Barron's Cover | SATURDAY, MAY 19, 2012 Dalio's World
By SANDRA WARD | MORE ARTICLES BY AUTHOR

Ray Dalio, fabled hedge-fund manager, says the U.S. has done a "beautiful" job delevering, but sees a 30% chance Europe will stumble badly.

It's hard to imagine anyone navigating the rough seas of the past decade more ably than Ray Dalio, master and commander of money-management firm Bridgewater Associates, which oversees $120 billion for a roster of global clients that include foreign governments, pension funds and endowments.

The Westport, Conn.-based company is the world's largest hedge-fund firm and one of just a handful of players to place more than one fund on Barron's annual Top 100 Hedge Funds ranking. This year Bridgewater's flagship Pure Alpha II and its All Weather @12% global macro funds both make the list, (see below for list.). Pure Alpha has tallied a three-year average return of 22.75% while All Weather gained 17.24% on that basis. BarclayHedge's index of hedge funds returned 9.05% a year in that time; the Standard & Poor's 500 gained 14.11% annually.

The Bridgewater funds make strategic bets on commodities, currencies, bonds, and equities around the world based on analysis of valuations and macroeconomic trends. Dalio, who brings an unusually broad and deep perspective to investing, recently shared his latest views with us.

Barron's: You've called the current phase of the U.S. deleveraging experience "beautiful." Explain that, please.

Dalio: Deleveragings occur in a mechanical way that is important to understand. There are three ways to deleverage. We hear a lot about austerity. In other words, pull in your belt, spend less, and reduce debt. But austerity causes less spending and, because when you spend less, somebody earns less, it causes the contraction to feed on itself. Austerity causes more problems. It is deflationary and it is negative for growth.

Restructuring the debt means creditors get paid less or get paid over a longer time frame or at a lower interest rate; somehow a contract is broken in a way that reduces debt. But debt restructurings also are deflationary and negative for growth. One man's debts are another man's assets, and when debts are written down to relieve the debtor of the burden, it has a negative effect on wealth. That causes credit to decline.

Printing money typically happens when interest rates are close to zero, because you can't lower interest rates any more. Central banks create money, essentially, and buy the assets that put money in the system for a quantitative easing or debt monetization. Unlike the first two options, this is an inflationary action and stimulative to the economy.

How is any of this "beautiful?"

A beautiful deleveraging balances the three options. In other words, there is a certain amount of austerity, there is a certain amount of debt restructuring, and there is a certain amount of printing of money. When done in the right mix, it isn't dramatic. It doesn't produce too much deflation or too much depression. There is slow growth, but it is positive slow growth. At the same time, ratios of debt-to-incomes go down. That's a beautiful deleveraging.

We're in a phase now in the U.S. which is very much like the 1933-37 period, in which there is positive growth around a slow-growth trend. The Federal Reserve will do another quantitative easing if the economy turns down again, for the purpose of alleviating debt and putting money into the hands of people.

We will also need fiscal stimulation by the government, which of course, is very classic. Governments have to spend more when sales and tax revenue go down and as unemployment and other social benefits kick in and there is a redistribution of wealth. That's why there is going to be more taxation on the wealthy and more social tension. A deleveraging is not an easy time. But when you are approaching balance again, that's a good thing.

What makes all the difference between the ugly and the beautiful?

The key is to keep nominal interest rates below the nominal growth rate in the economy, without printing so much money that they cause an inflationary spiral. The way to do that is to be printing money at the same time there is austerity and debt restructurings going on.

How do you expect Europe to fare?

Europe is probably the most interesting case of a deleveraging in recorded history. Normally, a country will find out what's best for itself. In other words, a central bank will make monetary decisions for the country and a treasury will set fiscal policy for the country. They might make mistakes along the way, but they can be adjusted, and eventually there is a policy for the country. There is a very big problem in Europe because there isn't a good agreement about who should bear what kind of risks, and there isn't a decision-making process to produce that kind of an agreement.

We were very close to a debt collapse in Europe, and then the European Central Bank began the LTROs [long-term refinancing operations]. The ECB said it would lend euro-zone banks as much money as they wanted at a 1% interest rate for three years. The banks then could buy government bonds with significantly higher yields, which would also produce a lot more demand for those assets and ease the pressure in countries like Spain and Italy. Essentially, the ECB and the individual banks took on a whole lot of credit exposure. The banks have something like 20 trillion euros ($25.38 trillion) worth of assets and less than one trillion euros of capital. They are very leveraged.

Also, the countries themselves have debt problems and they need to roll over existing debts and borrow more. The banks are now overleveraged and can't expand their balance sheets. And the governments don't have enough buyers of their debt. Demand has fallen not just because of bad expectations, although everybody should have bad expectations, but because the buyers themselves have less money to spend on that debt. So the ECB action created a temporary surge in buying of those bonds and it relieved the crisis for the moment, but that's still not good enough. They can keep doing that, but each central bank in each country wants to know what happens if the debtors can't pay, who is going to bear what part of the burden?

Have the French and Greek elections changed the outlook?

They are the latest steps in a long drama that is not in and of itself much more important than most of the other steps. It's normal that the pendulum swings to produce these sorts of changes, and it is to be expected that tensions will increase and agreements will be harder to come by. This will add to the risks over the next year.

So what is the solution to this? How will the European debt crisis be resolved?

What is happening in Europe now is essentially the same, almost totally analogous, to what happened in the U.S. in 1789. It is an interesting comparison.

Post-American Revolution?

Yes. In 1776, the colonies declared independence from Great Britain. We didn't have a country. We had independent states that had a treaty with each other, called the Articles of Confederation, and it was similar to the Maastricht Treaty that created the European Union and the euro currency. The independent states had debt problems and they had tariffs with each other. It wasn't until 13 years later, 1789, that those states started to form a central government, largely because of their debt problems. There was a constitutional convention, and we formed a country and we chose a president. We formed a treasury and imposed central taxation. That gave us the ability to produce revenue for the country and restructure our debts. There was the ability to have taxation and to issue bonds and to borrow. Europe does not have an ability to borrow. It doesn't have central taxation, that's material, and it doesn't have a treasury. It is a collection of countries operating for their own individual needs.

Europe is approaching a decision point. It will have to decide whether it wants to create a sufficient central government that has more than a treaty, that has the ability to collect taxes from the whole and the ability to issue debt that obligates the whole, or whether it does not. That is the crux of this issue. The question is how much pain is it going to cause in Europe, and does the pain cause a collapse before it causes the choices? When a debtor can't print money and depreciate its currency, it will go into a self-reinforcing terrible economic situation. The deleveraging in Spain is just beginning, and they already have nearly 25% unemployment. They need relief.

What does it mean for the world economy if Europe continues to struggle like this?

The ECB has increased the pool of assets that are eligible as collateral that it will lend against, and it could spread out these refinancing operations. The European banks must deleverage at an orderly pace. Wherever they are lending, they are going to be lending less. Countries and those that are depending on borrowing money from European banks will experience a tightening of credit.

Spain and Italy in the periphery and, to some extent, France and even Germany will be hurt by this. Europe will be in a depressed state. Certainly, the peripheral countries in Europe will be in depressions, and there will be high unemployment. But if it happens in an orderly way, which I think is most likely, the repercussions for the world economy won't be intolerable. While the deleveraging of European banks and reduced European imports will be a depressant on the world economy, global markets and economic conditions won't collapse, because countries outside of Europe will be able to replace retrenching European bank lending with other sources of lending. They will borrow from American banks, and you will see the emergence of banks in large emerging countries such as China and Brazil.

Ireland was early to go down this path. What have we learned from their restructuring?

Well, for the most part, the Irish government has taken on the responsibility for most of the debt. Now the government doesn't have enough euros to service the debt. It has a problem. Portugal is going down the same route. And so, the EFSF -- the European Financial Stability Facility -- will loan to those countries as they go through an adjustment process. But the debt will have to keep being rolled and it will be difficult.

It will be a very long, difficult period for Ireland, and it will be a very long, difficult period for Portugal, and it will eat away money from the EFSF. It will be spread out over a long period of time. But in those cases, it is governments dealing with governments. In the case of Italy and Spain, most of the debt is still in the hands of the debtors and the banks and hasn't been put on to the government, because the resources, the sizes of the problem in Spain and Italy, are much bigger and more difficult for them to be handled in the same way as Ireland and Portugal.

And so?

So the main picture I'm trying to create is there could be a shock. I would say that there is maybe a 30% chance in the next six-month to two-year period of a really bad shock from Europe. And that shock is made worse because there is no clarity of who has got authority or control. When you have a centralized government and you have the ability to enforce laws, you can resolve problems. There might be a lot of arguments, but ultimately decisions can be made.

There are no provisions in the Maastricht Treaty for the breakup of the monetary union. There are no rules, there are no means. If a country is exiting the monetary union and then says I'm going to pay off the debt in my local currency, how does that work? The Maastricht Treaty doesn't have any provision for any country leaving the monetary union. It doesn't say if this happens, then that happens. There is a question of enforceability.

Every society has to have the ability to enforce laws. How does Germany actually force Italy to pay? It isn't clear. Supposing Spain decides they want to exit the union. The unemployment rate is terrible. That's a very scary thought. Maybe they say, "We're going to pay you back in Spanish pesetas even though the contract is for euros." That's the history, by the way: Argentina and Brazil and Mexico did that.

Yes, but local currencies no longer exist.

That's the whole other complication. There are good incentives not to take that course, and yet there are also big problems if you don't take it. In any event, there isn't a good decision-making process. There isn't a single means of achieving resolution in Europe, and that's the big problem here.

Again, how do you see world markets behaving as a result?

At the moment, there is a tipping toward slowing growth and a question of whether there will be a negative European shock, and that will favor low-risk assets. But to whatever extent we have negative conditions, central banks will respond by printing more money. There will be a big spurt of printing of money, and that will cause a rally and an improvement in the stock markets around the world. It's like a shot of adrenaline: The heart starts pumping again and then it fades. Then there is another shot of adrenaline.

Everybody is asking, "Are we going to have a bull market or a bear market?" I expect we will have both with no big trend. Typically, in these up and down cycles, the upswing will last about twice as long as a down swing. We are now in the higher range of the up-cycle.

What will this mean for U.S. Treasuries?

The printing of money has the effect of negating deflation. It doesn't produce high inflation and it makes it difficult for the economy to have a sustained upward move. If you have too much printing of money, then you'll begin a bear market in bonds.

We are now neutral on bonds. Over the next couple of years, long-term bonds will be a poor investment because the government will print money to leave real interest rates low. It doesn't mean that bonds will go through a big price selloff anytime soon. It's more likely the yields provided will be too low relative to inflation and growth to provide an adequate return.

What's your outlook for the U.S.?

The economy will be slowing into the end of the year, and then it will become more risky in 2013. Then, in 2013, we have the so-called fiscal cliff and the prospect of significantly higher taxes, as well as worsening conditions in Europe to contend with. This is coming immediately after the U.S. presidential election, which makes it more difficult. This can be successfully dealt with, but it won't necessarily be successfully dealt with. We have the equipment and the policy makers, and as long as policy is well managed, we'll be okay.

What of China and the emerging economies at this point?

They are doing much better in the following way: They were in a bubble, and when I say a bubble, I mean a debt explosion. Their debts were growing at a fast rate. Their debts were rising relative to income and they were growing at rates that were too fast. Those growth rates have slowed up significantly and probably will remain at a moderate pace. They are in pretty good shape but will be subject to the deleveraging of European banks.

What about commodities?

I'm not very bearish or very bullish on commodities in general. There is now a moderation of demand.

Are you still a fan of gold?

Longer term, yes. It could temporarily be a bumpy ride because Europeans will have to sell gold in order to raise funds because they are squeezed. Most people should have in the vicinity of 10% of their assets in gold, not only because I think it will be a good investment longer term, but because I think it is a very effective diversifier against the other 90%.

And are you treating it as a proxy for eventual inflation?

I'm treating it as an alternative currency. The big issue is debtor-developed countries, the U.S., Europe, and Japan, all have a lot of debt and will have to print money or they will have credit problems. I don't want to have all of my money in those currencies.

What is the asset class you expect to perform best in the next year?

It very much depends on the European monetary system. I believe the ECB will print money, and that will most likely alleviate concerns and produce another rally in stock and credit markets. But this is a tougher time to be very confident about that scenario.

It's amazing to think that four years into it, the world is still deleveraging.

Deleveragings go on for about 15 years. The process of raising debt relative to incomes goes on for 30 or 40 years, typically. There's a last big surge, which we had in the two years from 2005 to 2007 and from 1927 to 1929, and in Japan from 1988 to 1990, when the pace becomes manic. That's the classic bubble.

And then it takes about 15 years to adjust.

Thanks so much, Ray.