An Update from Our CIOs: Navigating the Limits

Major market turning points are often driven by policy makers hitting or getting free of limits. Our CIOs assess how that dynamic looks today in the US and globally, and the implications for investors.

OCTOBER 15, 2024

BOB PRINCE
GREG JENSEN
KAREN KARNIOL-TAMBOUR

BRIDGEWATER

The macro environment is being shaped by how highly proactive policy makers navigate around economic and market limits (e.g., inflation, asset bubbles, currency weakness). The limits matter because hitting or getting free of them tends to drive major market turning points. In the third quarter, markets and policy makers were relieved as most economies moved safely away from inflationary limits and closer to equilibrium. Central banks have used that opportunity to begin an easing that we assess will extend the cycle.

Classically, these conditions are favorable for assets, but this is also tempered as a great environment is already priced in, particularly in the US. Significant productivity gains are likely necessary to square the pricing of US assets. Elsewhere, policy makers face different limits and trade-offs to manage them, contributing to significant opportunities.

In the rest of this report, we elaborate on this environment and its implications for investors.

The biggest drivers of market outcomes today are the limits policy makers face and how they choose to navigate them. By limits, we mean economic and market conditions that make the status quo unsustainable without negative consequences for productive capacity. The limits are not statistics (e.g., "$35 trillion of national debt") but dynamics like inflation, currency weakness, asset bubbles, or stretched pricing compared to available flows.

Policy makers have tools to navigate limits (e.g., rates, QE, fiscal), but each comes with its own trade-offs and can be exhausted. Navigating limits matters because hitting them can drive major market moves, as can being free of them. For example, 2008 came when limits of debt sustainability couldn't be managed by driving rates lower; strong asset performance throughout the 2010s came as disinflation left policy makers a free hand to keep rates at 0% and buy assets; the tightening in 2022 was driven by inflationary limits, the consequence of fiscal policy used to pull through the COVID shock. Even in the third quarter, Japan hit the limits of easy policy when yen depreciation went too far for comfort, prompting a policy pivot that rippled through markets.

These dynamics are especially relevant today because policy makers have been proactive in driving toward their preferred outcomes and because meaningful shifts in the factors that can push back or impose limits, such as domestic savings, productivity, and institutional credibility, are on the table (and have been important drivers lately).

Applying this framework to the United States today:

With the recent disinflation, policy makers in the US are less constrained by limits and are using that freedom to ease proactively. After COVID, the surge in fiscal stimulation kicked off an "upside-down" expansion led by public rather than private borrowing that hit its limits as inflation surged, requiring tightening. The US "got it all" (high wage growth, strong profits, and disinflation) through the tightening (1) because fiscal stimulus strengthened balance sheets, so spending continued despite the collapse in private credit, long after immediate transfer effects faded, and (2) because inflationary limits changed to accommodate much of that spending.

Over the first nine months of this year in particular, a rapid rise in the labor force and productivity absorbed US inflationary pressure at a faster rate than at any point in recent history (and more than was possible in the rest of the world). This pushing out of the limits has prompted the Fed to begin shifting toward "normal" interest rates. Typically, the concept of normal interest rates plays little role in monetary policy decisions (e.g., consider the deeply negative real rates of the 2010s), so this move suggests policy makers are willing to be more proactive when "normal" is in the direction of being easier and limits allow for it.

We expect easing will "hand the baton" to the private sector, extending the cycle and setting up a classically great economic environment for assets. The question is whether the debt service, credit creation, and wealth effects of the easing that's discounted are enough to offset the fiscal roll-off and slowing in labor markets, accounting for the ways that private sector balance sheets and responsiveness have changed over the past several years. We assess it will. While spending has cooled, the worst outcomes for growth have not materialized. Data revisions and employment prints point to a US consumer that remains on a stronger footing. Meanwhile, timely credit data is showing signs of a (small) pickup in response to easing. Typically, falling cash rates amid stable conditions are great for assets, though the limits of pricing remain a risk, as we discuss below.

The election is a critical juncture that will determine if the US remains less constrained in the medium term. The US presidential election odds are close, and the odds of a unified or divided government are about even. Whoever wins, the fiscal policies on the table would likely bring the US closer to inflationary limits, so it's impactful whether either party manages a "sweep" to establish a comfortable majority in Congress, at which point the government becomes much more capable of enacting its fiscal program. There are of course very different specific implications for fiscal policy, immigration, trade policy, and the US's broader institutional credibility depending on who wins the presidency. Rather than speculate on the likely political outcomes, we've invested in assessing the specific implications of each of the policies on the table (e.g., Trump's proposals on immigration and tariffs, any shift in the Fed's goals if its independence is eroded), so that we're prepared to flexibly adapt to and exploit the pressures that are manifested in policy.

While the US is relatively unconstrained by economic limits, it faces limits of pricing that mean it would take almost a miracle for US assets to repeat the last decade. US equity pricing now implies not just cyclical outperformance, but the pushing back of structural limits. One example is the limit of flows: US market cap is now roughly as large a share of global indices as one country has ever been. To keep rising, US equities need to attract ~65 cents of every dollar that flows into stocks. But the pricing doesn't make those flows attractive: in 2010, US earnings were discounted to grow modestly and at a similar rate to the rest of the world. The US then had an exceptional decade because its companies were more dynamic, had more supportive governance for shareholders, and operated against a more favorable policy backdrop.

Those factors remain in play. The difference is that today, US equities are extrapolating very fast earnings growth outright and versus the rest of the world. The complexion of equity and bond market pricing hints that to solve this, the US will have to push back its limits. Pricing is for persistent, very strong earnings growth, low inflation, and easy policy, a combination that is hard to sustain because strong conditions and easy policy typically cause inflation. The way to get it all is through sustained productivity growth.

An AI productivity miracle could push back the limits and extend US outperformance, so we are tracking this closely. AI will shape the environment directly, both near term (through capex, winners and losers, etc.) and more broadly over time (e.g., productivity growth expanding the limits). There are reasonable doubts: destructive use cases of AI could force substantial regulation that negates productivity benefits. The benefits could accrue as rents rather than consumer surplus. But our research and application of this technology in AIA Labs suggest that AI progress and potential are underappreciated. Combining LLMs with other AI and ML tools to mitigate weaknesses has allowed AI to take on more complex challenges in the past one to two years.

Whether AI develops at this pace to act with substantially more autonomy and capability or remains limited to more narrow tasks, we see the potential for AI growth and productivity impacts well beyond what markets are discounting. So far, market gains and AI capex have been confined to knowledgeable US technology companies and have roughly tracked earnings growth, rather than overextrapolating. And the levels of capex and productivity effects are still much smaller than we saw through the internet revolution, even as the world's richest companies with history's strongest balance sheets view this "arms race" as existential. When companies outside the core of AI begin using this technology to outcompete peers, we'll see how far the spending and productivity benefits can go.

Looking to the rest of the world:

Policy makers face more varied trade-offs now that high inflation is no longer a common limit, and they are pursuing paths with different implications for conditions, assets, and FX. In each country, understanding the cycle and the dynamics that are likely to push it forward (e.g., the relationship and trade-offs among growth, inflation, policy, and asset returns) requires tracking which limits are salient to policy makers and the paths they have to manage them. And looking at countries in more extreme situations helps clarify the ultimate implications of economic and market limits. To scan across examples:

- **Japan illustrates how easy policy can hit limits.** Japanese assets were among the best performing during the global tightening cycle, as policy makers sustained monetary stimulation and used it to support fiscal intervention. That intervention helped drive down real rates and bring up economic conditions from very low levels, but the cost was debt growth at much faster rates than underlying cash flow growth and debt monetization (e.g., central bank taking debts on its balance sheet). That eventually hit its limits in the form of currency weakness, forcing policy makers to change course. Enough progress was made via the ultra-stimulative mix that incremental moves toward tightening are appropriate for current conditions, but with so little "fuel in the tank," it would be challenging for Japan to stimulate if conditions weakened, highlighting the importance of increased productivity to get on a more sustainable long-term path.
- **China is recalibrating self-imposed limits, which is likely to support asset markets.** China has been managing a debt deleveraging and economic rebalancing, avoiding stimulating too much demand so as not to compromise other policy goals (combat hidden debt, don't reflate the property bubble, avoid moral hazard). Given debt burdens throughout the economy, the interest rate lever is close to exhaustion. But weak nominal growth and deflation have become intolerable, China does not yet face hard limits from currency weakness or bubbles, and central government balance sheets can take on substantial debt, so it's possible and appropriate to stimulate more vigorously through the fiscal channel. When conditions compel policy makers to ease and they are able and willing to do so, a balanced portfolio tends to do well, whether or not the stimulus is enough to kick off a self-reinforcing economic recovery that supports stocks. That has been the case recently, with bonds driving returns prior to the recent policy shift and equities driving returns since then.
- **Brazil illustrates another path toward limits that is increasingly relevant elsewhere.** Structurally, Brazil may be nearing the limits of high interest burdens relative to weak productivity that can't grow output in line with debt payments. Maintaining this status quo has the potential to create painful consequences for both productive capacity and institutional credibility, and to spiral if inflation becomes a limiting factor and markets demand higher real rates (the demands will be greater if institutional credibility is in question), with negative consequences for asset markets and domestic growth. Brazil's case is important because the underlying dynamics are not dissimilar from other countries. The UK, like Brazil, faces debt burdens well in excess of productivity, and when policy makers there presented an irresponsible fiscal plan without financing, markets disciplined them for pushing the limits, the long end spiked, and the FX sold off along with it. But for now, the UK has more institutional credibility to halt a spiral when it starts.

In terms of how we see these dynamics translating to different opportunities in the markets, we'd highlight a few examples:

- **Assets now look attractive relative to cash in aggregate.** Central banks' pivot to easing amid resilient growth is likely to encourage investors to move out of cash and into assets, even accounting for compressed risk premiums. Of course, at this early stage there are risks that more (or, more likely, less) easing may be required; a balanced portfolio would benefit from the risk premiums more consistently whether the easing path involves more weakness in growth or more of a pickup along the way. Assets look the most attractive in the US (where policy is furthest from limits) and China (where further stimulation is most obviously required).
- **The US dollar looks attractive against developed FX in weaker economies, such as CAD and AUD.** The level of US conditions remains stronger than across the rest of the developed world and is likely to keep that momentum as stimulus proceeds, while conditions point to the possibility of a slightly slower pace of normalization. Canada and Australia face relatively weak conditions (e.g., Canadian growth is weak, and inflation is well under target) that we expect will struggle to attract investment to fill a growing net external financing need going forward, given the deterioration in external balances both countries have experienced recently. China's stimulus and associated commodity demand are a risk to these currency views that we are monitoring closely.
- **Other currencies' moves over the last two months have created more tension with policy limits.** CHF, SEK, and several EM Asia currencies appreciated as carry trades unwound, despite weak domestic conditions that are likely to necessitate continued easy policy (and a backdrop that allows this, as global inflation has receded). The opposite is true for certain higher-yielding EMs with strong external balances, like Mexico. Despite rising fiscal spending, Mexico has avoided liabilities that could create a durable need to purchase dollars, though its currency is priced to depreciate sharply.
- **The environment now looks moderately bearish for US duration.** The evidence suggests the US economy has remained resilient, and the expectation and reality of Fed easing have created a modest bounce in activity and potentially a modest bounce in inflation. This weakens the case for aggressive easing.

We will keep you updated as our thinking evolves.

Important Disclosures and Other Information

This research paper 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 material is for informational and educational purposes only and is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned. Any such offering will be made pursuant to a definitive offering memorandum. This material does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors which are necessary considerations before making any investment decision. Investors should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, where appropriate, seek professional advice, including legal, tax, accounting, investment, or other advice. No discussion with respect to specific companies should be considered a recommendation to purchase or sell any particular investment. The companies discussed should not be taken to represent holdings in any Bridgewater strategy. It should not be assumed that any of the companies discussed were or will be profitable, or that recommendations made in the future will be profitable.

The information provided herein is not intended to provide a sufficient basis on which to make an investment decision and investment decisions should not be based on simulated, hypothetical, or illustrative information that have inherent limitations. Unlike an actual performance record simulated or hypothetical results do not represent actual trading or the actual costs of management and may have under or overcompensated for the impact of certain market risk factors. Bridgewater makes no representation that any account will or is likely to achieve returns similar to those shown. The price and value of the investments referred to in this research and the income therefrom may fluctuate. Every investment involves risk and in volatile or uncertain market conditions, significant variations in the value or return on that investment may occur. Investments in hedge funds are complex, speculative and carry a high degree of risk, including the risk of a complete loss of an investor's entire investment. Past performance is not a guide to future performance, future returns are not guaranteed, and a complete loss of original capital may occur. Certain transactions, including those involving leverage, futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors. Fluctuations in exchange rates could have material adverse effects on the value or price of, or income derived from, certain investments.

Bridgewater research utilizes data and information from public, private, and internal sources, including data from actual Bridgewater trades. Sources include BCA, Bloomberg Finance L.P., Bond Radar, Candeal, CBRE, Inc., CEIC Data Company Ltd., China Bull Research, Clarus Financial Technology, CLS Processing Solutions, Conference Board of Canada, Consensus Economics Inc., DataYes Inc, DTCC Data Repository, Ecoanalitica, Empirical Research Partners, Entis (Axioma Qontigo Simcorp), EPFR Global, Eurasia Group, Evercore ISI, FactSet Research Systems, Fastmarkets Global Limited, The Financial Times Limited, FINRA, GaveKal Research Ltd., Global Financial Data, GlobalSource Partners, Harvard Business Review, Haver Analytics, Inc., Institutional Shareholder Services (ISS), The Investment Funds Institute of Canada, ICE Derived Data (UK), Investment Company Institute, International Institute of Finance, JP Morgan, JSTA Advisors, LSEG Data and Analytics, MarketAxess, Medley Global Advisors (Energy Aspects Corp), Metals Focus Ltd, MSCI, Inc., National Bureau of Economic Research, Neudata, Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, Pitchbook, Rhodium Group, RP Data, Rubinson Research, Rystad Energy, S&P Global Market Intelligence, Scientific Infra/EDHEC, Sentix GmbH, Shanghai Metals Market, Shanghai Wind Information, Smart Insider Ltd., Sustainalytics, Swaps Monitor, Tradeweb, United Nations, US Department of Commerce, Verisk Maplecroft, Visible Alpha, Wells Bay, Wind Financial Information LLC, With Intelligence, Wood Mackenzie Limited, World Bureau of Metal Statistics, World Economic Forum, and YieldBook. While we consider information from external sources to be reliable, we do not assume responsibility for its accuracy.

This information is not directed at or intended for distribution to or use by any person or entity located in any jurisdiction where such distribution, publication, availability, or use would be contrary to applicable law or regulation, or which would subject Bridgewater to any registration or licensing requirements within such jurisdiction. No part of this material may be (i) copied, photocopied, or duplicated in any form by any means or (ii) redistributed without the prior written consent of Bridgewater® Associates, LP.

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.