exposures and the banks themselves reveals important differences that we believe produce significantly lower levels of capital risk.

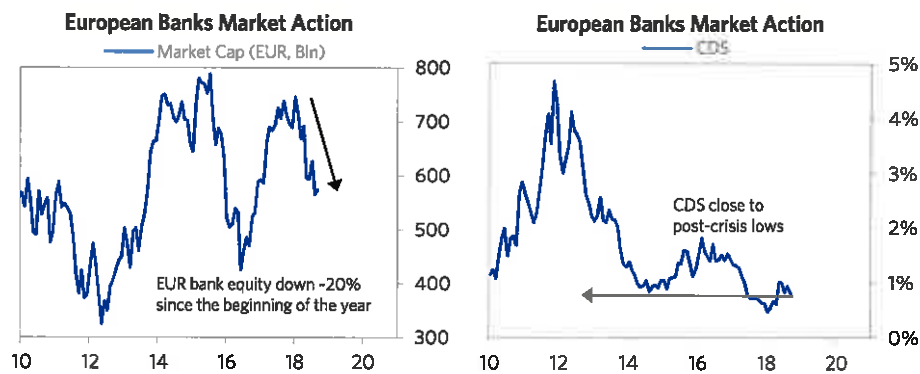


The bulk of Spanish bank exposure is via the ownership of local subsidiaries that fund, lend, and hold capital in local currency (Santander Brasil, BBVA Bancomer in Mexico, Garanti Bank in Turkey). While not our base case, if conditions in these subsidiaries get bad enough, capital losses can be capped at the direct ownership stake of the banks, which is a fraction of the overall exposure. The loss of these subsidiaries would be a huge blow to the earnings and market capitalization of the Spanish banks, but given the subsidiary structure, would be less likely to directly impact their lending in Spain. In contrast, the bulk of US bank exposure to Latin America in the 1980s was direct hard currency loans.

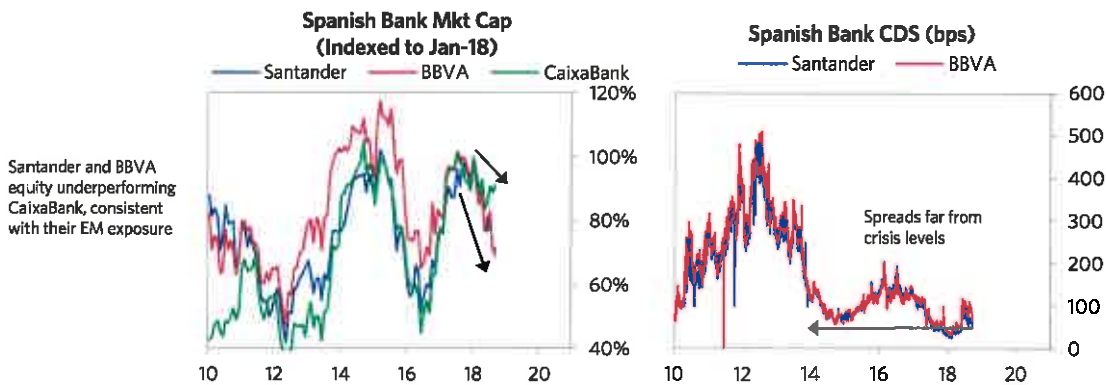


Market Action Also Suggests an Earnings Problem Rather Than a Capital Problem

At the aggregate system level, European bank equity has sold off ~20% since the beginning of the year, while spreads have remained close to post-crisis tight—consistent with the picture that EM strains should be more of an earnings problem than a major risk to the system.



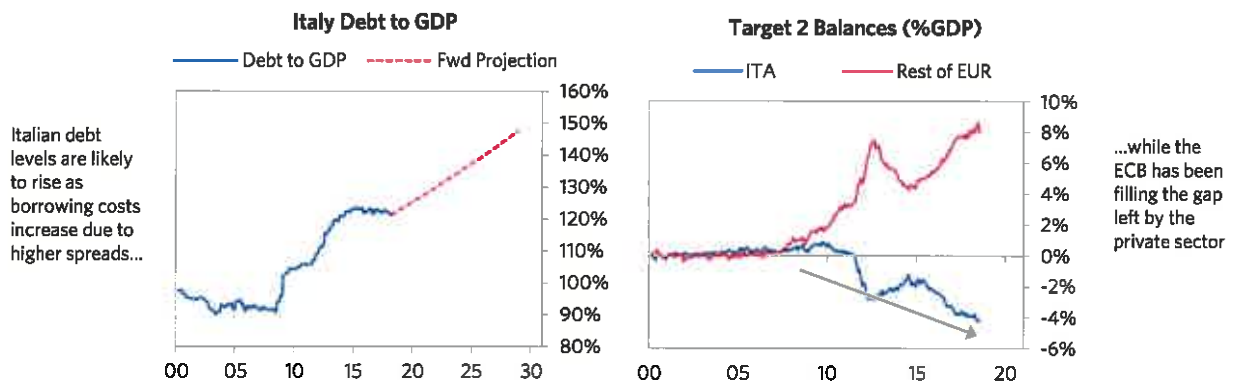
Even for the most exposed banks in Spain (Santander and BBVA), the market action looks similar in nature. While the more exposed Spanish banks have underperformed their less exposed peers in terms of equity, falling -30% since the start of the year, here too, spreads are little changed.



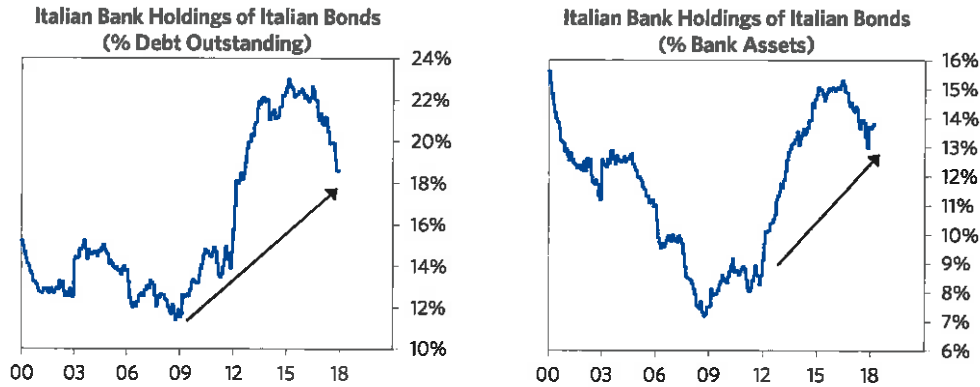
Italy (Not Emerging Debt) Is the Systemic Problem for Euroland

As we have previously communicated, conditions in Italy are fragile, which makes for both economic and political (populist) risks if there is either a tightening of monetary policy or a downturn. That is because Italy has made very little progress with structural reforms to deal with its larger problems (and given the current political dynamics, it is unlikely to make progress anytime soon), so it has been left in the dust relative to the rest of Europe. This leaves Italy more vulnerable to what happens when the ECB tightens policy in response to the aggregate recovery of the Euroland economy.

The charts below highlight the long-term unsustainable path of Italian debts and the role that the ECB has played in providing the money to fund their debt growth.



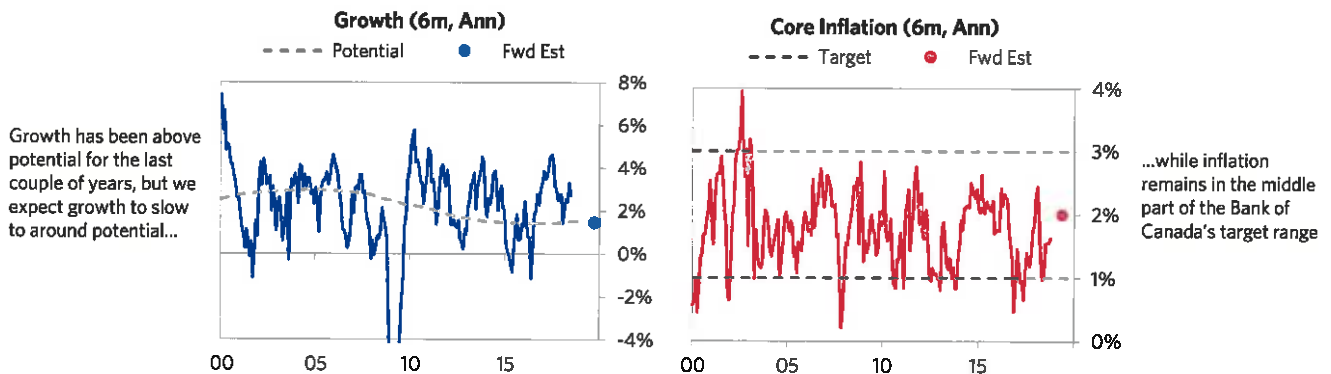
Any debt problem will quickly become a problem for Italian banks and likely many others in Euroland. Almost 20% of Italy's sovereign debt is owned by Italian banks, and these holdings make up almost 15% of the banks' aggregate assets. As a result, pressure on either the sovereign or on the banks quickly becomes an acute problem for the other, and could push a sell-off to become self-reinforcing if no other buyer of the bonds (like the ECB) is ready to step in.



Canada Faces Less Favorable Conditions and Meaningful Downside Risks

Jason Rotenberg | Sam Haber

A continuation of the tightening cycle in Canada in line with what is discounted looks to us like an unlikely extrapolation of how strong recent conditions have been. Over the last two years, Canadian policy makers have managed to navigate the difficult balance between cooling the housing boom while not creating a bust. At this point, though, macroprudential tightening combined with modestly higher rates has been enough to produce a meaningful cooling of household borrowing and the housing market. The impact of the tightening could prove more significant than it has been so far, as the impact on sales has been more substantial than the impact on prices. This slowdown, combined with the ongoing US tightening cycle and the likely slowing of US import demand, should lead to a moderation in overall Canadian growth. It's also worth noting that NAFTA renegotiations remain unresolved, and a trade shock is still not out of the question. With these factors taken together, our base case is a moderate slowdown toward potential, but we see the risks to the Canadian economy as asymmetric to the downside at a time when significant tightening remains priced in.

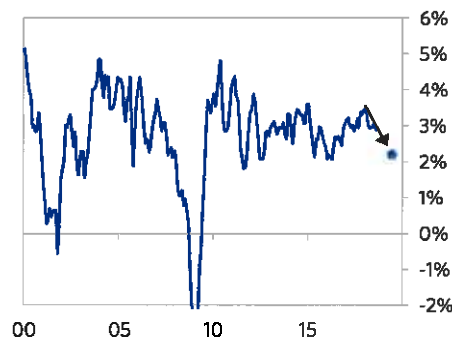


Household Credit Creation (%GDP)



However, the risks are to the downside as household borrowing has slowed...

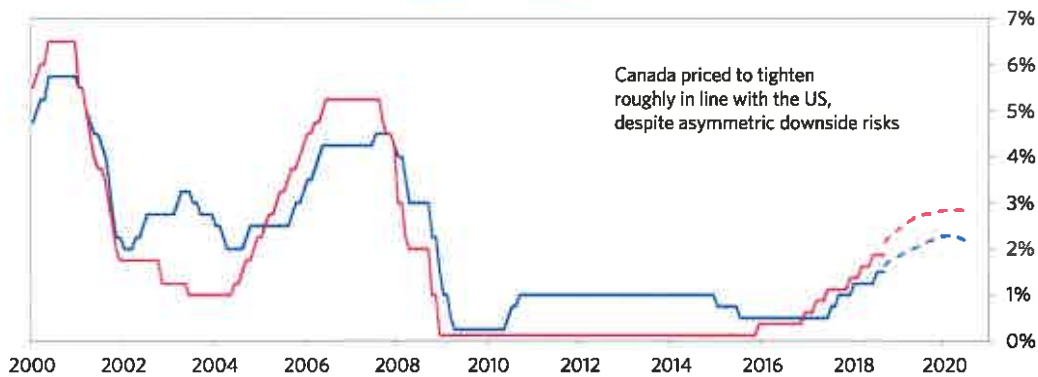
CAN Trade Partner Growth ● Leading Est



...and trade has been a source of growth that is at risk of fading, given US tightening and NAFTA renegotiations

Central Bank Policy Rate

— CAN — USA



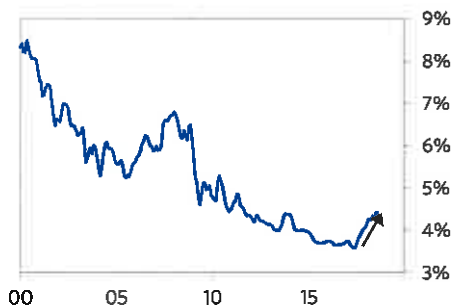
Macprudential Tightening and to a Lesser Extent Higher Rates Have Dramatically Cooled Household Borrowing

Since the summer of 2017, the Bank of Canada has raised interest rates by 100bps and is discounted to hike another two to three times in the next 12 months. Even more important have been the macroprudential moves. The most significant of these measures have been 1) introducing a foreign buyers' tax in Vancouver and Toronto and 2) initiating stress tests of borrowers' abilities to service their mortgages should interest rates rise in the future. While market mortgage rates have only risen 100bps since the middle of last year, the introduction of this stress testing requires that buyers can afford their mortgage if rates rise by another 2%, making the effective tightening quite a bit larger.

At this point, we're seeing the tighter policy flow through via falling unit sales and flat home prices nationwide. The impact of higher rates should also be felt faster in Canada, where most mortgage rates reset every five years.

Conventional Mortgage Rate

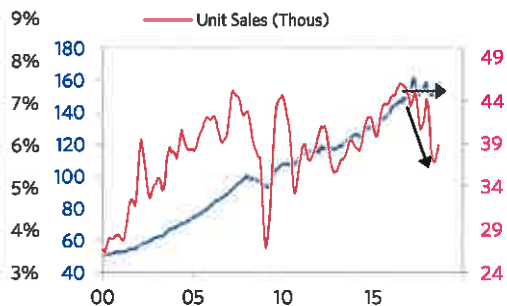
— 5-Year



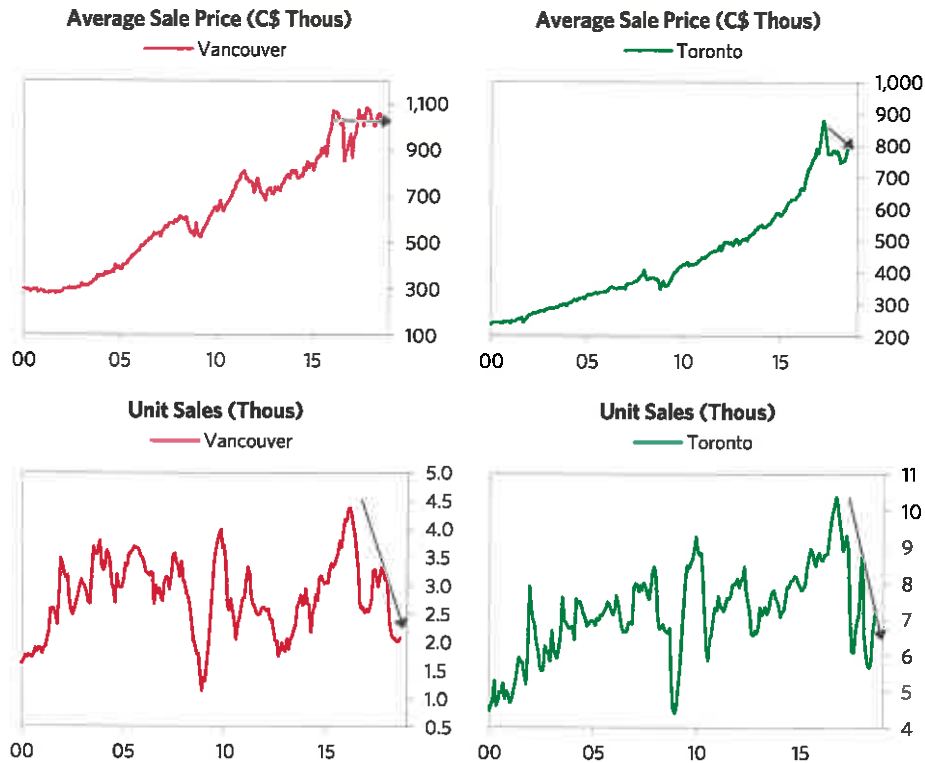
Canada Residential Market

— Avg Sale Price (Indexed to 2008)

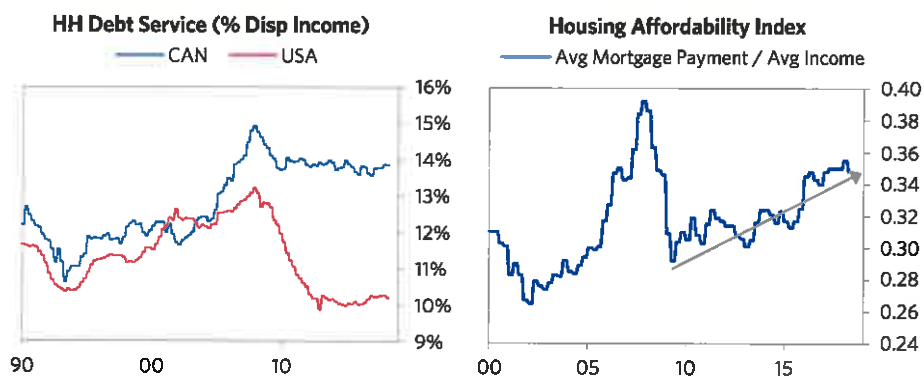
— Unit Sales (Thous)



This tightening has had a significant impact on the frothiest housing markets in Canada: Vancouver and Toronto.

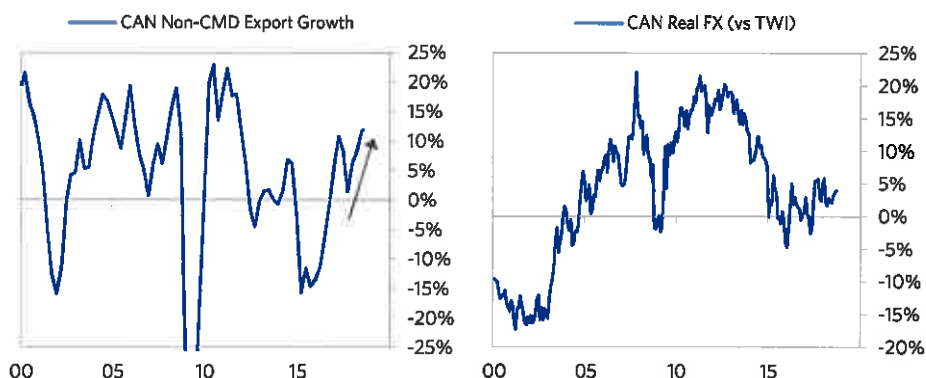


While the tightening so far has for the most part successfully cooled borrowing and home price appreciation without turning overall growth, the risks of overtightening are significant, given the lack of deleveraging in Canadian households. Household debt service as a share of disposable income remains at high, and even with the slowdown in home prices, houses are about the most expensive they've been relative to income in the last 20 years.

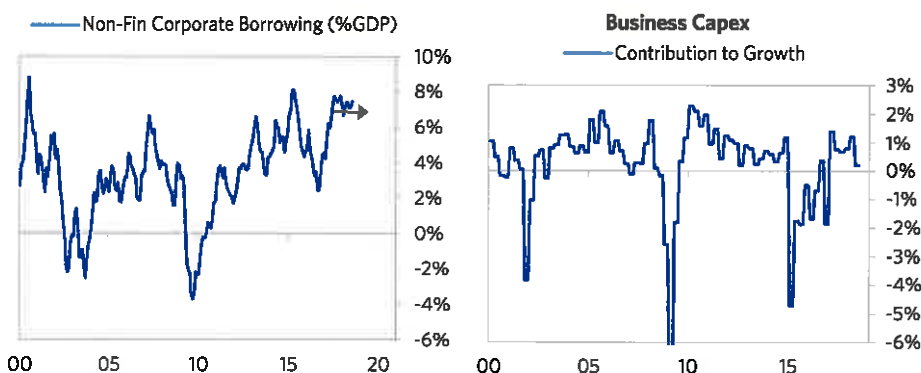


The Tailwind from Trade Is Likely to Fade, with Bigger Downside Risks if NAFTA Renegotiations Fail

Offsetting the slowdown in household credit creation and the roll-off of last year's fiscal stimulus has been strong trade-related growth in Canada. Tightening in the US is likely to result in some moderation, while the Canadian dollar hasn't moved much lately and isn't a support or a drag. Of course, the risks could be more substantial, depending on how NAFTA renegotiations progress.

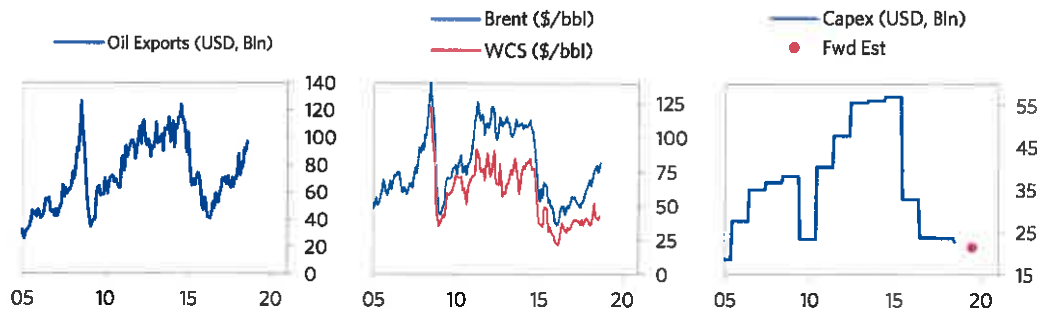


And while corporate borrowing remains high, much of this borrowing is being used to fund stock buybacks and mergers, similar to in the US. While this has been a support for stocks and will likely continue, it does not reflect strong, self-reinforcing underlying economic conditions. Business capex has actually rolled over recently, going from a small support to growth to closer to neutral.



Oil Prices Are a Support, but Relatively Small and Likely to Fade

Lastly, rising oil prices and increasing production have been a boost to growth over the last year. However, high breakeven costs, along with steep discounts for Canadian crude (WCS) due to pipeline limitations forming gluts locally, have led to limited new investment in spite of the higher global price.



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