

Bridgewater® Daily Observations

October 2, 2018

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Where Things Stand

Revisiting the key forces at work on global economies and markets:

We have transitioned from a long period of monetary easing to monetary tightening.

The flow of global money and credit is gradually rolling over, comprised of a contraction in money, which is raising asset yields, and an expansion of credit, which is supporting growth and cash flows.

The pace of monetary tightening is moderate, led by the Fed via the roll-down of the balance sheet and a rise in short-term interest rates, with impacts on the dollar that are in turn impacting the most liquidity-sensitive countries.

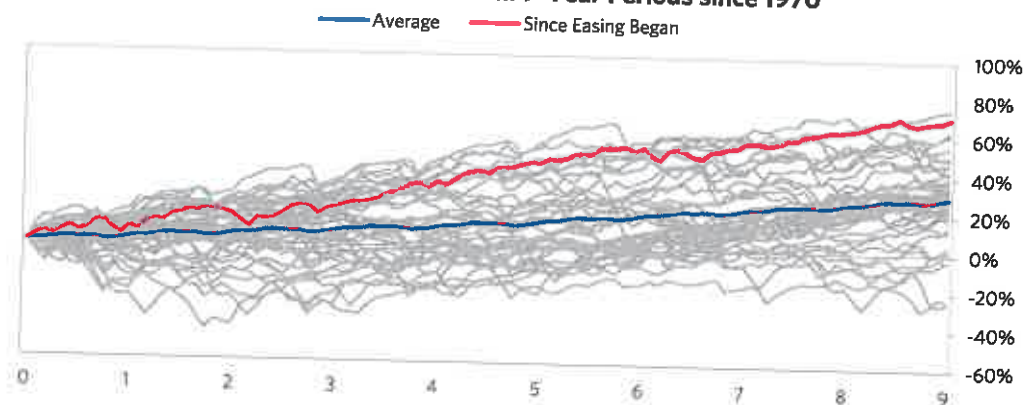
Unusual for this late stage of the cycle, the global financial system is not over-leveraged, is less vulnerable to a pullback in credit in response to the monetary tightening, and continues to support global growth.

China's economic policy is now of comparable importance as policy in the US and Europe. The past year's macroprudential tightening reduced financial leveraging in the system, so far without inhibiting the flow of core credit to the real economy or producing an economic slowdown. In response to trade tensions and the associated rise in risk premiums, the PBoC has eased monetary policy a bit, and the government is now preparing a round of targeted, moderate fiscal stimulation in case they need it.

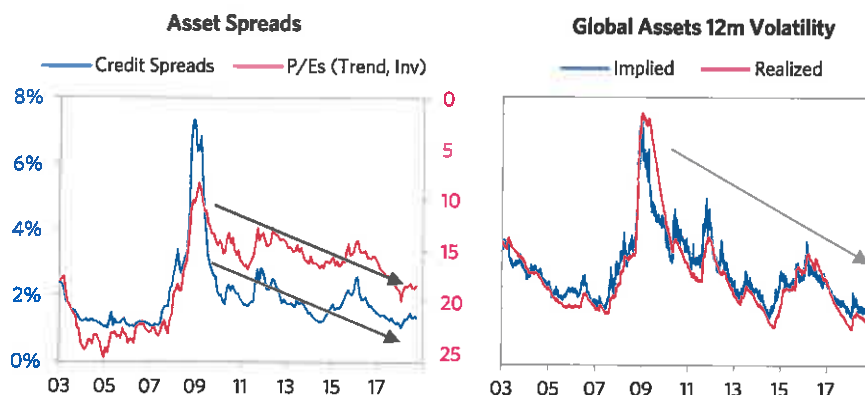
The expected returns of assets are low and the next downturn presents unique risks.

Looking back, nine years ago we had high risk premiums and monetary stimulation, and this stimulation lasted for many years. Now, we have low risk premiums and monetary tightening. The stimulation was successful and as a result of that success, asset returns over the period were as high as any nine-year period in history, and risk premiums fell from among the highest levels of the past 100 years to among the lowest. Below, we show the past nine years of returns in relation to all prior nine-year periods, and associated measures of risk premiums.

Global 60/40 Portfolio - All 9-Year Periods since 1970



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The depth of the 2008 recession and the magnitude of the rise in risk premiums at that time allowed a lot of room for economies to expand and for asset prices to rise. Given the debt overhang and the deleveraging pressures, it took a lot of stimulation to produce a moderate amount of growth, which then took a long time to approach capacity limits. Now, the transition from the mid-cycle to the late cycle is bringing forward an environment that is threatening to asset returns, as shown below.

Average Return-to-Risk Ratios Across Countries¹

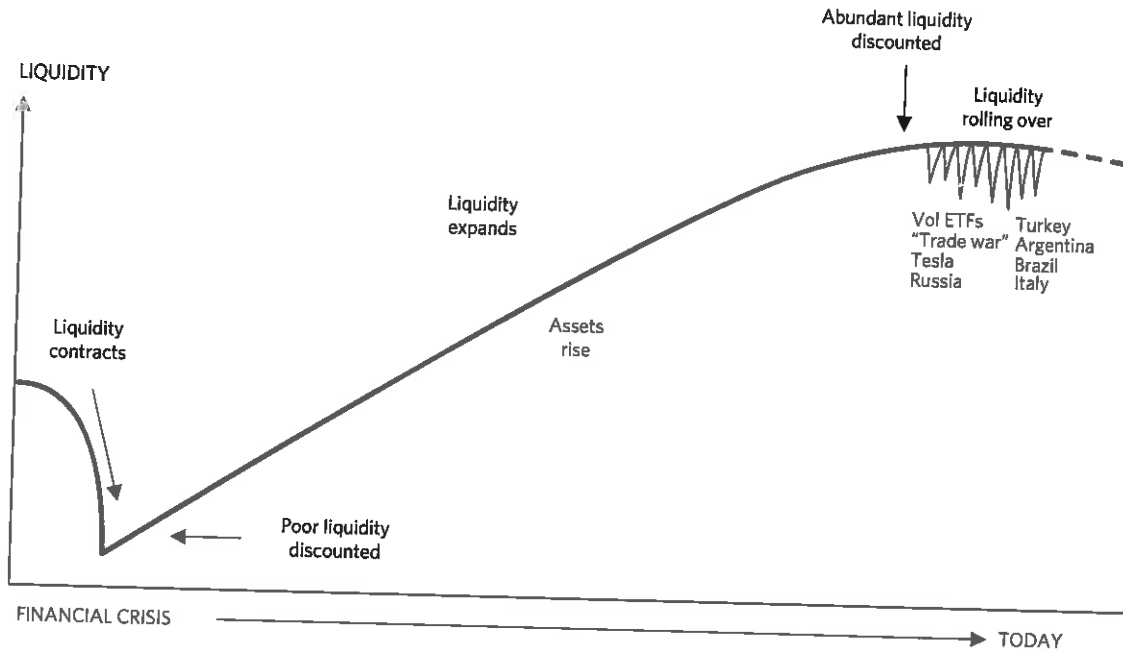
World			
Average Ratio	Early Cycle	Mid Cycle	Late Cycle
Equities	0.6	0.5	-0.2
Nominal Bonds	0.9	1.0	-0.4
IL Bonds	0.6	0.5	0.4
Credit	0.9	0.7	-0.4
Commodities	0.1	-0.2	0.4
World 60/40	0.8	0.7	-0.3
Balanced Portfolio	1.2	0.9	0.0

Transition

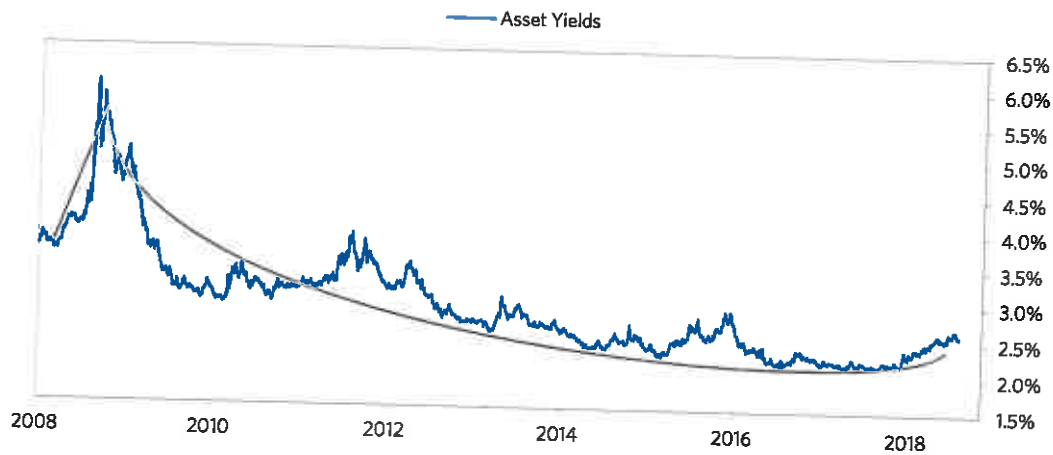
United States				Eurozone			
Average Ratio	Early Cycle	Mid Cycle	Late Cycle	Average Ratio	Early Cycle	Mid Cycle	Late Cycle
Equities	0.4	0.6	0.0	Equities	0.8	0.3	-0.5
Nominal Bonds	0.6	0.5	-0.2	Nominal Bonds	0.8	1.6	-0.5
IL Bonds	0.4	0.5	0.4	IL Bonds	0.3	1.6	0.0
Credit	0.9	0.5	-0.4	Credit			
US 60/40	0.6	0.7	0.0	Europe 60/40	0.9	0.5	-0.6
Balanced Portfolio	0.7	0.8	0.4	Balanced Portfolio	1.0	1.2	-0.3

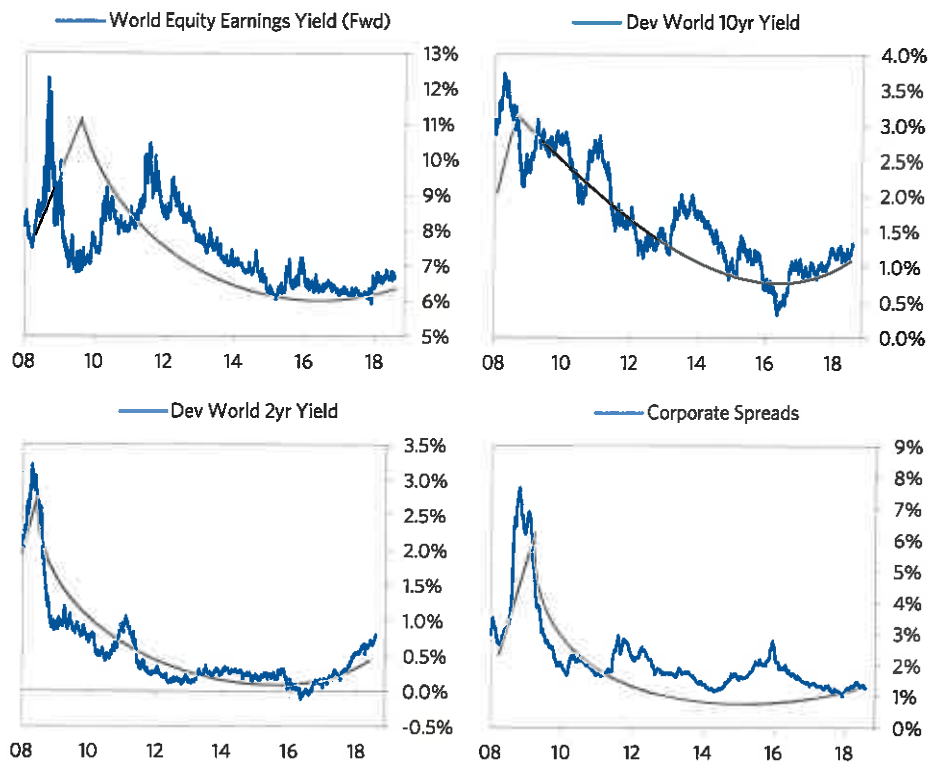
¹ Balanced Portfolio returns are based on the All Weather Asset Mix, which is simulated. It is expected that the simulated performance will periodically change as a function of both refinements to our simulation methodology and the underlying market data. HYPOTHETICAL OR SIMULATED PERFORMANCE RESULTS HAVE CERTAIN INHERENT LIMITATIONS. UNLIKE AN ACTUAL PERFORMANCE RECORD, SIMULATED RESULTS DO NOT REPRESENT ACTUAL TRADING OR THE COSTS OF MANAGING THE PORTFOLIO. ALSO, SINCE THE TRADES HAVE NOT ACTUALLY BEEN EXECUTED, THE RESULTS MAY HAVE UNDER OR OVER COMPENSATED FOR THE IMPACT, IF ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. Past performance is not indicative of future results. Please review the "Important Disclosures and Other Information" located at the end of the Daily Observations.

Unlike most late-cycle periods, in this one so far the rise in inflation is not much. And as a result, the pace of monetary tightening is moderate. At the same time, the financial system remains accommodative and supportive of growth, mostly because it deleveraged during the expansion instead of leveraging up as it normally would, i.e., the expansion was financed more by money than by credit. The combined flow of money and credit is now rolling over gradually. This year's series of risk events all had noticeable risk-off impacts at the time, but the effects dissipated rather than triggering a chain reaction because the flow of credit to the real economy has not been interrupted.

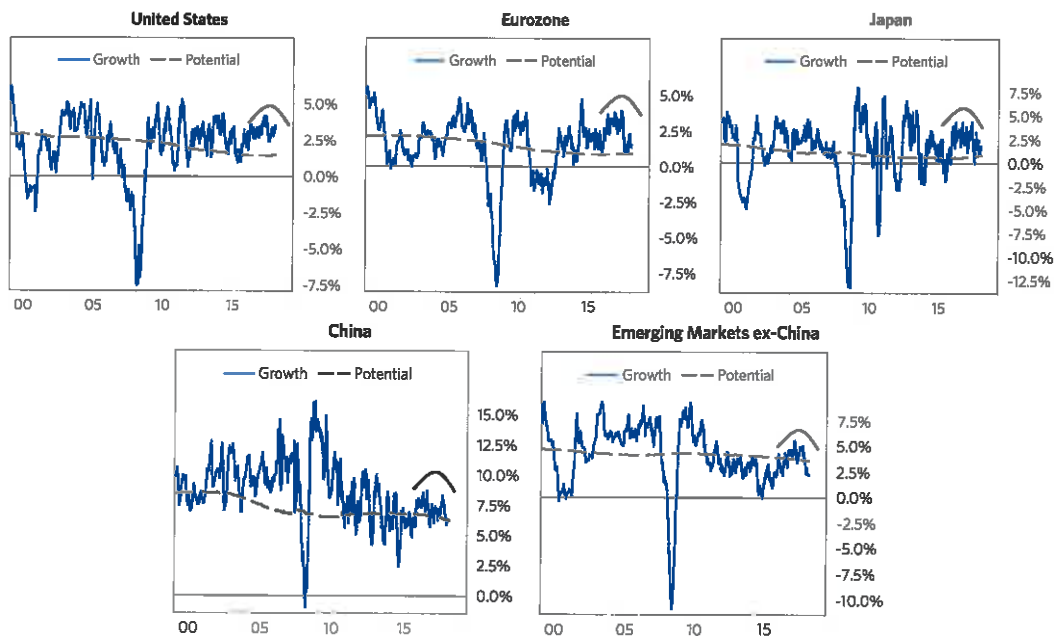


The retraction of liquidity by central banks has withdrawn a layer of excess liquidity that had previously been pumped into the financial system, which drove prices up and yields down. The pulling back of money and the raising of short-term interest rates have lifted the weight of excess liquidity on yields, allowing the yields on assets to drift slowly higher at a pace roughly commensurate with the pace of aggregate global monetary tightening.

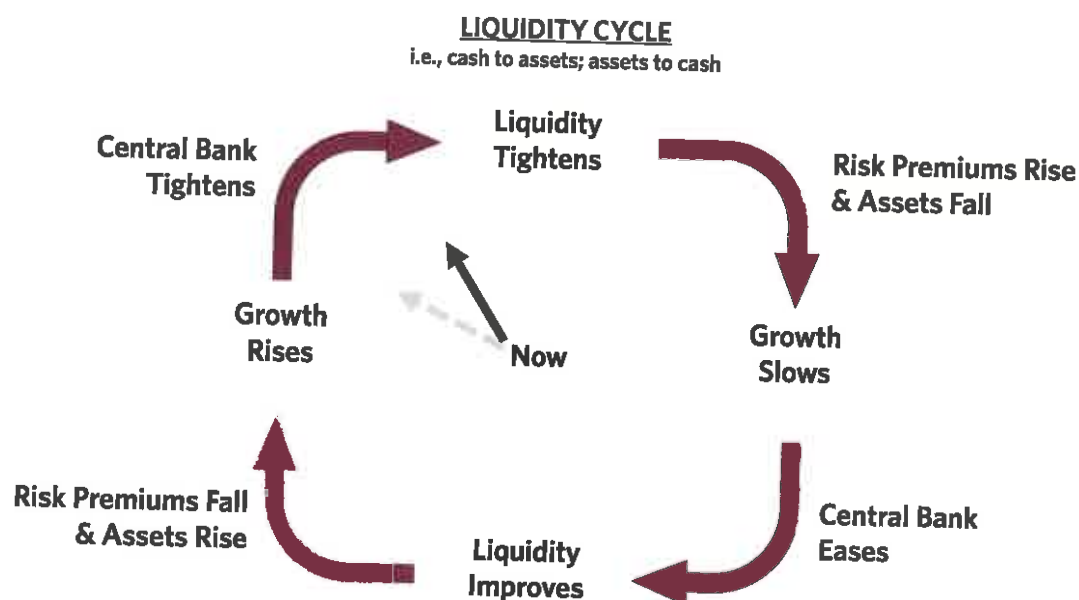




However, the flow of credit continues to support continued economic growth. Global growth has leveled off recently, as the impulse of the 2015-16 easing has faded and there has been a gradual tightening. But the flow of credit has prevented that decline from becoming more severe so far.

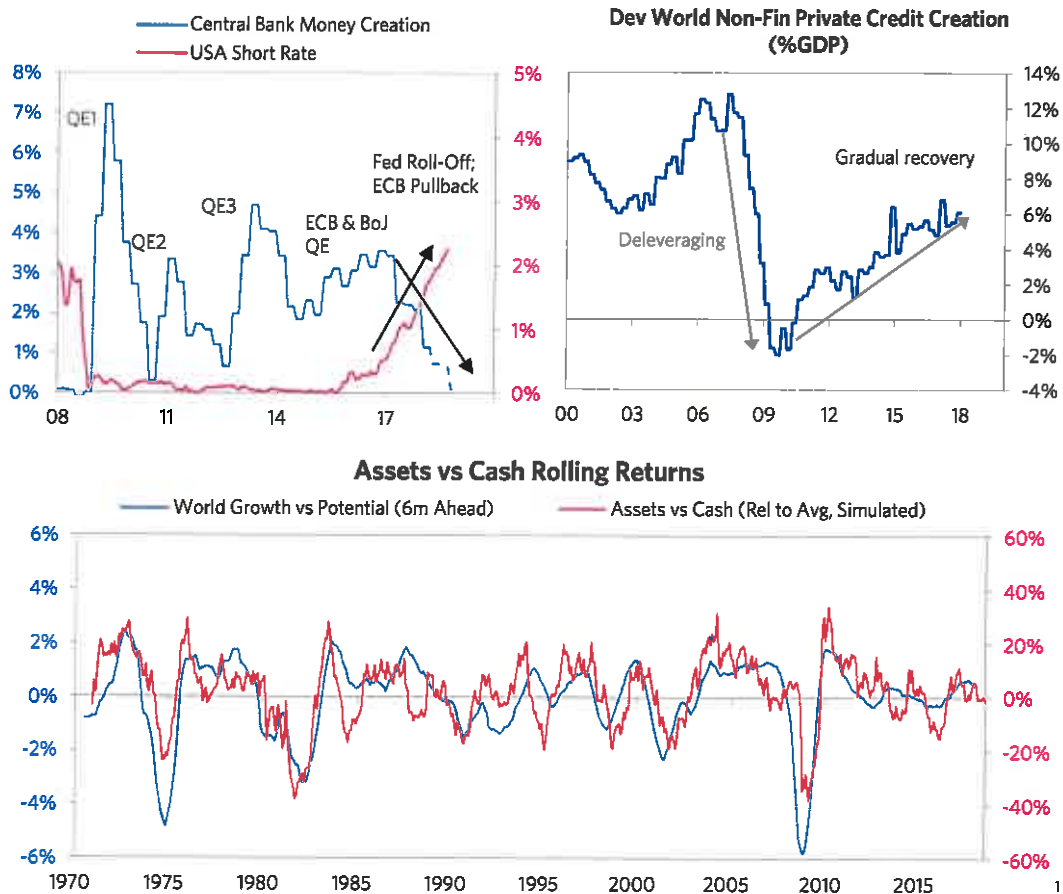


The following illustration conveys where we now stand in relation to the normal linkages between monetary policy, liquidity, risk premiums, asset returns, and growth. We're at about 10:30 on the dial and still moving in the clockwise direction. Recall that in 2016 we were at about 9 o'clock, an indication of the pace of this transition.



A key determinant of a move past midnight on the clock, when risk premiums rise and growth falls, is the flow of credit to the real economy. So far, the financial sector is supportive, and the rise in interest rates has not been big enough to cause a substantial decline in the demand for credit. In the US, interest-rate-sensitive sectors of the economy have slowed a bit, but the economy is now less dependent on housing than in times past and business sector spending has been sufficient to keep things moving.

Looking forward, the pipeline of liquidity to the economy has three main segments, and downturns typically occur when all three are in contraction. There is monetary policy, which controls the flow of money and the short-term interest rate, and leads by about 12 to 18 months. There is the financial system, which provides credit and responds to the demand for credit, and leads by about 6 to 12 months. And there is the movement of money between cash and assets, including debt as a short cash position, which leads by about 3 to 6 months. At the present time, you've got a moderate pace of global monetary tightening implemented via less QE (including the Fed roll-down) and rising short-term interest rates, you've got a credit expansion financed by the global financial system, and the movement of money between cash and assets is roughly at a standoff after the prior period of money moving out the risk curve.



Looking ahead to the next downturn, when it comes it will present unique risks because:

Central banks' ability to reverse it on their own without coordinated fiscal spending will be limited due to a limited ability to cut interest rates and risk premiums already compressed by QE.

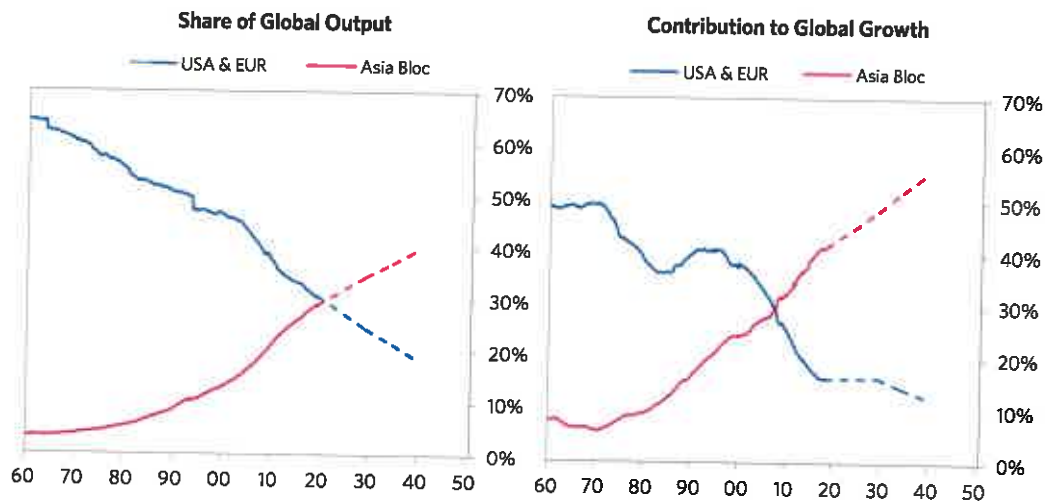
Political division will impact effective fiscal policy coordination.

Deflation with interest rates near zero can trigger a self-reinforcing rise in real interest rates, which would be bad for assets.

There are too many long-term financial promises to be kept, given low levels of nominal growth and asset returns.

¹ Assets v. Cash returns are based on the All Weather Asset Mix, which is simulated. It is expected that the simulated performance will periodically change as a function of both refinements to our simulation methodology and the underlying market data. HYPOTHETICAL OR SIMULATED PERFORMANCE RESULTS HAVE CERTAIN INHERENT LIMITATIONS. UNLIKE AN ACTUAL PERFORMANCE RECORD, SIMULATED RESULTS DO NOT REPRESENT ACTUAL TRADING OR THE COSTS OF MANAGING THE PORTFOLIO. ALSO, SINCE THE TRADES HAVE NOT ACTUALLY BEEN EXECUTED, THE RESULTS MAY HAVE UNDER OR OVER COMPENSATED FOR THE IMPACT, IF ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. Past performance is not indicative of future results. Please review the "Important Disclosures and Other Information" located at the end of the Daily Observations.

Against this backdrop, it is increasingly important for investors to take a secular view to the East, both as an investment destination and as a source of policy changes that have global impacts. What we refer to as the Asian economic bloc is increasingly large and increasingly independent from the influence of the West, providing true economic diversification and the potential for better returns (depending on pricing, etc.). Its output is roughly on par with the combined output of the US and Europe and is growing two or three times as fast. The capital markets have lagged behind the cash flows, but will catch up. From a cyclical standpoint, trade tensions have recently led to a discounting of higher risk premiums at the same time as growth has continued along without slowing much, the PBoC has eased, and China is preparing targeted fiscal stimulation. The summary images below convey the secular shifts at work.



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