As Economies Lose Potential Energy, Investment Considerations

OCTOBER 28, 2019

BOB PRINCE

BRIDGEWATER

The laws of physics give us the concepts of potential energy and kinetic energy. For example, when a ball is held high above the ground, it has a lot of potential energy; when the ball is released and in motion, this turns into kinetic energy; and when the ball is on the ground at rest, it has neither. Economies have analogous dynamics. When unemployment and interest rates are high and debts are low, you have the potential for a period of strong economic growth, which can be released by a cut in interest rates. But once unemployment has fallen to low levels, interest rates have been lowered to near zero, and debts are high, the potential energy of the economy is low. That is where most developed economies now find themselves. This is made worse by unfavorable demographics and slow productivity growth.

However, slow growth contributes to low and stable inflation, which frees up central bankers to run supportive monetary policies via low/zero/negative interest rates and plenty of liquidity. At the present time, they're doing what they can to keep things going until they confront clear warning signals of inflation moving sustainably above set targets.

From an investment standpoint, an environment like this implies less upside from growth, though also a lower probability of a sharp economic downturn, because sharp downturns are generally caused by a tightening of monetary policy and a pulling back of an excessive rate of borrowing, both of which are now unlikely, at least in the near term.

This scenario is challenging, but what would be even more challenging is a stall or downturn. The lack of potential energy in the system also means that it will be difficult for central banks to reverse a downturn. The last thing they want to do is cause a downturn themselves, so pre-empting a downturn and sustaining the expansion is logical and what they are now trying to do.

This nets to an environment of slow growth and low inflation, i.e., very low nominal growth rates, sustained by near-zero/negative interest rates and plenty of liquidity.

How to approach investing in such a world? Logically, certain types of longer-term income-based strategies can rise in importance relative to shorter-term price- or growth-based strategies. Possibilities include...

- Even in a world of low or no nominal growth, there will be a level of income (e.g., $20 trillion of nominal GDP/income) that is distributed like a layer cake in tiers: wages, taxes, profits, dividends, and so forth. And central banks have set a level of interest rates near or below zero in an effort to sustain current levels of income with perhaps a bit of growth. That leaves room to position for a spread on particularly reliable layers of income relative to the near-zero or negative cost of funds to finance them. For example, as discussed in the September 23 *Observations*, "Taking a Fresh Look at Dividends," in the US, dividend payments have always gotten a share of the income layer cake, whether nominal GDP was growing or falling. There will of course be mark-to-market and investment horizon considerations to assess. But thinking in level terms with respect to income and funding cost is a path to consider in this environment.
- Within the income layer cake, there will be shifts. Some companies will gain share relative to others. And across sectors of the economy, you will get changes in the distribution of income between business, labor, and government. In a lower-growth, lower-volatility macro environment with stable interest rates and plenty of liquidity, the proportionate influence of *shifts* in the *relative* share of income would rise in relation to the impact of changes in growth, inflation, and interest rates.
- The low-potential macro environment described above pertains mainly to the developed world. A number of emerging economies, particularly in the East, are likely to experience productivity growth in the 4% to 6% range, with ongoing potential for credit expansion. For some, nominal GDP/income are likely to grow by 5% to 10% per year over the coming decade, with local currency interest rates/funding below that and not far above interest rates in the developed world. A significant spread between long-term nominal GDP growth and interest rates has the potential to be a driver of longer-term investment returns.

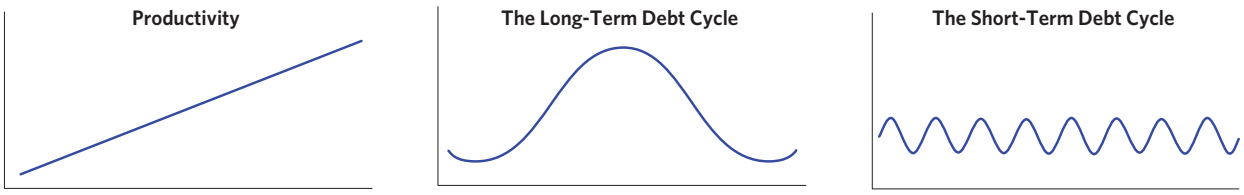
These are just a few examples of how thinking in terms of a) levels of income, b) over time, in relation to c) levels of funding costs associated with that income can create investment possibilities in a world that would reduce others.

We see these conditions and possibilities as elements of what we've described as a paradigm shift. Paradigm shifts are not a new phenomenon; they have happened regularly throughout history, and we've described a number of them. Importantly, a paradigm shift does not represent a wholesale change in the economic machine, just a new configuration of the elements of that machine. From an investment standpoint, the important thing is to perceive paradigm shifts and then to process that configuration of conditions through the lens of the machine in order to derive new sets of probabilistic outcomes and approaches for dealing with them. Each investor will do that in their own way, and as you know, we approach that challenge through our systematic research and investment processes.

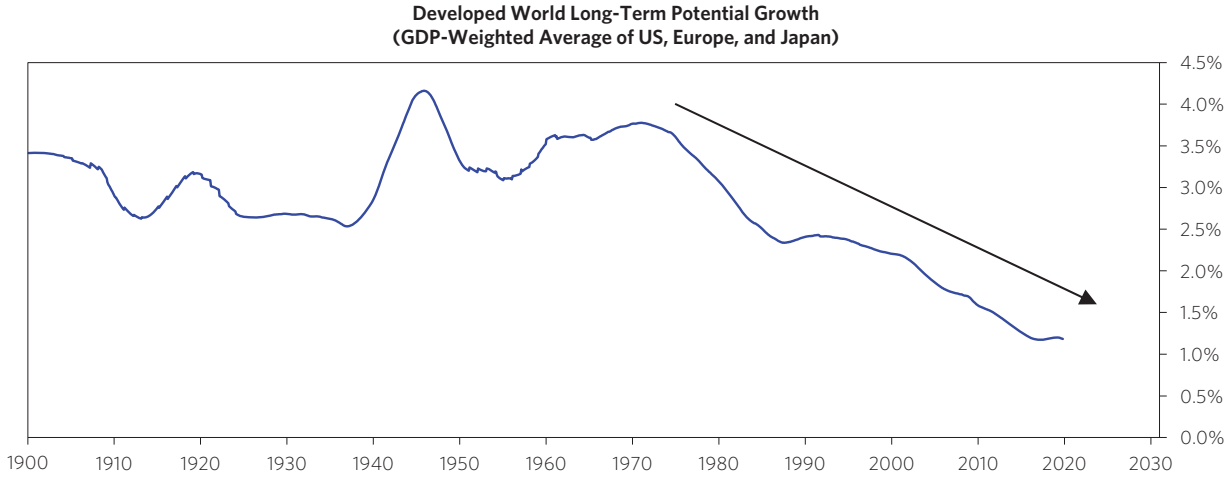
In the pages that follow, we've included a set of charts and summary descriptions to illustrate the unfolding environment.

Our Template for Understanding What Is Going On

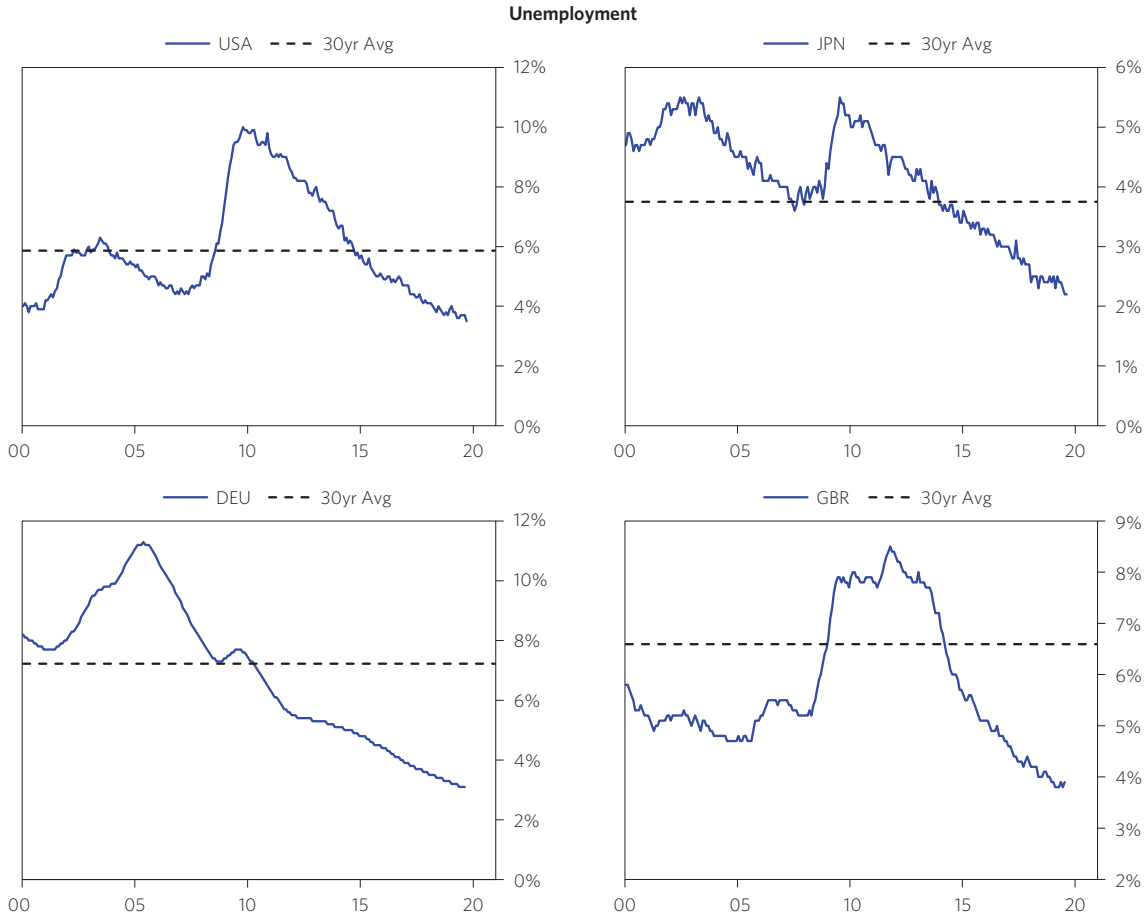
As a reminder of our template, we see three big forces on economies: productivity growth, a long-term debt cycle, and a short-term debt cycle. Productivity growth is a steady influence on real long-term per capita income growth. It's an important influence on longer-term growth rates but not economic cycles. The long-term debt cycle reflects the level of debt in relation to income and influences the potential for future credit growth. The short-term debt cycle shapes the business cycle and is driven by monetary policy and fiscal policy. Across most of the developed world, we are in the latter stages of both the long-term and short-term debt cycles, with meager prospects for long-term productivity growth and slow or negative growth in labor forces.



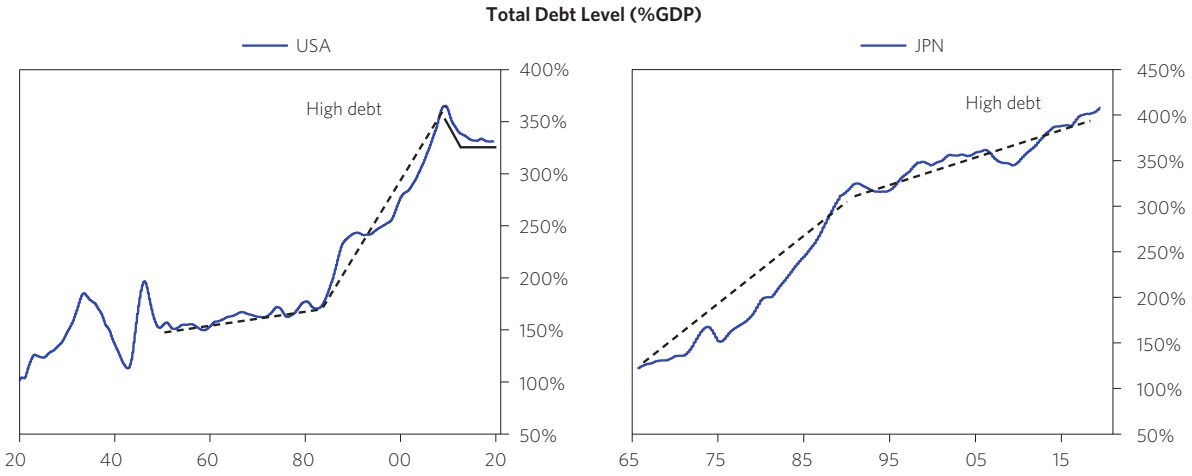
Looking to the longer-term forces, in the developed world productivity growth has been trending lower while demographics have deteriorated. As a result, potential GDP growth has recently fallen to the lowest level of the past century, near 1%.

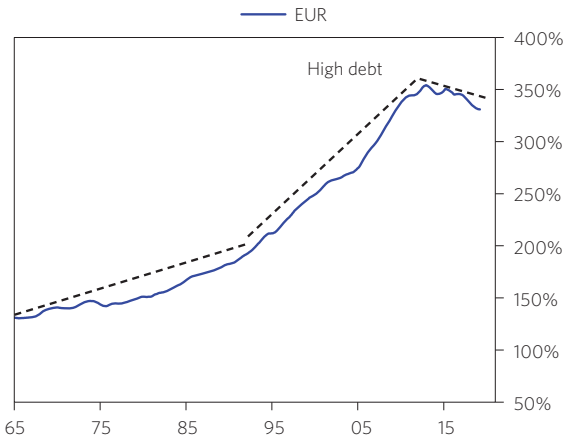


From a cyclical standpoint, you've got low unemployment rates, which limits growth relative to potential. It also raises the odds that a surge in demand will produce inflation. Should that occur, it would bring monetary tightening back into play, which would put a cap on that surge in growth.



You've also got high debt levels, which reduces potential future credit growth. The deleveraging process over the past decade brought them down some, but not by a lot, because the deleveraging process was quickly arrested and smoothed out by aggressive reflationary monetary policies.



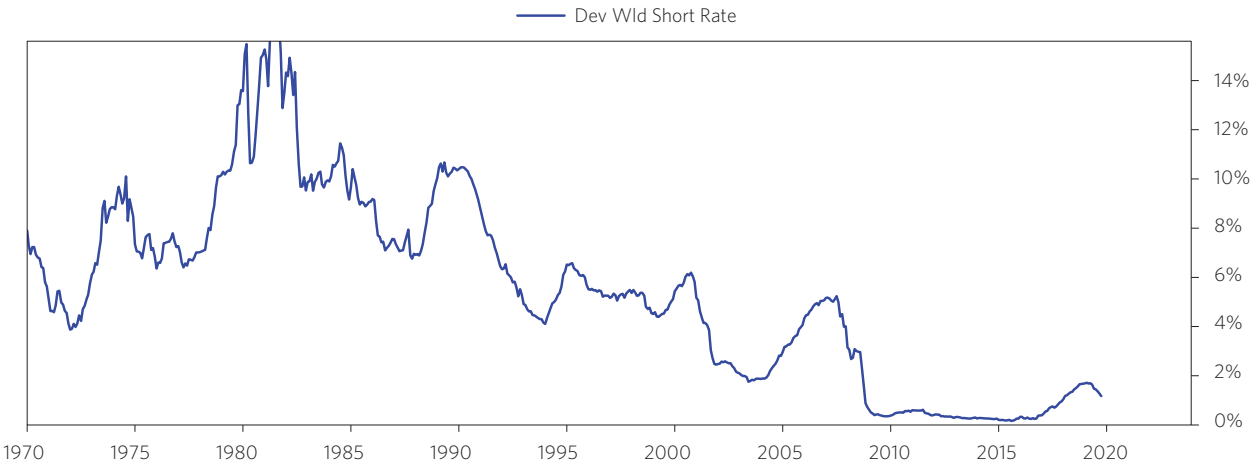


Historically, when countries' debt/GDP ratio was flat or falling, their growth rates were about one-third lower than when their debt/GDP ratio was rising, as shown below.

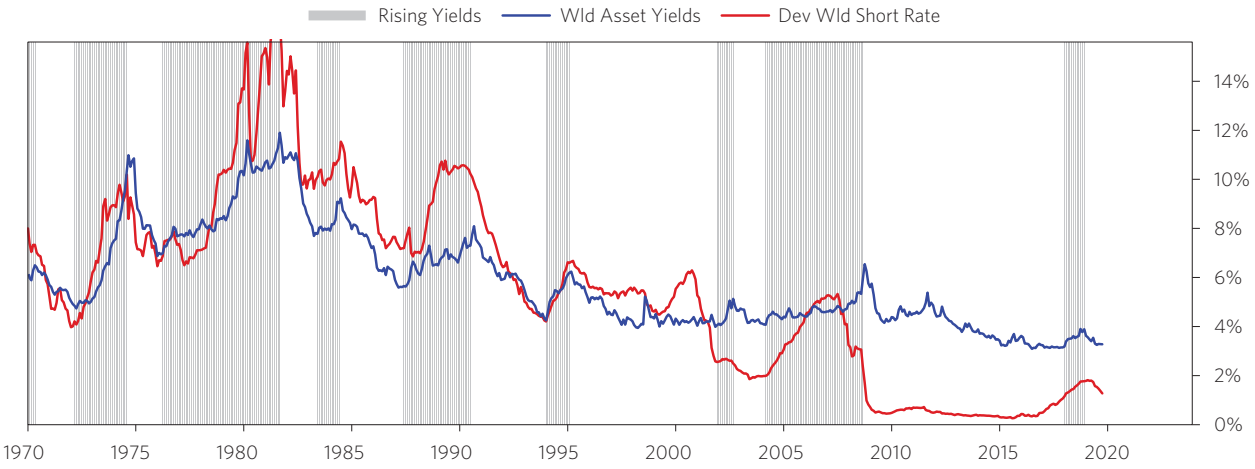
Growth and Inflation When Debt Burdens Are Rising/Not Rising

Debt Burdens	Real Growth	Inflation	Nominal Growth
Rising	2.6%	3.1%	5.8%
Not Rising	1.4%	2.4%	3.8%

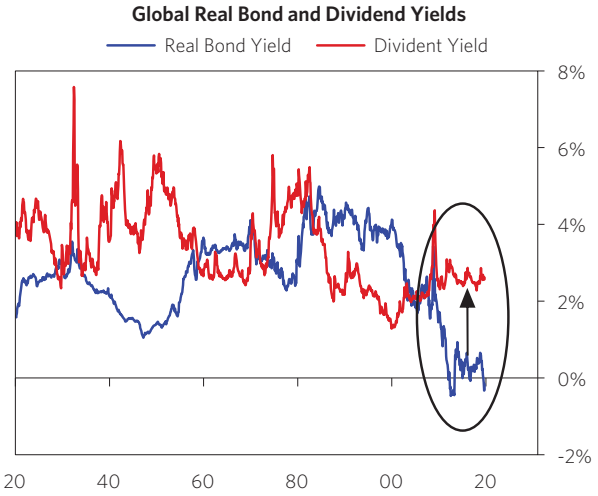
And you've got near-zero interest rates, which further inhibits the ability to stimulate a credit expansion.

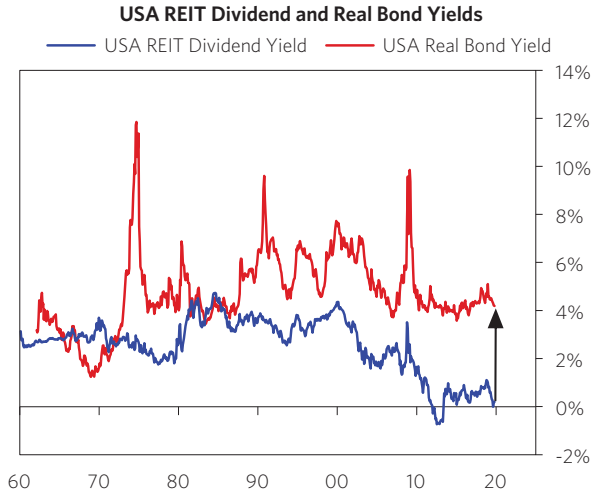


On the other hand, you've still got a level of yields on assets that can be financed at those zero or negative interest rates, so long as you can tolerate the price volatility of holding those assets. Even if you don't get much growth, you can get some spread against a low financing cost that can accumulate over time.

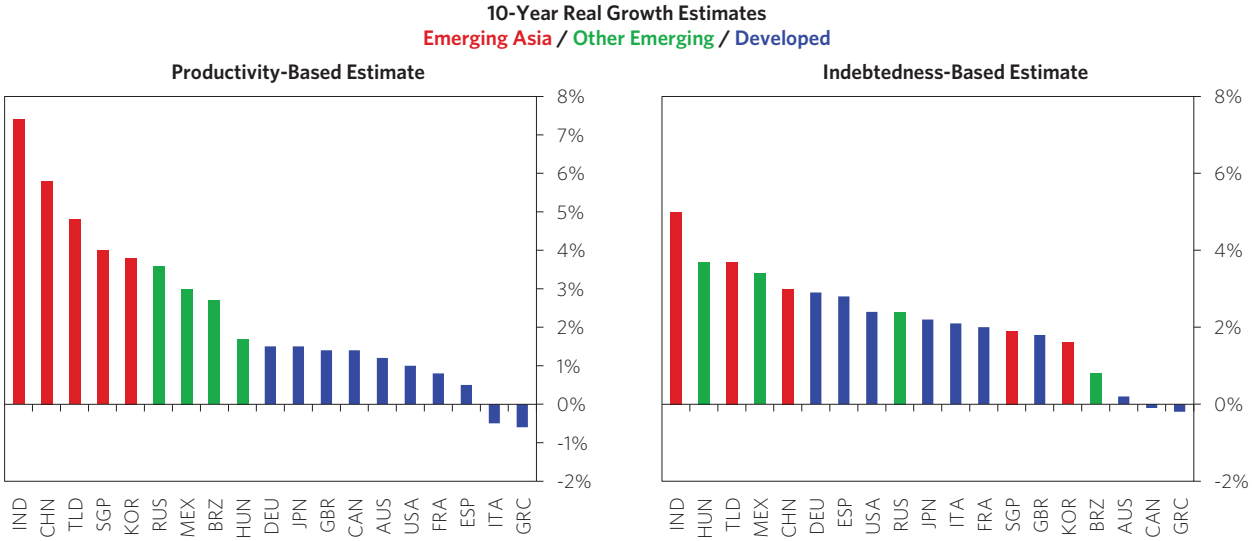


As an example, below you can see the spread between the dividend yield and the bond yield globally, and the same for the dividends on REITs and the bond yield in the US.

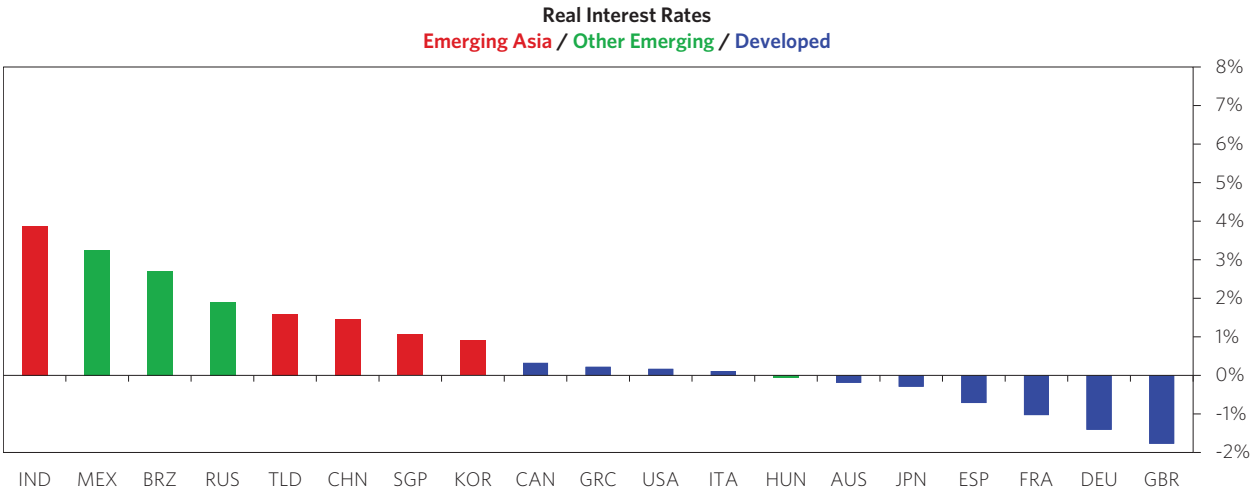




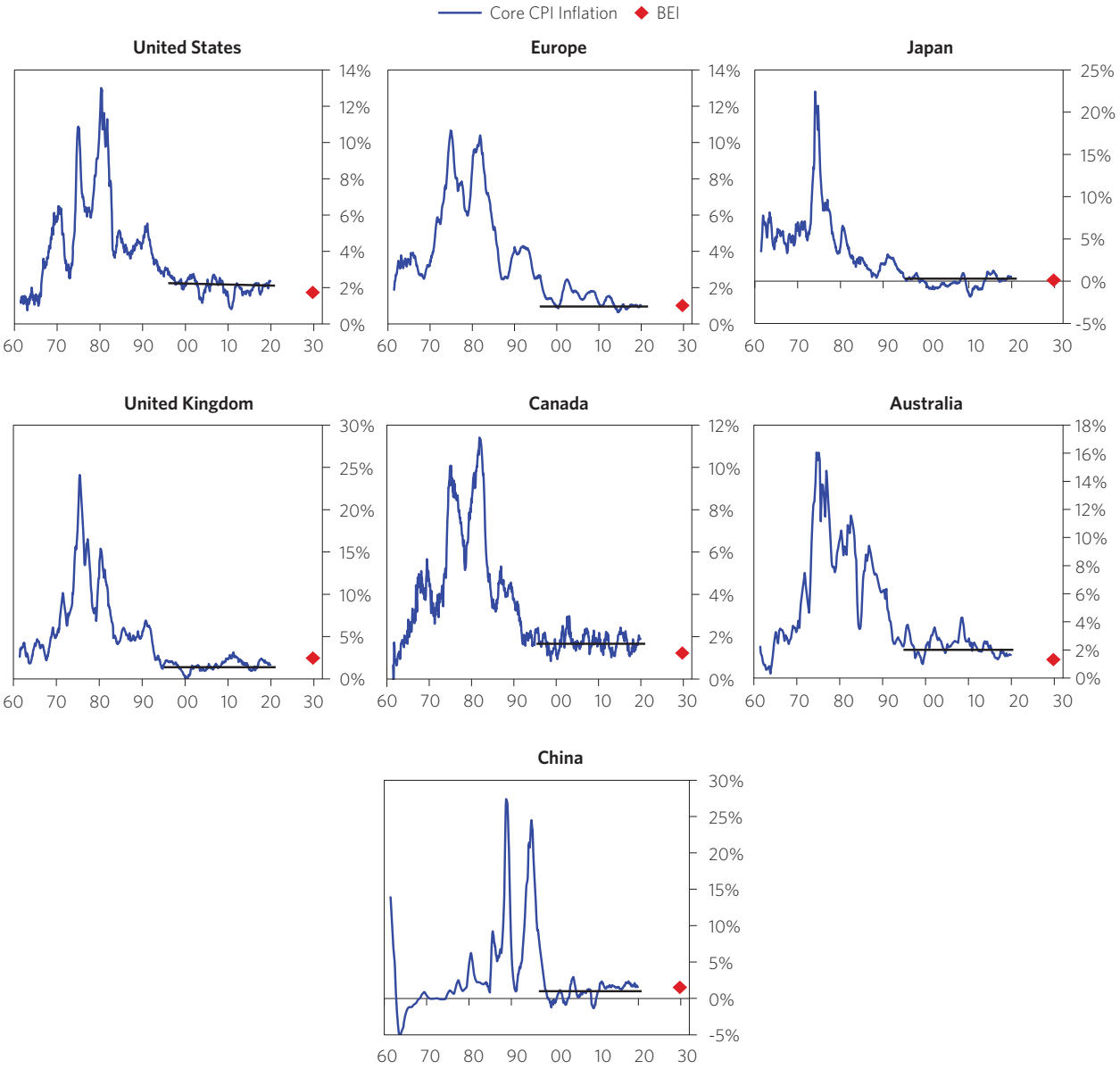
That is the picture in the developed world. As you move to the emerging world, you have the potential for higher nominal growth rates from both higher productivity and more room for a credit expansion. The following charts show our 10-year projections of productivity growth and debt-financed growth for emerging and developed economies.



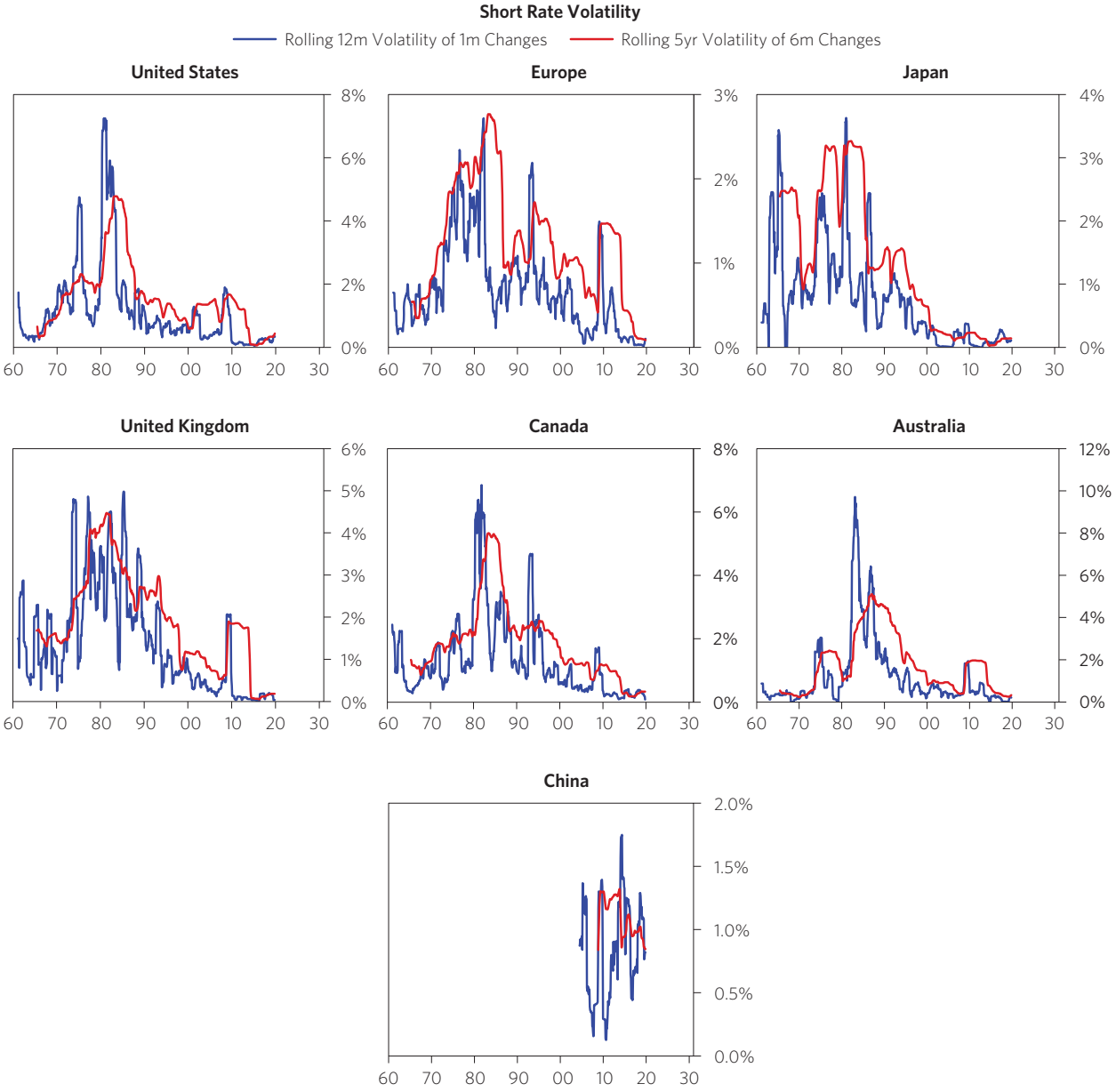
Partly because emerging economies' interest rates are impacted by the level of interest rates in the developed world, the cash flows from these nominal growth rates can be financed at interest rates that are significantly below the nominal growth rates.



Low and stable inflation will be a key factor in whether central banks can sustain accommodative monetary policies. Inflation will rise if either a) the money demand for goods exceeds the quantity of goods supplied, or b) exchange rate movements produce monetary inflation. These should both be watched for, but so far the secular forces of technology, globalization, and sluggish growth have held down the first of these, and the aggressiveness of monetary actions, as well as other dynamics such as the currency denomination of the debt and so forth, has not yet produced the second.



The gradual unfolding and acknowledgement of stable inflation rates has contributed to the steadily reduced volatility of short-term interest rates. As a point of reflection, 25 basis point decisions get a lot of attention. Whereas it's taken more like 500 basis points to change the economics of borrowing and spending by enough to have a significant impact on the direction of the economy, and a normal annual change in short-term interest rates over the past 50 years has been +/-200 basis points per year (i.e., one standard deviation).



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