

Our 2021 Global Outlook

JANUARY 2021

BOB PRINCE
RAY DALIO
GREG JENSEN

In the markets, the biggest opportunities and the biggest risks arise when you have a confluence of unsustainable flows of money and credit forming prices that discount unlikely future economic scenarios. Today, we see a number of such opportunities and risks unfolding over both cyclical and secular time frames, including the risk of severe wealth destruction if the new paradigm of zero interest rates and coordinated monetary and fiscal policy (MP3) is pushed to its limits.

From a cyclical standpoint, the past year's extreme levels of economic distress, as well as differences in the level of distress across countries and differences in the policy response to it, have pushed prices to extremes and away from one another, to levels that now discount a number of unlikely scenarios given how money and credit conditions are likely to transpire over the coming year.

From a secular standpoint, the rebalancing of economic power between East and West, and between China and the US, has moved forward at an accelerated pace as a result of differences in the past year's management of the virus simultaneous with the money and credit flows associated with these policies creating forward prices that are discounting a reversal in those secular trends. And beyond that, we see a growing and increasingly imminent risk of real wealth destruction in the assets and currencies of those countries that constitute the existing world order.

How do we arrive at our views? While this research is about our outlook, it is important to register that we don't value conclusions or outlooks very much. What we value is the logic of the cause-effect linkages that are the basis of those conclusions. The merit of the views can be assessed, and as conditions inevitably change, the implications of these changes will naturally fall out. Because the cyclical naturally occurs in the context of the secular, we will address our secular perspective first.

Secular Divergences

In our template for what drives economies, we see four big forces. Today, these forces are producing secular divergences across countries and regions.

The four big forces that drive economies are:

- productivity, which is the source of real income and wealth over time
- a long-term debt cycle, which impacts the levers and the cause-effect linkages
- a short-term debt cycle, which is the result of the pulling of the levers and how the cause-effect linkages play out
- politics, which shapes who pulls the levers and how they pull them

Applying this template, we see that most developed economies will be experiencing a coming decade of low productivity growth. They are also in the latter stages of their long-term debt cycles, characterized by high debts and near-zero interest rates. High debts and near-zero interest rates limit the potential for spending and income growth and make reversing a downturn more difficult, which is why we are now in an MP3 world that requires fiscal policies to work in tandem with monetary policies to manage economies. At the same time that the traditional policy levers are more limited, populism—driven by the wealth and opportunity gaps—is leading to rising internal conflict, which is polarizing the politics and creating bigger demands on the system. As the policy choices narrow and the pressures grow, debt and monetary restructuring become an increasingly desirable way to relieve the pressures. Lifting the burden of debt restores policy latitude.

When you apply the same template to a number of other economies, you see a very different set of conditions, particularly for economies in the East, most importantly for China. The determinants of long-term productivity growth indicate a coming decade of strong productivity growth, and these countries are still in the earlier stages of their long-term debt cycles. They have more policy flexibility to stimulate growth and manage cyclical conditions. They have the risk of big wealth gaps, with differences in culture and governance to manage them. Dealing with the gaps is an established priority, though it remains to be seen how well they will pull the levers to do that.

The big differences between East and West and between the US and China are exerting another pressure on the system: geopolitical conflict of the rising power challenging the incumbent power, referred to by the Harvard political scientist Graham Allison as the Thucydides Trap. Such conditions have occurred a number of times through history and the effects have been studied by us and by others. The track record is worrisome; about 75% of the time these circumstances have led to war. War generally approaches in stages, and there are also different types of wars. We've already had a minor trade war. There are also capital wars and technology wars, which we've gotten a whiff of. We see the election of Joe Biden as reducing the degree of geopolitical antagonism. But the divergent forces that are the root cause of these tensions will continue to build.

These divergent secular forces also have big implications for asset returns and investing. Differences in the degree of monetary stimulation and liquidity provisions have led to higher yields on the assets of countries that are likely to have the most productivity growth, are in long-term debt cycle up-waves, and have the most policy flexibility, the best balance sheets, and the least amount of money printing. And yet, their higher asset yields mean that the forward pricing of their cash flows in common currency terms are at a big discount to those countries that have near-zero bond yields, have lower productivity growth, are in the latter stages of their long-term debt cycles, have less policy flexibility, have more internal conflict, are increasingly dealing with their circumstances through monetization, and are progressively moving toward what countries have done through history when faced with such circumstances—a debt and monetary restructuring. From an investment standpoint, this *at least* calls for geographic diversification to balance the risks. And tactically, we favor the currencies and unhedged assets of one in relation to the other.

Real Wealth Destruction

We want to register a warning about the new paradigm that we are now in and the risk of real wealth destruction that we could face.

With respect to the money and credit part of the new paradigm, there is the creation of a lot of fiscal debt that is supported by money printing, in order to get checks into the hands of people so that you don't have a depression or revolution. And there is the need for this to continue. This is a subtle way of transferring wealth and making the debt overhang that we face easier to repay. When you print money to fund government debt, it lessens the value of money and debt, and this move to what we refer to as MP3 is necessitated by zero interest rates.

With the limitations of zero interest rates and central bank policy less effective on its own, we asked ourselves what this new paradigm could look like. That led us to examine 200 years of panics and reflations and 500 years of the rises and declines of empires and reserve currencies so that we could see a lot more sample size than we had before.

Through these investigations, we saw a picture of repeated wealth destruction in every type of financial asset as countries inevitably took whatever steps were necessary to restore tolerable economic conditions. The process of reflation typically progressed through four stages, depending on the nature of the problem and the choices of policy makers. They generally started with monetary stimulation, and if that didn't work you had fiscal stimulation, and if that didn't work you had debt restructuring, and if that didn't work you had monetary restructuring. In virtually 100% of the cases, reflation ultimately worked—as in, it relieved the economic distress. The only question was how far you had to go and what impact it would have on asset holders.

What was most interesting was that through the economic circumstances that have played out and the policy actions taken, **at some point in history every asset has experienced a decline in real purchasing power of 50-80%, including cash, which was an extremely risky asset to hold when viewed through the lens of purchasing power.**

This work led to the development of our “reflation indicator” (i.e., when to bet against cash and to bet on reflation) and the design of an alternative storehold of wealth that we call AltCash, which we believe is a safer alternative to cash with respect to purchasing power over time.

The new paradigm that we find ourselves in today has the markings of such dangerous times of the past. Cash and bonds are already destroying wealth through negative real yields. And the printing of money to fund government debt—to augment lost income, not to make productive investments—is reducing the value of those currencies at a time when the nominal return from holding the bonds is near zero. Being at the latter stages of the long-term debt cycle, combined with the wealth and opportunity gaps along with geopolitical conflict on the rise, means that the pressure to borrow, print, and raise taxes will be with us until the monetary system breaks.

Consistent with the histories that we have studied, we are now in a time to print money and devalue, and the determination of where the money and credit will go will be directed by the government. It’s an open question as to how much will go to raise economic productivity and how much will go to helping people. We’re not saying this can’t be a good thing; it just depends on how effectively it is used to address the biggest problems of the economy and society.

This is mostly a very US-centric view, impacting the US dollar and US capital markets. But Europe has its own version. And to some extent, the same conditions exist in other reserve currencies like the yen and sterling, which are the currencies of countries on the downhill side of the super-secular cycles of empires.

As discussed above, there are other countries that are in other parts of the long-term debt cycle. And this has implications for investing in other places. **We believe what’s most important from an investment standpoint is diversification across currencies and countries as well as asset classes.**

Think about currency allocation, not just asset allocation.

We find that investors devote a lot of attention to their asset allocation and not enough attention to their currency allocation, which can be managed separately. Currency depreciation is a desirable way, and a hidden way, of dealing with a debt problem. Through this process, nobody actually says who’s paying the price. And a currency decline is stimulative for the local economy in nominal terms and drives asset prices up in that currency; the wealth destruction is indirect. **This is a big deal.**

Against this backdrop, as described, there are notable differences in how certain countries like China have handled the challenges of 2020 from the pandemic point of view and from the economic point of view. This has occurred simultaneously with big divergences in the supply and demand for money and credit, with Western economies producing a lot of money and debt, and Eastern/Asian economies producing less. Alongside these divergent conditions, we see China’s incremental opening of their capital account as accommodating the path toward a more prominent global role for the RMB. **There is a big shift going on in the world from a monetary point of view that we should all get ready for.**

Moving to the cyclical perspective, we will highlight a few of the more significant opportunities that we see.

A Flood of Liquidity

Looking at the sources and uses of funds, we've seen a flood of liquidity accumulating in cash that will likely be bad for cash and favor a well-diversified set of assets.

Looking back over the past year the big economic forces were:

- **a collapse in incomes**
- **caused by a pandemic**
- **with interest rates at zero**

Leading to:

- **reflations and a move to MP3**, with governments borrowing to supplement lost incomes, with that borrowing financed by central bank money printing. This creation of money and credit has produced a massive layer of excess liquidity.
- **storeholds of wealth outperforming** as liquidity poured into them.
- **a wide differentiation in outcomes** between those most impacted by the collapse in spending and those that benefit most from the flood of liquidity.

As unusual as the pandemic has been, and as novel as the policy responses have been, their effects can be understood by way of how they pass through an economy's sources and uses of funds. For any entity its sources of funds must equal its uses of funds, and for an economy these sources and uses of funds take the following forms.

$$\begin{array}{ccccccc} \text{Sources} & & & & & & \text{Uses} \\ \hline \text{M} & + & \text{C} & + & \text{I} & = & \text{S} & + & \text{F} & + & \text{R} \\ \text{Money} & & \text{Credit} & & \text{Income} & & \text{Spending} & & \text{Financial} & & \text{Reserves} \\ & & & & & & & & \text{Asset} & & \\ & & & & & & & & \text{Purchases} & & \end{array}$$

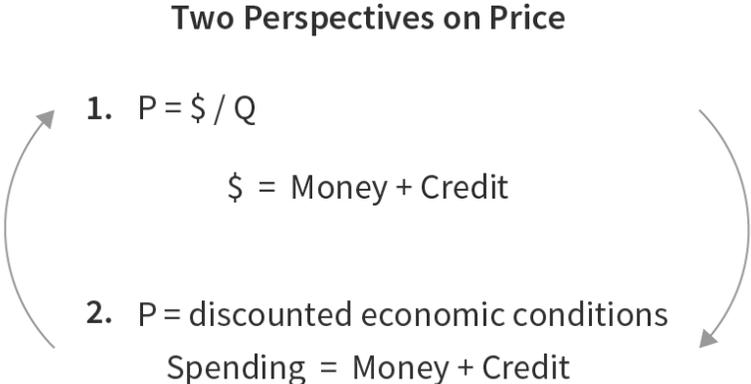
The net of where we are today is that globally there has been more than enough money and credit produced to offset incomes lost, producing a net surplus of income in relation to spending. **That excess is now sitting in cash earning near-zero nominal yields and negative real yields, looking for places to go.** What happens with it will be an important influence on the near future.

In this environment, we'd expect to see the devaluation of cash relative to well-diversified portfolios of assets. And with respect to the economy in the near term, as the influence of the virus fades there will likely be some release of pent-up demand, particularly in those forms of spending that have been most impacted. And at a sector level, housing is an area that has plenty of potential after a decade of supply contraction, near-zero mortgage rates, extra money for down payments sitting in bank accounts, and an incrementally higher need/desire/capability to work from home.

Imbalances and Mispricings

We see current prices reflecting unsustainable flows and imbalances, creating an environment ripe with opportunity.

What matters most to investing is how prices are formed and, once formed, what they imply for the future. We've used the following diagram a number of times to convey these key building blocks. What it says is that prices are formed by an exchange of currency for quantity, and once that price is formed, it implies the discounting of future economic scenarios. The fuel for the system is money and credit, which is where the funds come from for the exchange that sets the price, and where the funds come from to finance the spending that is discounted in prices.



The biggest opportunities occur when unsustainable flows of money and credit form prices that discount future economic scenarios that are unlikely given the next round of money and credit conditions. Due to the extreme levels of money and credit flows recently produced, the big differences across countries, and the extreme impacts on spending, income, and prices, we see a number of cases where unsustainable flows have formed prices that are discounting unlikely future economic scenarios.

As an example, Mexico is a country that experienced the full brunt of a declining economy and retraction of liquidity and did not offset the decline in the economy with fiscal stimulation or the printing of money. Their spending, income, and imports collapsed, and their fiscal and monetary balance sheets remained largely unchanged. As a result, their current account moved into big surplus at the same time that their currency and asset prices fell. Thus, their exchange rate and asset pricing are now implicitly discounting a continuation of the extreme flows that shaped them and the collapsed levels of income and spending that are consistent with those flows. Anything in the direction of a normalization of money and credit flows would produce an economic scenario much better than what is discounted and at the same time would relieve the liquidity squeeze that formed the current set of prices.

These sorts of imbalances are leading to some of the largest opportunities we have seen in our decades of managing money. The number of markets where our signals (which represent the conviction of our views across markets) are near their maximums is large. Across a number of countries, the combination of prior currency declines, equity declines, and rising interest rate differentials has made their discounted future cash flows in USD terms very cheap (i.e., their unhedged assets). In the developed world, Japanese stocks unhedged in USD terms are as undervalued as we've seen in decades. In the emerging world, Brazil is an example with similar dynamics to Mexico. And behind a lot of what is going on, you have the record amount of dollars and dollar debt being created relative to the long-term demand to hold dollars. Currency exposure is going to be a big deal.

This research 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, including data from actual Bridgewater trades. Sources include the Australian Bureau of Statistics, Bloomberg Finance L.P., Capital Economics, CBRE, Inc., CEIC Data Company Ltd., Consensus Economics Inc., Corelogic, Inc., CoStar Realty Information, Inc., CreditSights, Inc., Dealogic LLC, DTCC Data Repository (U.S.), LLC, Ecoanalityca, EPFR Global, Eurasia Group Ltd., European Money Markets Institute - EMMI, Evercore ISI, Factset Research Systems, Inc., The Financial Times Limited, GaveKal Research Ltd., Global Financial Data, Inc., Haver Analytics, Inc., ICE Data Derivatives, IHSMarkit, The Investment Funds Institute of Canada, International Energy Agency, Lombard Street Research, Mergent, Inc., Metals Focus Ltd, Moody's Analytics, Inc., MSCI, Inc., National Bureau of Economic Research, Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, Renwood Realtytrac, LLC, Rystad Energy, Inc., S&P Global Market Intelligence Inc., Sentix GmbH, Spears & Associates, Inc., State Street Bank and Trust Company, Sun Hung Kai Financial (UK), Refinitiv, Totem Macro, United Nations, US Department of Commerce, Wind Information (Shanghai) Co Ltd, Wood Mackenzie Limited, World Bureau of Metal Statistics, and World Economic Forum. 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.