BARRON'S Online

Monday, March 24, 2003

Near Ground Zero

The Fed is almost out of room for rate cuts, says Bridgewater founder, and that poses perils

By SANDRA WARD

An Interview With Ray Dalio - Since founding Bridgewater Associates close to 30 years ago, Dalio and his team have garnered a reputation for rigorous thinking, innovative analysis and superior investment performance. Just how solid Bridgewater's performance has been is reflected in the returns of its hedge fund, which has gained 15.1% after fees since 1989. The fund has only had two down years net of fees, with the worst a loss of 1.5% in 1995. As a result, the Westport, Conn.-based firm has also amassed $38 billion from pension funds, endowments, foreign governments and central banks eager to tap into its expertise in spotting opportunities across asset classes around the world, with a special focus on credit markets and currencies. Clients gain access to Dalio's insights through the firm's Daily Observations letter. But with so much at stake as the U.S. went to war against Iraq last week, we were eager to hear straight from Dalio himself what the implications are for investors and what his concerns are. Here's what he thinks.

Q: *What are the implications of war for world economies and world markets?*
A: It's one of those situations in which there's a wide range of unknowns. It could go quickly with not too many complications. If Saddam Hussein leaves and administrating the affairs of Iraq doesn't prove too complicated and we don't have any subsequent terrorist activity, then Americans might be relieved and want to celebrate and go out and buy things, and the market goes up. But it's also possible to imagine a worse situation. All it takes is three backpacks and three malls and there's really very little anyone can do about terrorism of that nature. Thinking hard about the administration of a country of 23 million people, with all sorts of ethnic and religious rivalries, also makes it clear this war with Iraq could be a can of worms. And we're concerned about what comes next. Iraq is a symptom of a problem, not the problem.

Q: *Meaning what, exactly?*
A: Technological advances have made nuclear weapons more accessible to countries and individuals, and conflicts over nuclear proliferation will be increasingly more likely as less developed countries assert themselves and make demands using nuclear weapons as a threat. It puts the U.S. in a kind of prisoner's dilemma. We go after Saddam, hoping to reduce the chances of future conflicts with other countries.

Q: *But this is occurring with generally weak conditions around the world, so does war make things weaker or does it somehow lead to stronger economies?*
A: We're at a period of extraordinarily high risk, and it's high risk because interest rates are at 1.25% and they can't go below zero. The average amount of Fed easing that's been necessary in the 10 recessions that we've been through in the post-World War II period to produce an expansion has been 5.5% -- and the smallest amount of easing that's been required was 2.3%. Now, if something goes wrong, we are close to the end of that classic monetary response. The market isn't discounting the level of risk that represents.

Q: *How is that?*
A: The markets are discounting a level of risk below that which was discounted following Sept. 11; below that which was discounted in 1998 when we had the Russian and Asian debt crisis; [and] materially below that which existed in 1990, which is when we had the last Gulf War and the recession and credit problems. It's also materially below the level that existed in 1987 around the stock-market crash. If the markets are right, that

"There is a lot of debt. There is about a 25% chance we are going to need to cut rates by more than 1.25%."

frame of reference would say it's a period of above-average risk but not a period of risk on a par with those previous periods.

Q: *Is that how we should be viewing this?*
A: Whenever you make an investment decision, you must start with what is being discounted, and then you have to make your bet against that. I think the risks are higher than what is being discounted.

Q: *So why are the markets treating this period so differently from these other tense times?*
A: There is a tendency of markets to key off what happened historically. We know the last war with Iraq went well, and the army of Iraq is now one-third the size it was then. The reaction last time was to buy stocks when the shooting began.

This time around, there is a terrorism fringe that exists around the war, but the markets aren't treating that as a serious threat. Excluding the looming issues of 1.25% rates and high debt, the risk level projected by the market is probably reasonable. In other words, the war probably will go well, it will not spill over, and a terrorist event probably won't occur here anytime soon. But I don't think the implications of 1.25% interest rates and the limited ability to resolve problems through interest-rate cuts is being adequately assessed in determining the friskiness of the environment.

Q: *Some would say the Federal Reserve has plenty of ammunition, if it needs it.*
A: In the U.S. in all times and in almost all countries throughout all times, the one reliable means of guiding the economy is by monetary policy through interest-rate changes. If you look at all the cycles, we pulled out of recessions because of interest-rate cuts. From 1.25% it is unlikely that rate cuts can be large enough to produce a recovery.

Q: *Do you believe we are in a recovery phase, or have you begun to have doubts?*
A: This recovery is roughly tracking a normal recovery at this stage, except the investment component is lagging because there was such overinvestment in the preceding period. It is a very anemic recovery if you compare it to past recoveries.

It looks reasonably normal, it looks good. But I also know I can't say for sure whether it is going to continue to track. There is a lot of debt and a lot of vulnerability. There is about a 25% chance we are going to need to cut rates by more than 1.25%. That means there is a 75% chance we won't, but there is a 25% chance that we will. People don't realize the profound implications of not being able to cut interest rates enough.

Q: *OK, what are the implications?*
A: Interest-rate cuts stimulate the economy in three ways: They create debt-service relief, for one. They make items bought on credit, say a house or a car, cheaper and more affordable without producing deflation, because the monthly payments go down, even though the price of the asset doesn't go down. It's a way of lowering the price of merchandise to stimulate marginal buyers without creating deflation. Thirdly, cutting rates also raises the present value of assets and creates a wealth effect: Lower interest rates result in future cash flows being discounted at a lower rate. And that causes the present value of those cash flows to rise, so that any stream of payments -- from bonds, rental properties or stocks -- has a wealth effect.

Our ratio of debt to gross domestic product has accelerated because interest rates have come down and our monthly payments to service the debt have not really changed. In a credit-based economy, growth is very tied to credit creation: As interest rates come down, people can borrow more, and spending increases and interest payments don't rise. All that encourages positive psychology. If you get to zero interest rates, that dynamic ceases to work.

Q: *What happens then?*

A: At 0% rates, there's no debt relief and debtors have cash-flow problems, then credit problems, and that typically results in asset sales. The asset sale produces the cash flow to create the debt relief and that, in turn, produces more deflation pressures. The dynamic that I'm referring to is not part of the normal business cycle. It is a dynamic by which you don't create debt relief, the debt burden rises, incomes start to decline and the debt-service-to-GDP ratios rise. The debt stays the same but because incomes go down, the debt burdens increase. Most debt crises don't begin because somebody or some country got into too much debt, because when they were lent the money they had either the income or the asset values to justify the lending. The problem emerges when income levels fall or asset values fall and debt burdens rise relative to those.

Q: *We're walking a thin line here. How close are we to the dynamic you've just described?*
A: It is especially hard to say at this time of exceptional uncertainty. To paraphrase Thomas Jefferson: "He who knows not is closer to truth than he whose mind is filled with falsehoods." While I think there is a 75% chance we get through this period OK, even though the recovery will be anemic, what is important is the 25% chance we don't. We are at war. There is a fragility to the economy. We know the economy is highly indebted and isn't robust. We know, too, interest rates are at 1.25%. In all the range of possible outcomes, there is some probability associated with the fact the Fed will need to shoot more than 1.25% of stimulation into the economy and it is not going to be there. In that case, we will enter another domain and we should understand what that domain looks like.

Q: *The domain of deflation?*
A: This is the domain in which the Federal Reserve has to run monetary policy in a way it has not run monetary policy before. It is very much like a doctor asked to perform an operation he's never done before. It is a very imprecise science. There's a lot of uncertainty.

Table: How Dalio Rates Them[1]

Q: *But haven't we been through this before?*
A: Only during the Great Depression. And Japan is faced with it today.

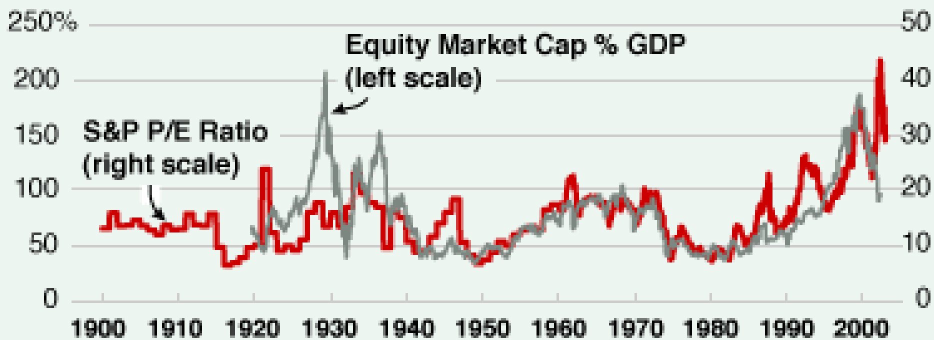
Q: *Europe hasn't cut interest rates as much as the United States and still has room to move. Does that provide more of a cushion?*
A: The U.S. market is a driver of the rest of the world's markets, and world bond markets and stock markets key off the U.S. Europe, because of its rate structure, will be an island, but Europe isn't going to be a locomotive of world recovery. If they cut 150 basis points, it is not likely to pull us out of the trench we've dug.

Q: *Some feel sanguine about the Federal Reserve's promise to buy as many bonds as it takes to keep deflation at bay.*
A: The government can monetize debt. They can go out and buy bonds, but that is a much less precise and a much riskier process. Normally, the Federal Reserve provides reserves to the banking system, and there is a multiplier effect and there is lending and the economy is run in a free-market way. Individuals and businesses make decisions based on the cost of funds.

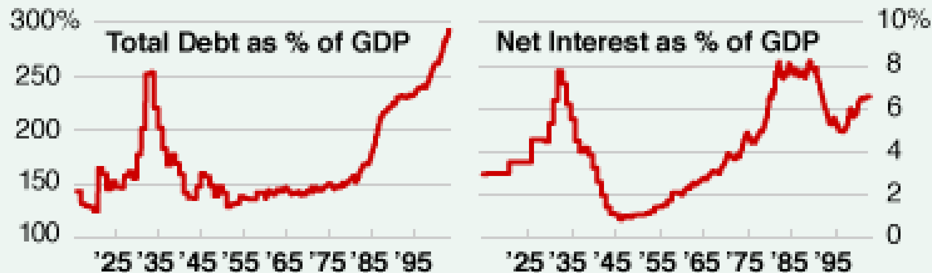
That is no longer the case when you are dealing with monetization. I've spent a lot of time examining this issue in all different countries and watching it in Japan. The Bank of Japan, for instance, has bought a lot of bonds, equivalent to about 9% of GDP, to try to stimulate the economy. There are questions of how much to buy. Which bonds to buy. How to create a normal flow of liquidity. The controls are not precise.

THE WAR AT HOME

Despite the steep plunge in P/E ratios and the market value of all publicly traded companies, both remain high by historical levels and suggest the stock market still hasn't reached bottom.



With interest rates at 40-year lows, total debt as a percentage of gross domestic product has hit record highs and debt-service costs have been in a downward trend. This virtuous cycle is likely coming to an end, as rates don't have much more room to fall below 1.25%.



Source: Bridgewater Associates

Q: *Which bonds does the government buy?*
A: It's a Pandora's Box. If it buys corporate bonds, then the government is lending essentially to some companies and not others. This gets into the realm of politics. And politics is a problem because it impedes decision-making. But I'm mostly concerned that no one is paying attention to the risk that the traditional relationship between monetary policy and economic activity could break down. Everybody is assuming our monetary policy -- where you cut rates and trigger a certain response and you cut rates again and trigger another response -- will go normally, because it has always gone normally. Since 1981, every major cyclical low and every major cyclical high in interest rates was lower than the one before it. So for more than 20 years, we've had this tendency of rates to go down, allowing debt to increase without raising debt burdens. That produced prosperity. That has been the dynamic. The problem is when you get close to 0%, there are no incremental cuts to produce the incremental demands.

Q: *Are you as pessimistic as you sound?*
A: No. I think we are going to have a relatively slow recovery.

We will know the answer to the 25% chance of rates going to zero in three to six months, a relatively short time. We are monitoring a lot of numbers, a lot of measures, on a day-to-day basis to assess the odds -- not because we can forecast well, because we can't, but so we can interpret well, which is what we do best, and shift our bets. Right now, we're leaning more toward a normal economy.

But I think this 25% chance of a worst-case scenario happening warrants attention and understanding. Think back to all the planning and preparations for Y2K. What I've outlined has a much higher probability of being a problem than Y2K ever had.

I'm an investment manager with $38 billion under management. I have to have a strategy that takes into consideration the possibility of this occurring and that will make us do well if it occurs. I don't know if it is going to occur, but I have to understand it thoroughly, in case it does. When you don't have interest rates changing, you can't use them as a guideline. You have to understand how to measure monetization and its effects, and so on. And I have to consider different outcomes. Right now, I have much lower-than-normal risk levels on, and I've become a lot more defensive because I think the risks are high.

Q: *When did you become more defensive?*
A: In the past three months. We are less exposed than we would be under a normal set of conditions. We've cut all our positions by about one-third, on average.

Q: *Where do you stand on the dollar?*
A: Our biggest bets are short the dollar. These are not bets based on any economic scenario. The nature of the capital flows that supported the dollar had very little to do with macroeconomic conditions. They had more to do with mergers and acquisitions and equity purchases from pension funds. European pension funds, for instance, previously weren't allowed to invest in international equities, but changes to those rules resulted in a lot of investment in the U.S. For those kinds of reasons, the capital flows that caused the dollar to go up were temporary in nature and not driven by macroeconomic factors. We are short the U.S. dollar against most currencies.

Q: *What are the exceptions?*
A: The Mexican peso is probably the only exception, but we have a lot of cross-currency positions. For example, we're particularly long the Canadian dollar.

Q: *That's a bigger bet than the euro?*
A: Yes, because of the nature of the capital flows. Canada is running a very large current-account surplus, and the Canadian dollar got very cheap because a lot of Canadian investment was made outside of Canada due to pension-fund deregulation and changes that allow investment outside the country. The buying wave is largely past.

What we have is a situation where the U.S. is in the opposite situation. There was a wave of capital that came into the U.S., and now we are running a very large current-account deficit. That means on the margin, we have to attract capital that amounts to 5% of GDP to fund the deficit. What we have is a situation where the two countries are at extreme odds in terms of the nature of the demand for their assets, and that won't be sustainable.

Q: *What about the euro?*
A: We are long the euro, but a lot less so compared with the Canadian dollar.

Q: *And the yen?*
A: We have a small long-yen position. Japan is in this classic set of circumstances, which if you were to just look at the economy, you would say they should depreciate their currency and print a lot more money and create a lot more liquidity. But we're judging them based on what they do, not what they should do. And the Bank of Japan has not been easy enough. On the other hand, because of their domestic credit problems, they're in a position where there is a strong desire to repatriate capital, which occurs when investors who are getting squeezed pull assets back from faraway places. That is a positive for the yen.

Q: *What about credit markets?*
A: There is a lot of sweetening in the yield curve priced into credit markets, particularly in the United States but also in some other countries. We're betting that interest rates will not rise nearly as fast as is being discounted. We are very long European credit instruments as a spread against U.S. credit instruments, because we think that there is a lot more room for easing in Europe. That will encourage the rate structure in Europe to fall faster than it will in the United States. Also, European countries are net capital exporters and we're capital importers. In an environment of greater risk, there is a tendency of those that need capital to run into more problems than those who have capital.

So we're long European bonds, particularly German government bonds, as a spread against U.S. and U.K. bonds.

Q: *And equities?*
A: We have very small long positions in all the major equity markets, and we are making different sector bets and taking bets on different sector spreads by going long some sectors and shorting others. We just recently started buying equities after a hiatus of a couple of years. Pricing became attractive only recently. Another plus for equities is that under funded pension plans in the U.S. are going to have to make pension contributions. They will end up purchasing stocks. Those numbers could be in the vicinity of $100 billion-$150 billion -- that's a lot of buying. So not only do equities look comparatively cheap, but add in the sizable pension-fund

purchases, and that's a lot of demand.

Q: *What other asset classes do you like?*
A: We have bought fairly small quantities of different kinds of emerging-market debt -- Mexico and Russia, in particular, because their balance of payments are really in good shape due to strong cash flows from oil exports. They are not likely to run into any credit problems. We don't have much in the way of emerging-market equities. We are long inflation-index bonds in a spread against nominal bonds, or traditional Treasuries, because the break-even inflation rate is 1.5% and we think that's too low.

Q: *Do you buy gold, at all?*
A: We have had a small long position in gold futures for the past four to six months.

Q: *What's your approach with gold?*
A: We approach it two ways. We approach it as a proxy for global liquidity, so the more monetization there is, the more we would be inclined to own gold. We also approach it from simply a supply-demand basis. Who are the producers? Who are the sellers? And what are the central banks doing with gold? We believe that China will increase its gold reserves, which represent about 2% of their total reserves. The central banks which have been selling will be doing less selling.

Q: *What equity sectors do you like?*
A: In the U.S. we like insurers, pharmaceuticals and no cyclical consumer-goods companies. We're still bearish on telecom, software, most information-technology companies, cyclical consumer-goods companies and media and photography.

Q: *All of this is valuation-based?*
A: It is based on a lot of things. It has to do with valuations and changing measures of economic conditions that affect companies.

Q: *What's your outlook for growth in the economy?*
A: In the next 12 months, we expect it to be in the vicinity of 2.5% to 2.75%, mainly because of subpart investment in part of the economy.

Q: *So what's your projected return on the equities you like, on average?*
A: We look at five- and 10-year returns in determining valuations, but even with the low projected economic growth we see, the growth we see for equities is around 7%, including dividends. Stocks have gotten comparatively cheap compared with bonds and the economic backdrop. However, if the 25% chance of another blow to the economy happens, all bets are off and everything changes. In Japan's decade-long downturn, the average annual earnings growth rate was minus 9% a year. So the growth rate could change in a really profound way if we were to resume the downturn.

Q: *Thanks, Ray.*

E-mail comments to editors@barrons.com[2]

URL for this article:
http://online.wsj.com/barrons/article/0,,SB1048295484773518000,00.html

Hyperlinks in this Article:
(1) http://online.wsj.com/article/0,,SB104829825579672100,00.html
(2) mailto:editors@barrons.com

BARRON'S Online

Monday, March 24, 2003

How Dalio Rates Them

Credit Markets

Asset	Rating
U.S. Bonds	Neutral
Canadian Bonds	Neutral
U.S. Short Rates	Strongly Bullish
Eurodollars	Strongly Bullish
U.K. Gilts	Strongly Bearish
Euroland Bonds	Moderately Bullish
U.K. Euro Sterling	Moderately Bullish
Euroland Short Rates	Strongly Bullish
Japanese Bonds	Neutral
Australian Bonds	Moderately Bearish
Japanese Euroyen	Moderately Bullish
Australian Bank Bills	Moderately Bullish
Currency Markets	
Canadian Dollar	Strongly Bullish
Euro	Moderately Bullish
Japanese Yen	Moderately Bullish
Australian Dollar	Moderately Bullish
U.S. Dollar	Bearish
Equity Markets	
U.S.	Neutral
Japanese	Neutral
German	Neutral
U.K.	Neutral
French	Neutral
Canadian	Neutral
Australian	Neutral

URL for this article:
http://online.wsj.com/barrons/article/0,,SB1048298255796721 00,00.html