

# Bridgewater®

## Daily Observations

January 3, 2012

©2012 Bridgewater Associates, LP

(203) 226-3030

Ray Dalio  
Jason Rotenberg  
Stephen Modelfino

### Update on the Seismic Shift

- Debtor developed countries that can print money (e.g., the US and the UK) are spreading out their deleveragings so that they have slow, fragile growth.
- Debtor developed countries that can't print money (European PIIGS) are entering deflationary depressions.
- Creditor emerging countries that can't stop printing money are seeing cracks in their debt bubbles and slower growth rates.
- The world as a whole is slipping toward deflationary contraction while central bankers are reflate, with central bankers in the weakest areas easing the most and those in the strongest areas easing slightly.

#### **In the US: The Credit System is Healing Slowly**

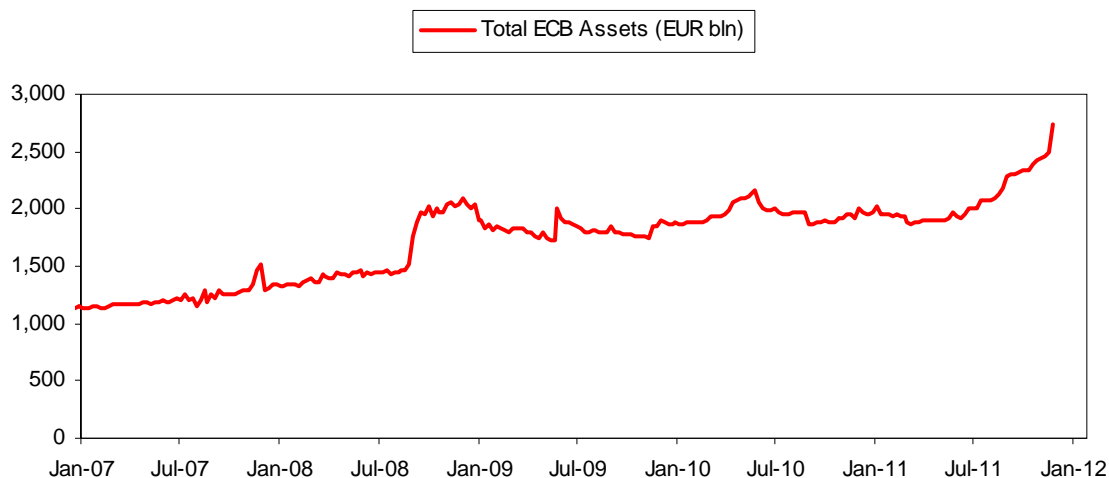
While recent growth rates have been a bit higher than are sustainable (as they have been supported by declining savings rates and budget deficits that are unsustainably large), the spreading out of the debt adjustment process is progressing in a slow, orderly way, with real growth in the 1 ½% to 2% vicinity, nominal growth about 3 ½% to 4% and nominal interest rates below these nominal growth rates. This is about as good as it gets – steady but precarious.

#### **In Europe: The ECB is Aggressively "Printing" to Offset the Contraction in Private Sector Debt**

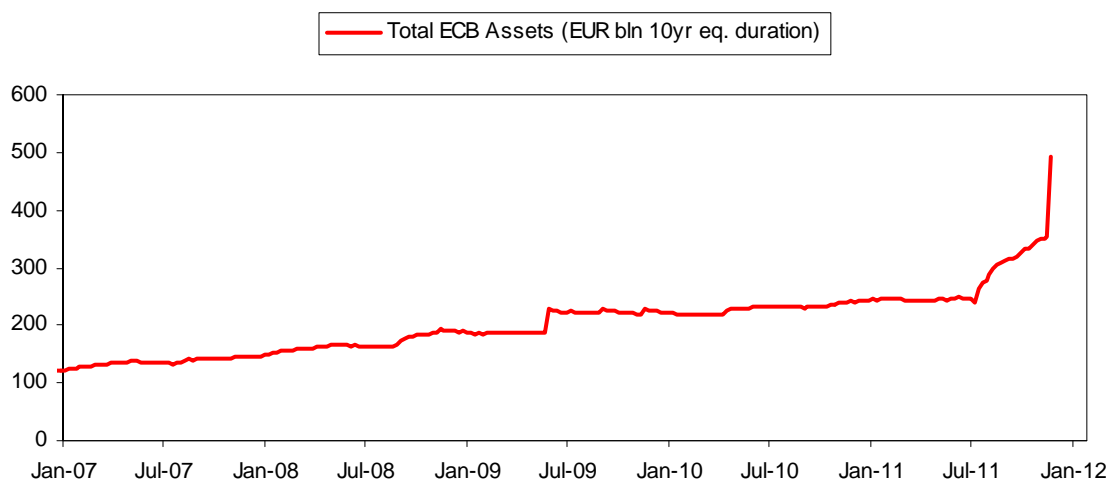
When the dust settles and we look back to tally the numbers to see how much of the European debt crisis was resolved via transferring wealth, restructuring debt and "printing" money, the printing of money number will almost certainly be much larger than the other numbers. "Money printing" has been the biggest number in virtually all deleveragings in history (for good reasons), though it must be accompanied by wealth transfers and debt restructurings in order to get the balance right. To get the balance right, the rate of "money printing" must offset the rate of credit contraction, keeping nominal interest rates below nominal growth rates, gradually lowering debt/income ratios and creating positive real growth without causing unacceptably high inflation. Also, the central bank must spend the money that it "prints" on financial assets that will save the system but will not sustain non-essential entities, leaving them in a Zombie state. That is why restructurings are important.

Policy makers typically find this right mix of alternatives via painful trial and error processes rather than from studying past deleveragings and understanding how they work. They typically do too much or too little of one or the other policy, which leads to painful consequences, which leads them to readjust the mix until it's good. That's what they are now doing in discovering how effective (i.e., ineffective) fiscal budget austerity is in resolving debt crises.

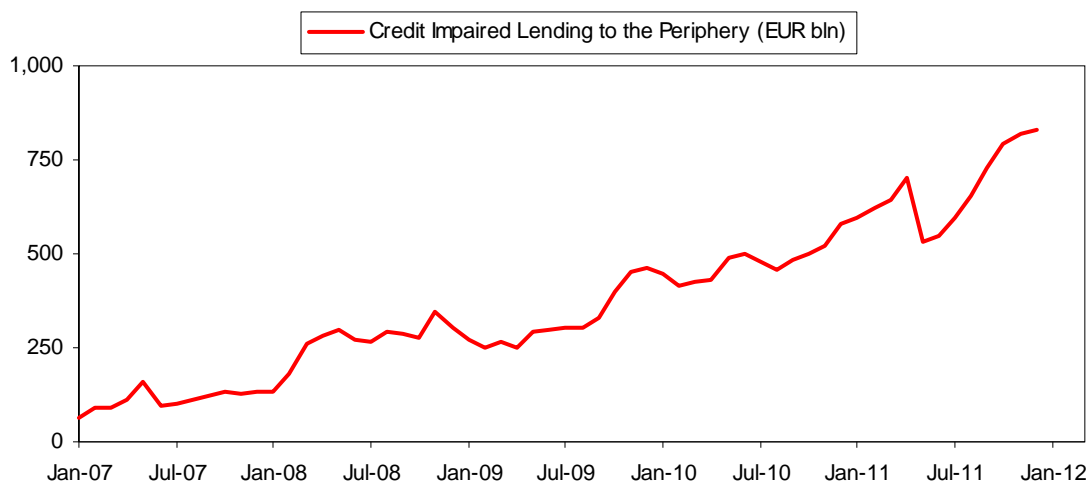
For all its coyness, when pushed to the edge, the ECB chose to aggressively "print" money – i.e., it chose to accept a lot of bad collateral in exchange for subsidized, low interest rate loans – in order to support banks and sovereigns. The chart below shows the ECB's balance sheet. It is taking on a lot of exposure, increasing the size of its balance sheet to €2.7 trillion, an increase of €700 billion over just the last six months.



The prior chart understates the degree of the ECB's "printing" because it treats all assets the same. It is better to look at these numbers on a duration and credit quality adjusted basis because lengthening the duration of the debt held and holding lower quality assets produces greater effects. The next chart shows the ECB's assets in duration terms.



The next chart shows the ECB's holdings of what we will call "credit impaired" assets to convey those with credit risk, by which we include assets of peripheral banks or sovereigns.



European central bankers following this path is less objectionable to purists because this path appears more in keeping with their mandate. At the same time it deals with the banks' liquidity problems and provides an indirect path to buying sovereign bonds. By easing aggressively in this way and simultaneously talking strongly about refusing to deviate from their mandates, central bankers can easily move down this monetization path. It is easy for them to convince themselves and others that they are making good loans because nobody can yet be sure how much of its collateral will end up being bad.

Knowing what we know about the collateral, it seems likely the ECB will suffer large losses, even relative to the resources it can draw upon to absorb those losses. Still, if we were in the ECB's shoes of having to prevent a deflationary depression and quickly compensate for excesses of the past and inadequate fiscal policies, we would do the same or similar things in order to 1) have money printing offset credit contracting, 2) to save systemically important entities and 3) to work toward lowering nominal interest rates relative to nominal growth rates. While it is sad to say, buying bad debt and monetizing it is clearly now the favored path.

This expansion of the ECB's balance sheet 1) will certainly reduce the risks of a deflationary depression (which are still significant) and 2) is not necessarily bearish for the euro or inflationary over the short term. It is a strong stimulant administered by the ECB to its patient in response to the patient's plunging blood pressure. This stimulation can give stocks and the economy a boost, though it should not be assumed that it will have sustained stimulative effects.

### **The "Printing" is Not Short-Term Bearish for the Value of Money Because of the Short Squeeze, but it is Long-Term Bearish**

Despite all the "money printing" by all the major central banks, the forces of deflationary debt contraction are still stronger than the forces of reflation. That is because there is currently a short squeeze for money. Debt is a short money position – i.e., a commitment to deliver money that one doesn't have – so cash is king when there is a credit contraction, even when the central bank is printing a lot of cash. For this reason euros (and dollars) are now in demand despite their bad fundamentals. When the shorts are done being squeezed, these currencies and the "safe-haven"/"high grade sovereign credit" denominated in them will suffer and alternative currencies (e.g., gold) will benefit. But that time is not now and the exact timing of this shift remains uncertain. Most likely, it will be sometime in the next 12-18 months. For now, the risks of deflationary deleveraging are greater than those of reflationary inflation.

## Globally, the Seismic Shift is Tipping Toward Deflationary Depression, Making These Shifts Appropriate

The world is still severely out of balance. Naturally, when it is out of balance a lot of pain is produced and pressures build to move it back into balance. The pain intensifies until there is a snap that might seem very painful at the time – like the shifting of seismic plates that is an earthquake – but that bring things closer to equilibrium. Important shifts in history are typically marked by these big market and economic shifts.

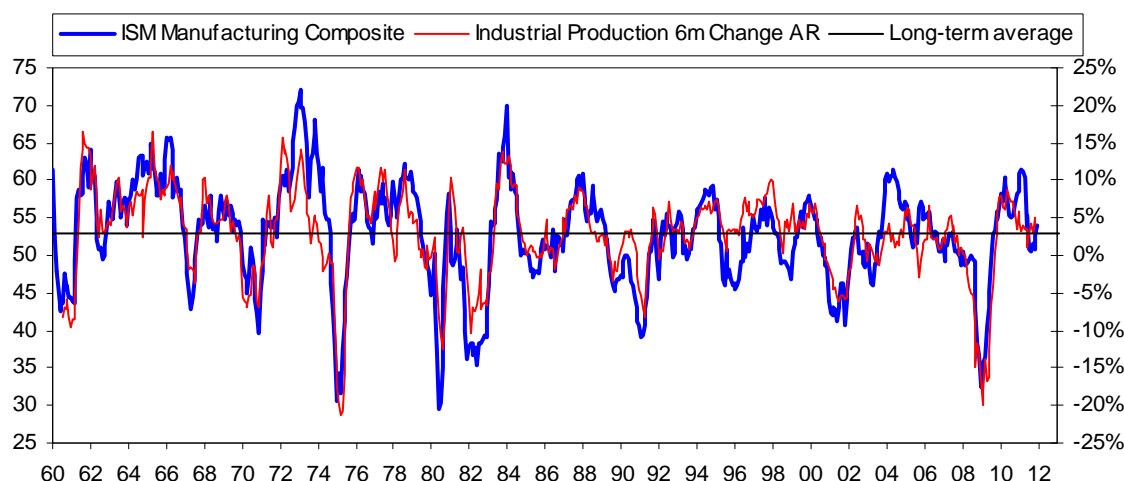
As you know, we believe that a) there are logical limitations to the amounts of debt that creditors will choose to lend to debtors, b) at this time numerous debtors have passed their limits, and c) the projected rates of adjustment that policy makers are using, which generally mean slightly slower rates of increase in indebtedness rather than debt reductions, cannot happen. In other words, despite attempts of policy makers to push this debt expansion further, they can't. Significant funding gaps will remain. Banks and sovereigns must deleverage. Pursuing their stated paths (e.g., having fiscal deficits of 8%-9% of GDP in Spain at the same time as private credit growth is contracting) won't work; it will lead to a "seismic shift" in the form of unmanaged deleveragings that could lead to a global depression. That view is no longer controversial. It is now obvious. So, understandably, central banks are now trying to fill the funding gaps with abundant liquidity. At the same time, banks must contract and consolidate as they can't adequately recapitalize.

In Europe especially, and for the world generally, we are not sure which side of the point of no return we are on, but we are confident that we are on the edge. There is a more than trivial chance that the deleveragings of banks (and other financial intermediaries), their customers and sovereigns cannot be well managed, let alone reversed, and that we have entered a new phase in which the deleveraging process will gain momentum and will test the effectiveness of monetary and fiscal policy makers. The forces of deflationary contraction and the forces of reflation are both gaining momentum and are coming together like two big waves that are about to collide. This increases the likelihood of a violent blow-off in the markets.

## United States

### ISM Report

US growth is now a bit above average at around 3%, and Tuesday's ISM report is roughly in line with this (i.e., slightly above average growth). As discussed earlier in this report, current growth rates are not likely to be sustained, and we expect growth to be slow modestly. The chart below shows the ISM report against industrial production growth. Both are slightly above average.

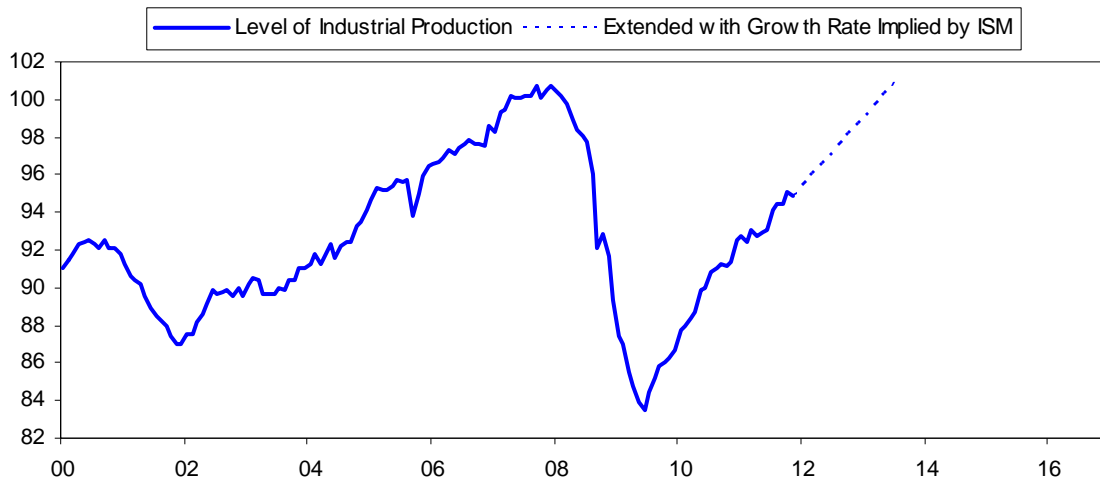


Looking at the breakdown of the ISM survey, the strength is fairly broad-based, with the major components (production, new orders and employment) above average to different degrees. The main exception is exports, which are expanding but at a weaker pace than their long-term average. The prices component is weak, but is not particularly informative, as it reflects the recent dip in industrial metal prices.

**ISM Manufacturing Survey**

Index	Current Percentile	M-M	Dec-11	Nov-11	Oct-11	Sep-11	Dec-10	1yr Avg
Purchasing Managers Index	52%	1.2	53.9	52.7	50.8	51.6	58.5	55.3
Production	72%	3.3	59.9	56.6	50.1	51.2	63.0	57.5
New Orders	57%	0.9	57.6	56.7	52.4	49.6	62.0	56.5
Employment	80%	3.3	55.1	51.8	53.5	53.8	58.9	57.5
Export Orders	29%	1.0	53.0	52.0	50.0	53.5	54.5	55.3
Import Orders	70%	5.0	54.0	49.0	49.5	54.5	50.5	53.6
Inventories	54%	-1.2	47.1	48.3	46.7	52.0	51.8	50.1
Backlog of Orders	38%	3.0	48.0	45.0	47.5	41.5	47.0	50.3
Deliveries	32%	0.0	49.9	49.9	51.3	51.4	56.7	54.7
Prices	16%	2.5	47.5	45.0	41.0	56.0	72.5	65.2

Production levels remain depressed at almost 6% below peak levels. If the strength in the ISM does translate into a pickup in production, industrial production may return to peak levels in about a year and a half.



Bridgewater Daily Observations is prepared by and is the property of Bridgewater Associates, LP and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives or tolerances of any of the recipients. Additionally, Bridgewater's actual investment positions may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment restrictions, portfolio rebalancing and transactions costs, among others. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This report is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned.

Bridgewater research utilizes data and information from public, private and internal sources. External sources include International Energy Agency, International Monetary Fund, National Bureau of Economic Research, Organization for Economic Co-operation and Development, United Nations, US Department of Commerce, World Bureau of Metal Statistics as well as information companies such as BBA Libor Limited, Bloomberg Finance L.P., CEIC Data Company Ltd., Consensus Economics Inc., Consumer Metrics Institute, Credit Market Analysis Ltd., Ecoanalitica, Emerging Portfolio Fund Research, Inc., Global Financial Data, Inc., Global Trade Information Services, Inc., Hewitt Associates, LLC, Intex Solutions, Inc., Markit Economics Limited, Mergent, Inc., Moody's Analytics, Inc., MSCI, RealtyTrac, Inc., RP Data Ltd., Standard and Poor's, Thomson Reuters, TrimTabs Investment Research, Inc. and Wood Mackenzie Limited. While we consider information from external sources to be reliable, we do not assume responsibility for its accuracy.

The views expressed herein are solely those of Bridgewater as of the date of this report and are subject to change without notice. Bridgewater may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.