# Bridgewater®
## Daily Observations
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# United States

## Too Tight

Classic to deleveragings 1) policy makers and the public realize that they are plagued with too much debt, which leads them to 2) be tighter (fiscally and monetarily), which leads to 3) weak economies and economic related pain, which leads to 4) monetary and fiscal easing.

At this time policymakers in the US, Europe and most major emerging countries are tightening their fiscal and monetary policies. While in emerging countries they are tightening for good reasons, in developed countries this tightening is occurring at the same time as private sector credit and economic growth rates are either slow (in the US) or negative (in peripheral Europe). In these developed countries, the moves to tighter fiscal and monetary policies in the face of the weakness in credit and economic growth is due to worries about having too much debt. This looks pretty classic to us. We expect real GDP growth in the US to settle down (after the distortions work themselves out) at about 1.5% - 2.0%, with the risks on the downside. We also expect the credit and economic crisis in Europe to worsen unless these policies ease up.

The US debt ceiling deal was approved by the House of Representatives Monday night and is expected to be voted by the Senate on Tuesday. It puts the US on an austerity path, although most of the austerity is back-loaded and could easily be reset after the 2012 elections. We will discuss how the deal works and then illustrate the plan's impact on growth if it plays out as currently envisaged.

We think the most likely path through the next five months is as follows:

- Initially the bill cuts $917 billion in spending over ten years starting in fiscal year 2012 and grants an immediate $400 billion increase in the debt ceiling. This consists of $750 billion in spending cuts over ten years, mostly on non-defense agency spending, i.e., education, the State Department, transportation – not on entitlements like Social Security and Medicare. Additionally, $156 billion in interest payments is saved by not taking on that new debt.
- In September, the $400 billion increase in the debt ceiling runs out. This bill grants the President the power to increase it by another $500 billion, but Congress has the power to disapprove (and likely will). Obama can then veto this rejection of a debt ceiling increase. Unless Congress overrides the veto (with a 2/3 majority), the debt ceiling increases another $500 billion. It appears this set of provisions was created to give Congressmen and Senators who feel the need to vote against the debt ceiling an opportunity to do so without it actually mattering (i.e., only 1/3 really need to vote yes on this).
- On November 23, a bipartisan bicameral Joint-Select Congressional Committee put together by the leadership will deliver a plan for at least $1.5 trillion in additional spending cuts.
- By December 23, both houses must vote "up or down" on the Committee's proposal. If either the Committee fails to agree on a new deal, or if the deal fails in either the House or Senate, a $1.2 trillion series of cuts automatically kicks in, starting in 2013 ($600 billion in defense and $600

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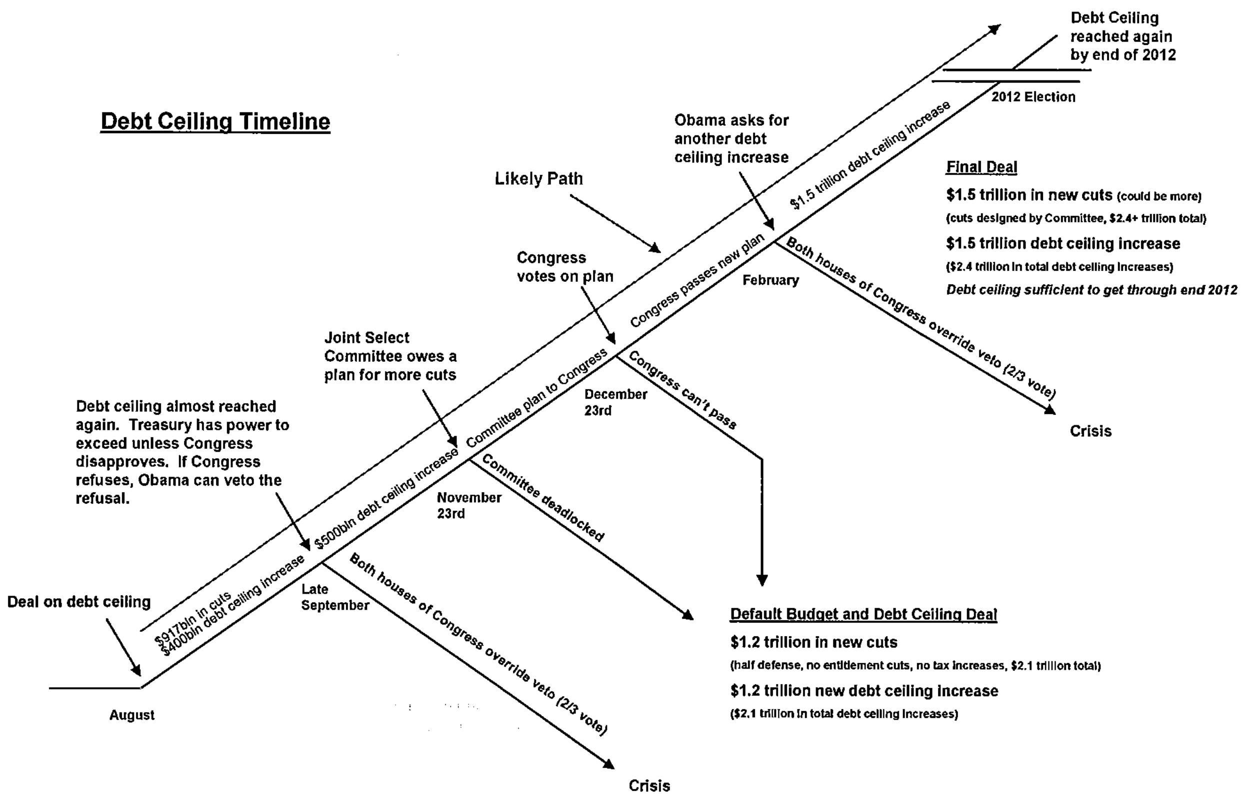
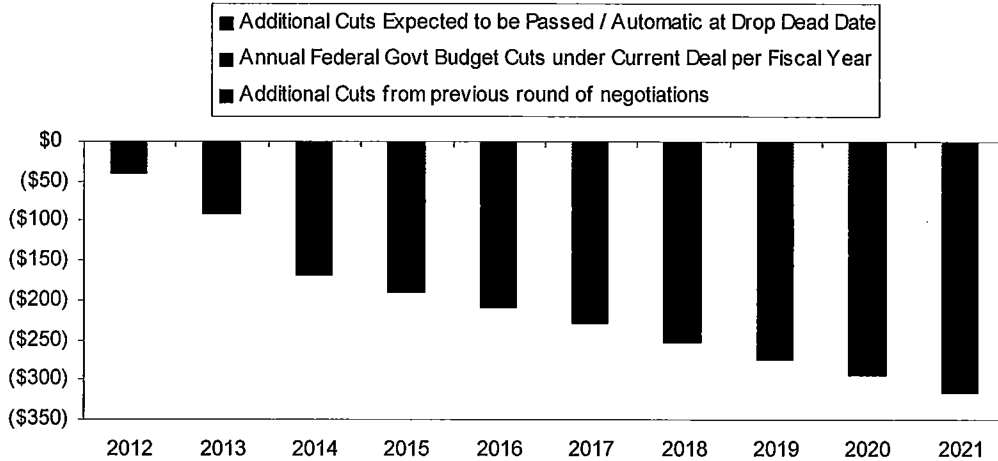
billion in other discretionary spending). These cuts are designed to be painful to both Republicans and Democrats, raising the incentives for members of both parties to agree to the

Committee's plan. Early in 2012, the President can seek a debt ceiling increase equal to the magnitude of deficit cuts, either up to $1.5 trillion of the cuts entailed in the Committee's plan (if these were approved) or equal to the $1.2 trillion in automatic cuts (if the Committee's plans were not approved). This increase in the debt ceiling would once again need a 2/3 majority to overturn it.

The following timeline illustrates the ins and outs of the deal.

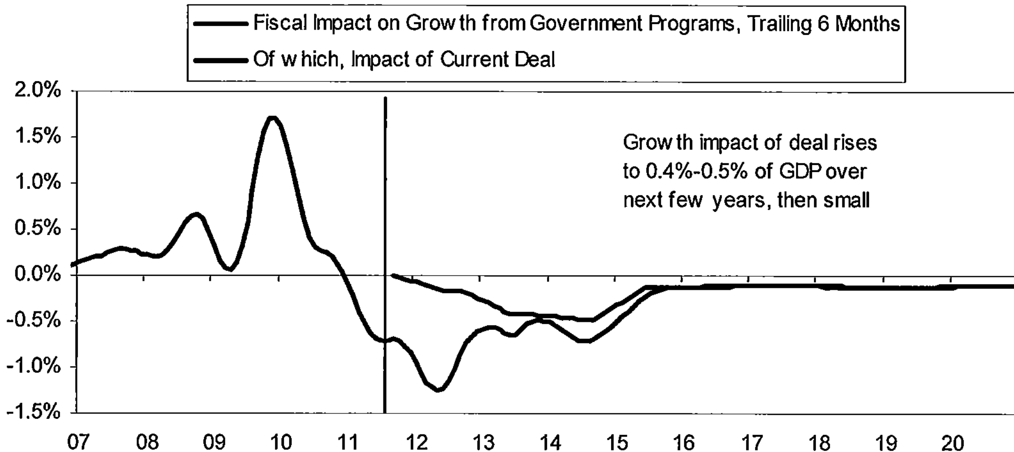


The chart below shows the likely path of direct budget cuts, including the known cuts over the next ten year (the first $750 billion in direct cuts passed by the House Monday as well as cuts passed in the previous rounds of negotiations) and the likely schedule for $1.2 trillion to $1.5 trillion in additional cuts phased in over the course of the next decade.



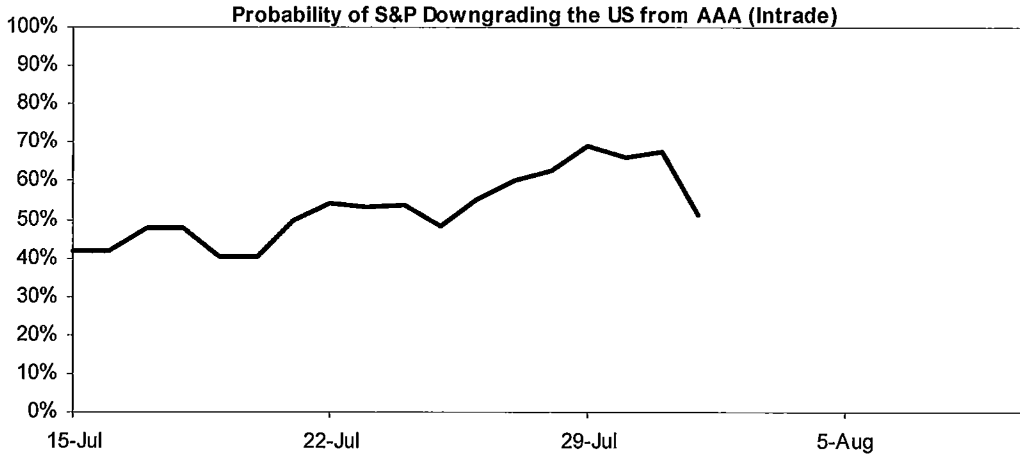

## The Implications of the Spending Cuts for Growth

These cuts will create an additional drag on US growth over the next several years, on top of the fiscal tightening that is already occurring. Absent these cuts, the drag from fiscal cuts on growth alone would be getting larger over the next few months and after peaking early in 2012 would have largely faded over the next year or so. With these new cuts in spending, there will likely continue to be a fiscal drag of about 0.5% through 2015.

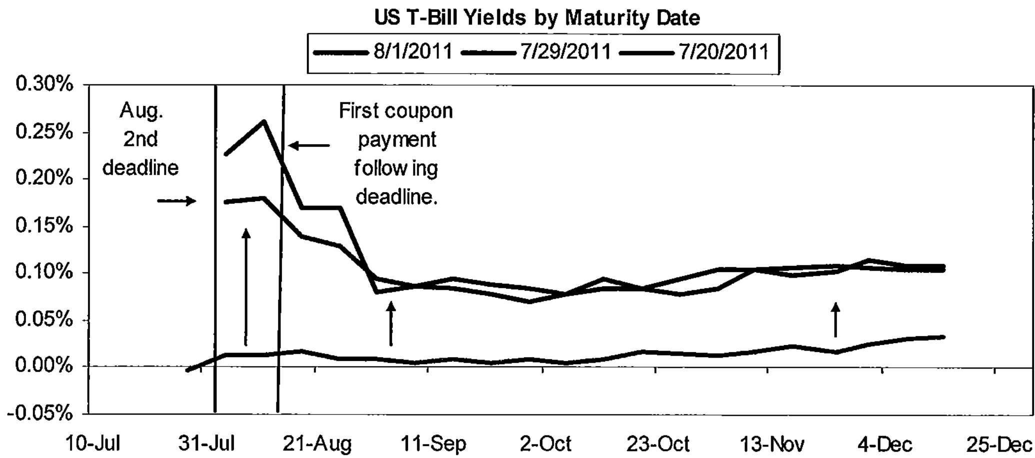


Market Pricing

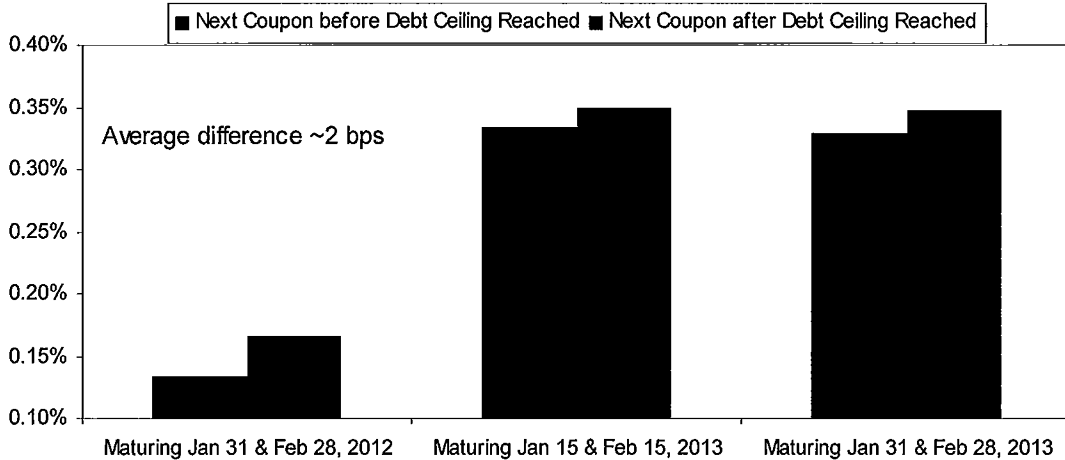
The markets' pricing of the likelihood that S&P will downgrade the US from AAA has fallen about 20% in recent days.



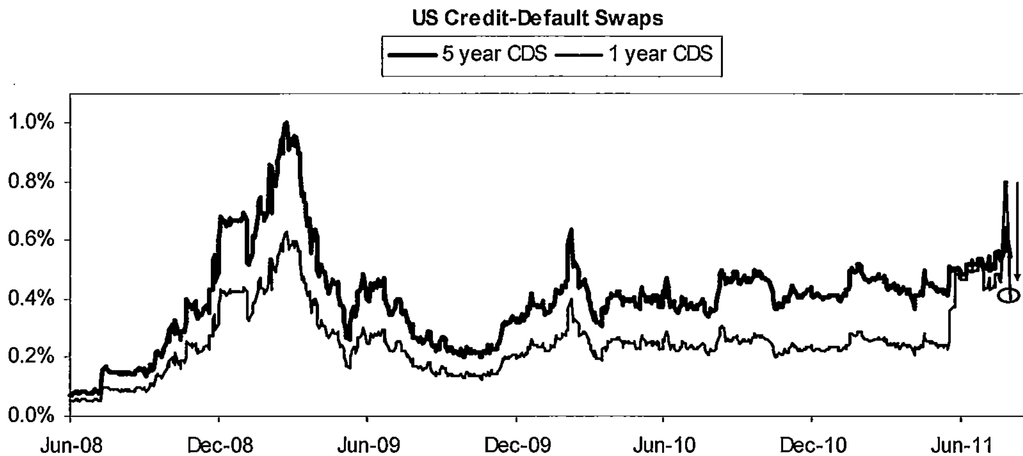

Last week the T-bill market started to show signs of pricing in the impact of a failure to increase the debt ceiling. Yields on T-bills with maturities immediately after August 2 increased about 25bps last week and are now at roughly 16bps. Even with the political progress made over the weekend and Monday toward passing a deal, T-bill yields remain elevated.



While there has been an increase in the pricing of the impact in the bill market, the bond market continues to reflect little expected impact. Treasury bonds with similar maturities that pay coupons before and after the debt ceiling is reached have only a 0.02% difference in yield.



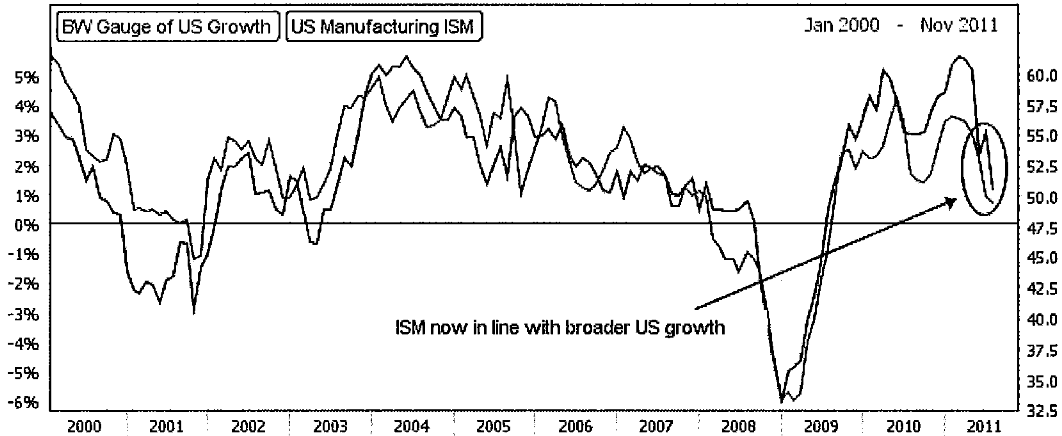

One year CDS on the US dropped dramatically Monday to around 40bps, which is the level it has roughly traded at since May when the debt ceiling was reached.




It is typical that deleveraging leads to austerity as the intuitive reaction to having too much debt is to try to pay it down. But this policy leads to even weaker conditions and eventually back to reflationary policies. With the White House and Congress likely stuck on a path of austerity for now, we suspect expansionary policies will have to come from the Fed.

## Manufacturing ISM Confirms US Economic Weakness

Over the past few months, the ISM has been the major outlier among US statistics, indicating stronger growth than the rate implied by broader indications of underlying conditions. July's decline to 50.7 means the ISM is now by and large in line with our measures of overall growth conditions.




The sector-by-sector breakdown shows a broad-based slowdown. Computers and electronics and auto production, the sectors most affected by the Japan-related supply-chain issues, are **not** among the 40% of sectors that are now contracting, suggesting that the slowdown in production growth is not a function of the distortions from Japan and is more broad-based.

### July ISM

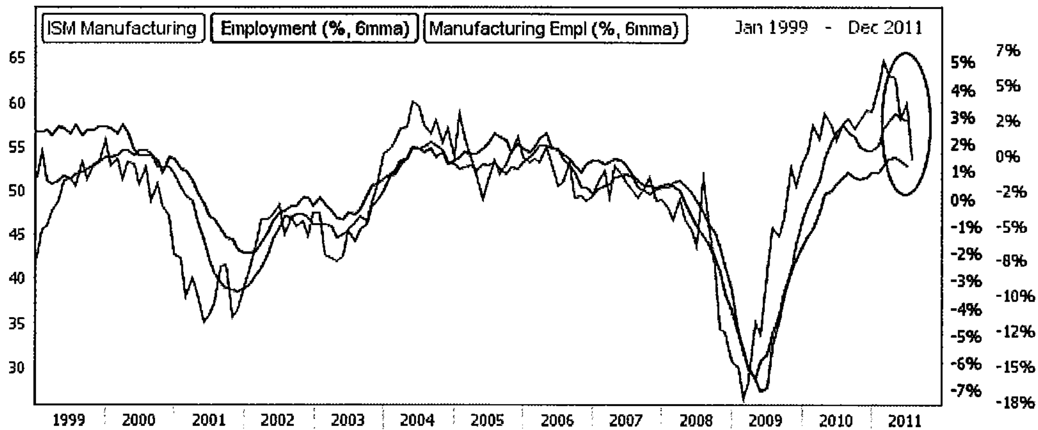
| Sectors that are Growing | Sectors that are Contracting |
|---|---|
| Paper Products | Apparel, Leather and Allied Products |
| Furniture | Plastics and Rubber |
| **Computer and Electronics** | Textiles |
| **Transportation Equipment** | Electrical Equipment, Appliances, and Components |
| Wood Products | Food, Beverage, and Tobacco |
| Petroleum and Coal Products | Machinery |
| Printing | Chemical Products |
| Primary Metals | |
| Fabricated Metals | |
| Minerals | |

The individual components of the ISM show large declines in employment and inventories, and new orders slipped into contractionary territory. The backlog of orders collapsed.

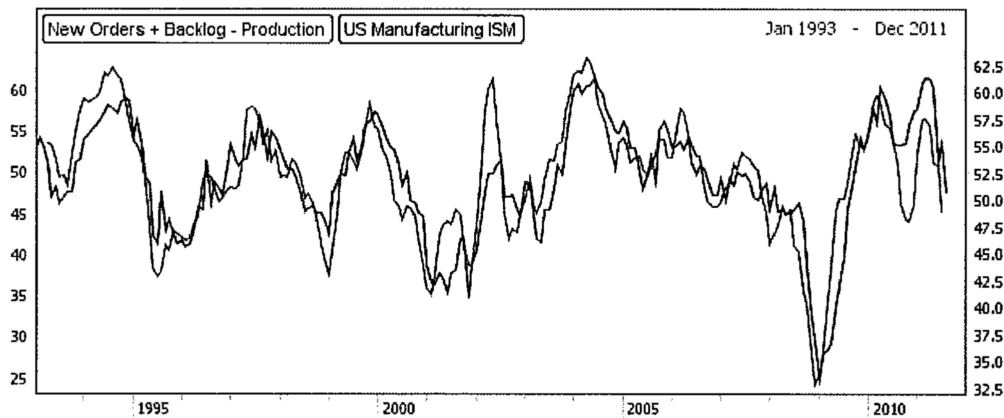
**ISM Manufacturing Survey**

| Index | M-M | Y-Y | Jul-11 | Jun-11 | May-11 | Apr-11 | Jul-10 | 1yr Avg |
|---|---|---|---|---|---|---|---|---|
| Purchasing Managers Index | -4.4 | -4.2 | 50.9 | 55.3 | 53.5 | 60.4 | 55.1 | 57.3 |
| Employment | -6.4 | -4.1 | 53.5 | 59.9 | 58.2 | 62.7 | 57.6 | 59.5 |
| New Orders | -2.4 | -3.7 | 49.2 | 51.6 | 51.0 | 61.7 | 52.9 | 58.3 |
| Production | -2.2 | -4.6 | 52.3 | 54.5 | 54.0 | 63.8 | 56.9 | 60.1 |
| Prices | -9.0 | 1.5 | 59.0 | 68.0 | 76.5 | 85.5 | 57.5 | 73.5 |
| Export Orders | 0.5 | -2.5 | 54.0 | 53.5 | 55.0 | 62.0 | 56.5 | 57.3 |
| Import Orders | 2.5 | 1.0 | 63.5 | 61.0 | 54.5 | 55.5 | 62.5 | 54.1 |
| Inventories | -4.8 | -1.0 | 49.3 | 54.1 | 48.7 | 53.6 | 50.3 | 51.9 |
| Backlog of Orders | -4.0 | -9.5 | 45.0 | 49.0 | 50.5 | 61.0 | 54.5 | 51.0 |
| Deliveries | -5.9 | -7.6 | 50.4 | 56.3 | 55.7 | 60.2 | 58.0 | 56.7 |

The employment component of the ISM, like the overall measure, had suggested stronger growth than underlying conditions. For much of the past year, its level suggested stronger manufacturing payroll growth than what's actually been occurring -- and manufacturing payrolls had been stronger than overall jobs growth. After the big decline in July, the ISM employment gauge now suggests manufacturing jobs growth is converging toward the more mediocre pace of overall payroll expansion.




Generally speaking, the leading components of the index (new orders and the backlog of orders) are the weakest components. It looks to us like manufacturing output will continue to lose steam in the coming months. New orders plus the backlog of unfilled orders less production typically leads the overall index.




Overall, the ISM confirms the picture we see of slowing private sector activity at the same time as both fiscal and monetary policies are tightening in the US. We suspect growth will stay weak for a long period, which will eventually lead to a change in policies.

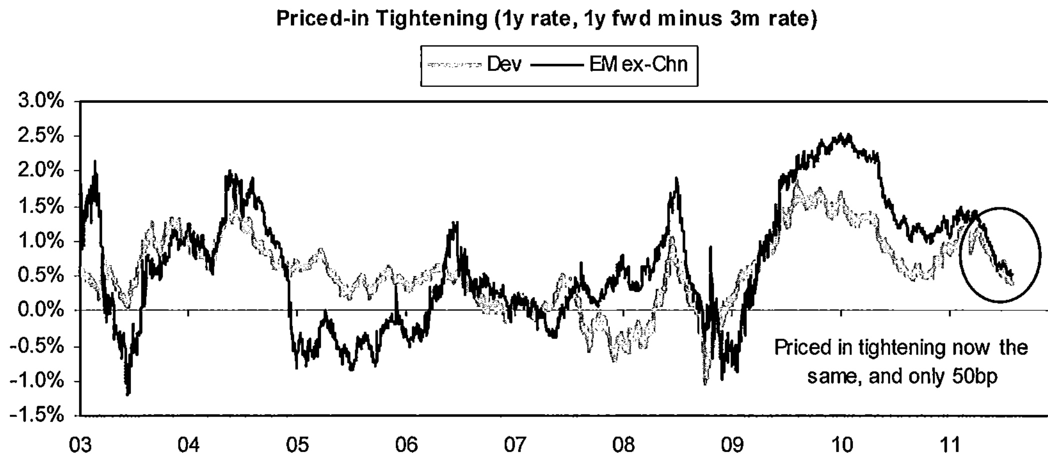
# Other Countries

## Mediocre Growth Priced in for the Emerging World

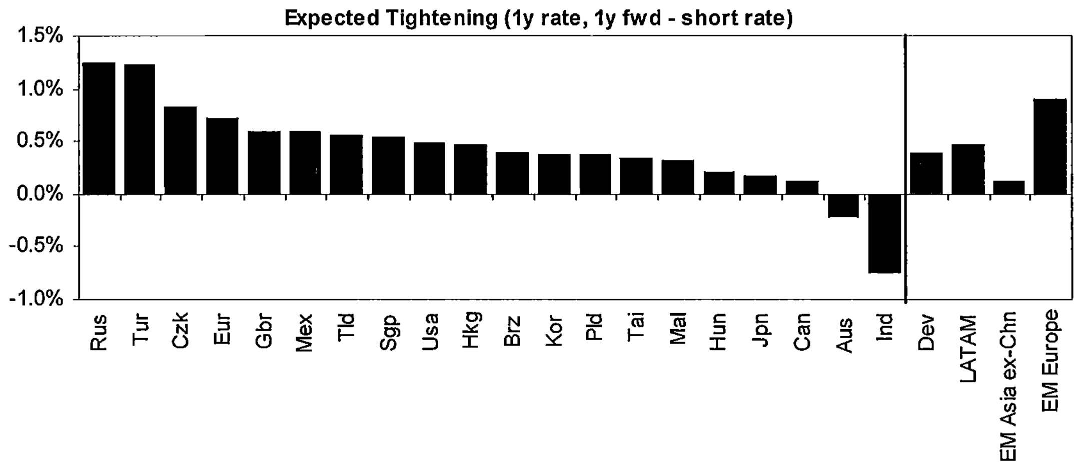
The lack of tightening expectations in the emerging world for the next 18 months, at a time when the level of activity is high, the level of real rates are low and core inflation has been rising (but is moderate), implies a scenario where growth remains well below potential. While similar pricing in the developed world makes more sense to us, where these economies are hampered by high debt levels and low credit growth (as well as more significant fiscal tightening), we expect growth in the emerging world to return to close to potential once the effects of Japan's earthquake and higher commodity prices early in the year fade and to ultimately require more tightening. So far, emerging world central banks have not slowed their pace of tightening much. They may do so to a modest extent until it is clear that underlying growth remains in place. However, it seems unlikely that the future path of tightening will be as slow as is currently priced in for the emerging world. We are particularly short emerging Asian long rates, as almost no tightening is priced and levels of activity are highest. We are also long emerging currencies, in part because we believe tightening needs to happen through both channels.

Priced-in tightening is now the same in the emerging and developed worlds despite much tighter capacity conditions in the emerging world. Less than 50bp is priced in on average over the next year and a half. While a continuation of the global slowdown might justify this lack of tightening, we expect a greater rebound in the emerging world and a continued need for faster tightening.

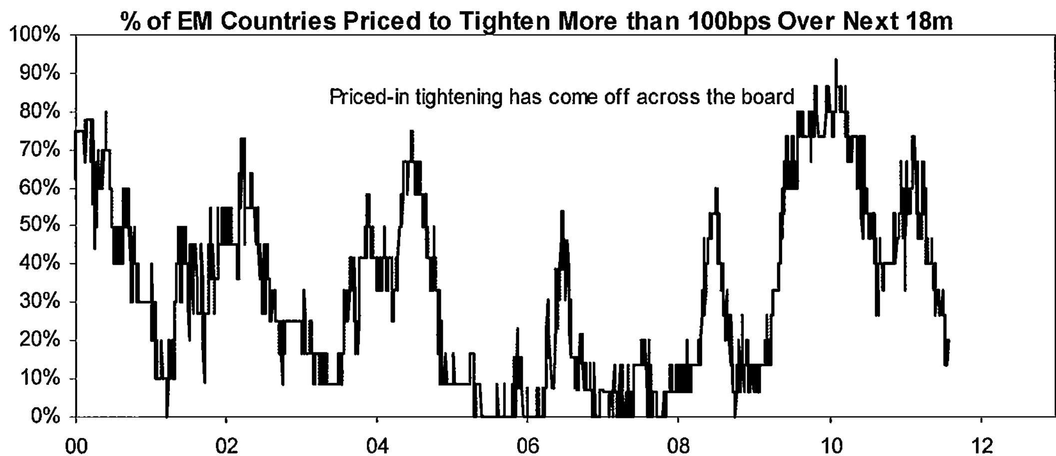
**Priced-in Tightening (1y rate, 1y fwd minus 3m rate)**



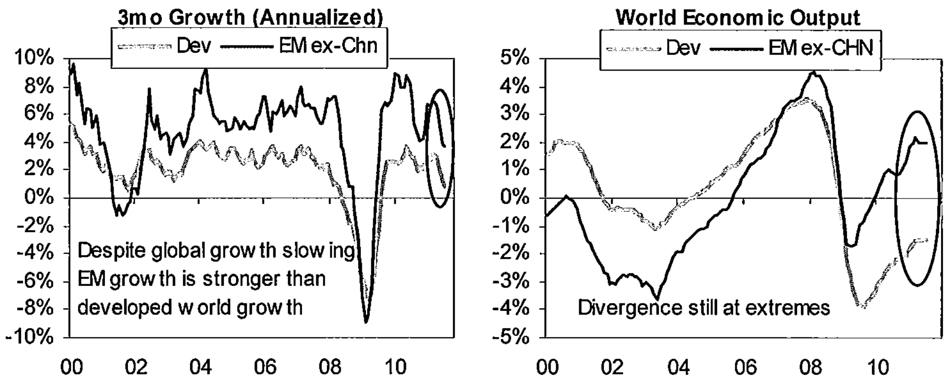

Looking across the different countries, the only emerging countries with significant tightening priced in are those in emerging Europe, where central banks have not yet tightened as much given their countries' weaker post crisis recoveries. Emerging Asia stands out as having particularly little priced-in tightening despite being the economies with the highest output levels and fastest credit growth. Interestingly, India is priced to ease despite tightening more than was priced into markets just last week and commenting on the need to cool the continuing inflation problem. On average, most emerging countries are priced to tighten around 50bp, similar to what is priced into US interest rates.



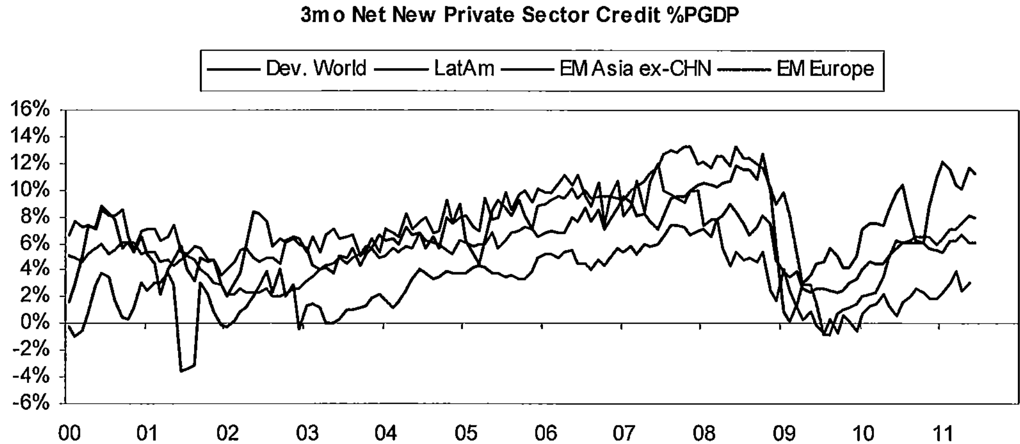

The chart below shows the percentage of emerging countries expected to tighten at least 1% over the next 18 months. At this point, only around 10% of countries are expected to keep tightening at this pace, down from 80% in 2010 and 60% earlier this year.



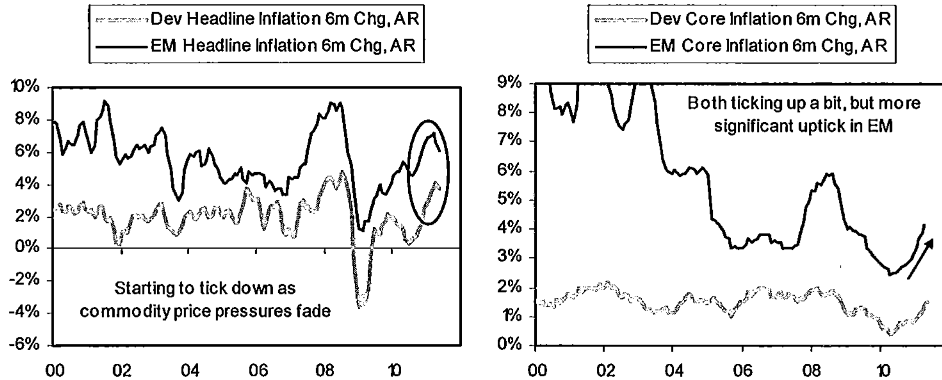

The drop in expected tightening happened along with the sharp slowdown in global growth over the last quarter. Despite the slowdown, the divergence in emerging and developed world output levels remains at extremes with tight capacity in the emerging world and plenty of slack in the developed world. If growth remains slower and below potential in the emerging world, capacity pressures will ease, lessening the need for tightening. But, as described before, we expect growth in the emerging world to re-accelerate, again putting increased pressure on capacity and inflation and necessitating the need for significantly tighter policy than is needed in the developed world.



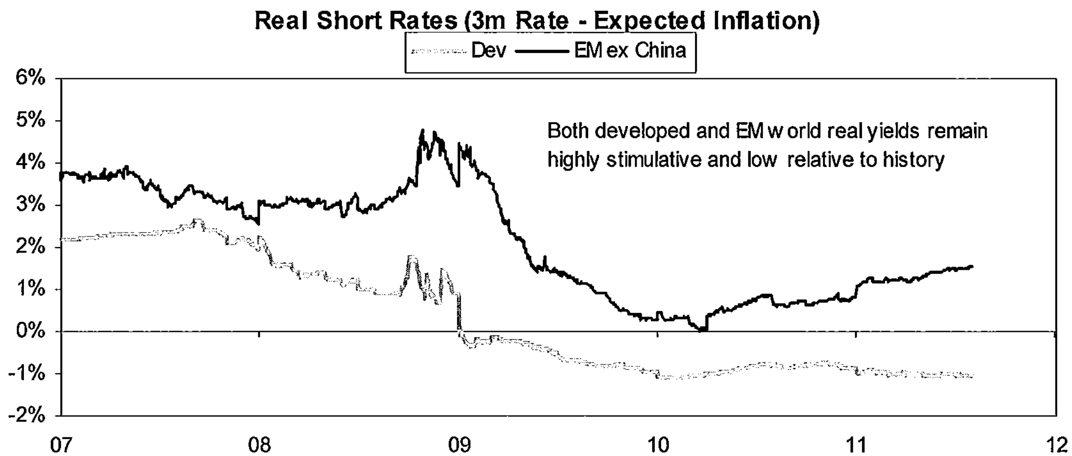

Low real yields, relatively low consumer indebtedness and strong income growth have led to a much faster recovery in emerging market credit creation. As credit growth has accelerated, concerns about potential asset bubbles (Asian real estate) and over-levered entities (rapidly growing Brazilian payroll-based loans) have begun to rise. Targeted non-interest rate tightening measures have been attempted in many countries to slow down credit going to these areas (e.g., Korean mortgage regulation), but there has as of yet not been a meaningful slowdown. The desire to take on credit with low interest rates and fast economic growth is likely to keep producing risks of asset bubbles.



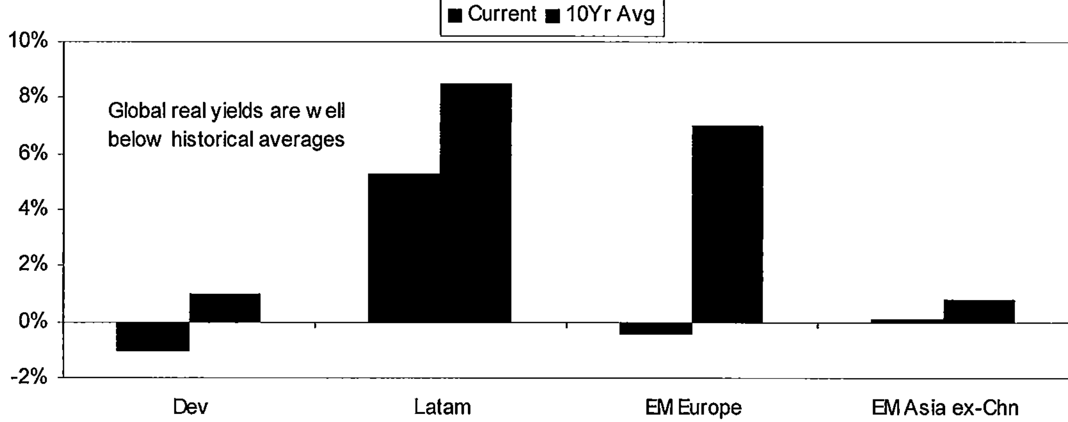

We have already seen the manifestation of tight capacity and strong growth in increased pressure on inflation in the emerging world. While headline inflation has ticked down in both the emerging and developed worlds as commodity price increases have faded, core inflation has clearly ticked up much more significantly in the emerging world.



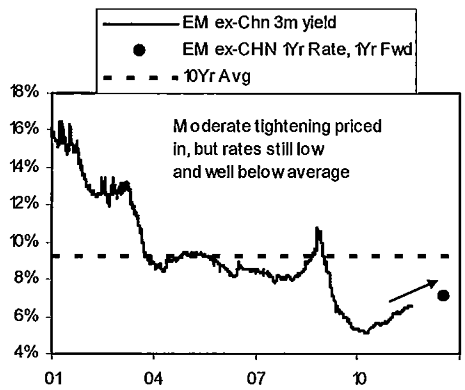

While real short-term interest rates are negative in the developed world, they remain low in the emerging world as well. During the last expansion, real short-term rates averaged over 3%, and currently they remain well below that, while overall conditions are approaching those experienced prior to the crisis with overheating economies, fast credit growth, rising asset prices, and rising inflation. The current level of rates remain stimulative in the low-debt emerging world, while it is still producing mediocre response in the developed world.

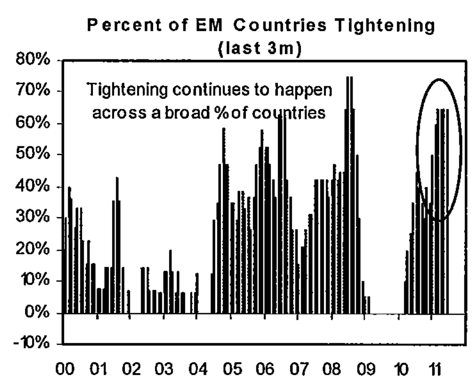


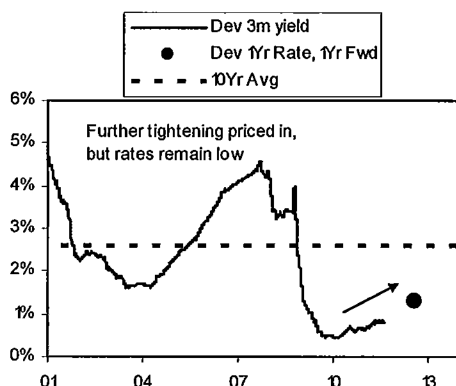

Despite modest tightening in the emerging world over the last year and a half, real interest rates remain very low relative to both potential growth and historical levels. Rates are particularly low in EM Asia, where conditions are strongest. In our view, monetary policy in the emerging world is still too stimulative given the current mix of economic conditions.

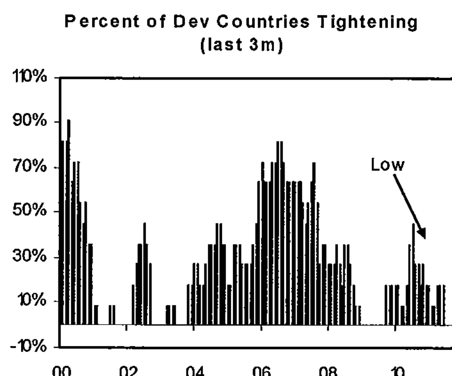



Looking backward, emerging market central banks have raised rates by about 150bp since the tightening cycle began last year as they have sought to fight overheating growth and rising inflation. While this is more than the developed world, typical interest rate cycles need to be many hundreds of basis points, and the level of rates are low. Developed world central banks, by contrast, have only tightened slightly (about 40bps on average), though quantitative easing measures have been pulled back. As the charts below show, roughly 65% of the emerging central banks we monitor have been tightening over the past three months, whereas only a couple of developed world central banks have been tightening (most notably Euroland despite the concerns over the periphery and slowing economy). Even if tightening occurs as expected in the emerging world, the level of rates in the emerging world will still be close to historical lows. Should the rebound in emerging growth occur or inflation pressures feed on themselves, more tightening than is discounted will be necessary.






Below we highlight a few recent emerging market central bank statements, noting the concerns they raised. While there was mention of easing commodity prices and rising global uncertainty (in Turkey) as a reason for holding back from rate increases, most central bankers also cited domestic inflation pressures and slowing but still strong growth. It's also notable that Taiwan, Colombia and Poland all tightened, though in small steps. As mentioned earlier, India tightened more than expected due mostly to inflation pressures.

| RECENT CENTRAL BANK ANNOUNCEMENTS | | | | | | |
|---|---|---|---|---|---|---|
| Country | Rate | Date | Prev | Est | Actual | Quotes from Statement |
| India | Repo Rate | 7/26/11 | 7.50% | 7.75% | 8.00% | Actual inflation so far has been even higher than expected. In particular, **non-food manufactured product inflation has been significantly higher than the average rate of 4 per cent over the last six years.** Several indicators such as exports and imports, indirect tax collections, corporate sales and earnings and demand for bank credit suggest that **demand is moderating, but only gradually.** |
| Brazil | SELIC Target Rate | 7/20/11 | 12.25% | 12.50% | 12.50% | **Inflationary outlook has improved** but do not forsee inflation at mid-point of target range until mid-2013. Expressed increased **concern over the global recovery**, particularly a stronger-than-expected slowdown in China. |
| Turkey | One-week Repo Rate | 7/21/11 | 6.25% | 6.25% | 6.25% | **"Private consumption shows signs of slowdown, investment growth is moderating, and external demand outlook remains weak.** Although core inflation is likely display some upward movement over the short term, **the increase is expected to be limited due to the slowdown in economic activity"** |
| South Korea | Base Rate | 7/13/11 | 3.25% | 3.25% | 3.25% | "The Committee judges the **economy to have maintained its underlying upward trend, given for instance that exports show robust growth and that domestic demand is increasing modestly.** Consumer price inflation rose to the 4.4% level in June, due mostly to sharp rises in the prices of some agricultural and livestock products. **The Committee expects the high level of inflation to continue in the coming months..."** |
| Chile | Policy Rate | 7/14/11 | 5.25% | 5.25% | 5.25% | "Private inflation expectations show a decline, although some of them remain above the target. **The Board estimates that, in the most likely scenario, additional increases in the monetary policy rates will be necessary.."** |
| Australia | Cash Rate | 7/5/11 | 4.75% | 4.75% | 4.75% | "The global economy is continuing its expansion, but the pace of growth slowed in the June quarter. **The supply-chain disruptions from the Japanese earthquake and the dampening effects of high commodity prices on income and spending in major countries have both contributed to the slowing...**Year-ended CPI inflation is likely to remain elevated in the near term due to the extreme weather events earlier in the year." |

Though recent changes of priced-in tightening in emerging market and developed world rates have been correlated as global growth has turned down, the underlying need for delinking monetary and exchange rate policy remains.

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