Bridgewater Daily Observations

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Bubble or Boom?

One of the central questions that underlies our outlook for U.S. stocks, bonds and the dollar is whether the U.S. economy is in a speculative bubble or a productivity boom. We lean toward speculative bubble, but we have not studied the question thoroughly enough to have a strong view. As we discussed last week, today's innovations are certainly changing the world, but past innovations also changed the world. Are today's technological advances more significant than past innovations such as electricity and the telephone? And a more relevant question is, what are the projected growth, inflation and earnings impacts of today's advances and are these higher or lower than what is discounted in today's prices?

We do not have satisfactory answers to these questions. But we are working on answering them. We will pass along our answers and observations as we develop them.

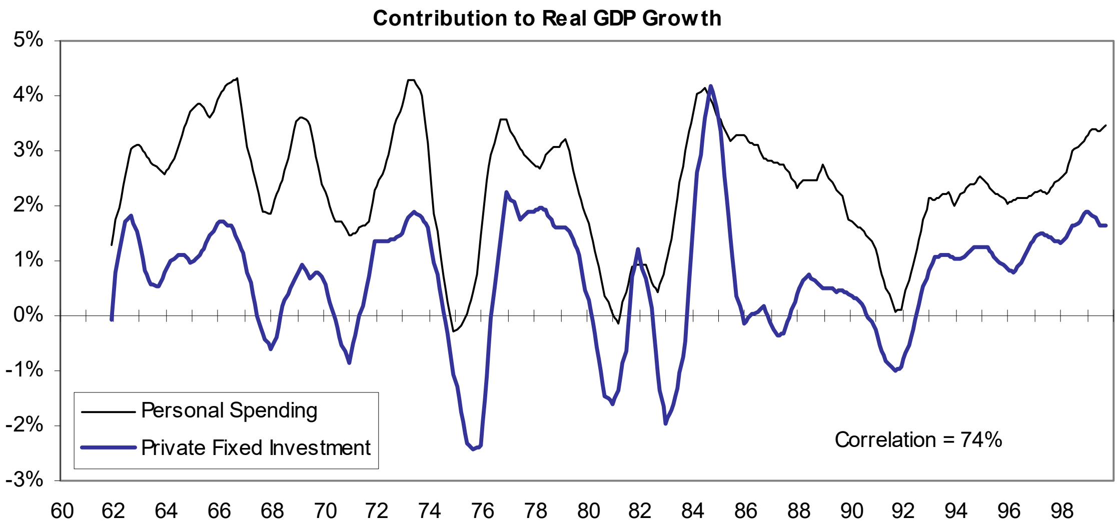
So far most of our work has focused on understanding today's conditions in the context of the way that we would expect things to normally work. How much of today's conditions can be described by normal influences? How much appears to be new and unaccounted for by normal drivers? Can these unaccounted for conditions be described by new technological advances, increased global competition, or other paradigm shifts?

In pursuing this end our first step is to tear apart the financial structure of the U.S. economy. Let's get away from theories and focus on cash flow and very clear cause-effect linkages.

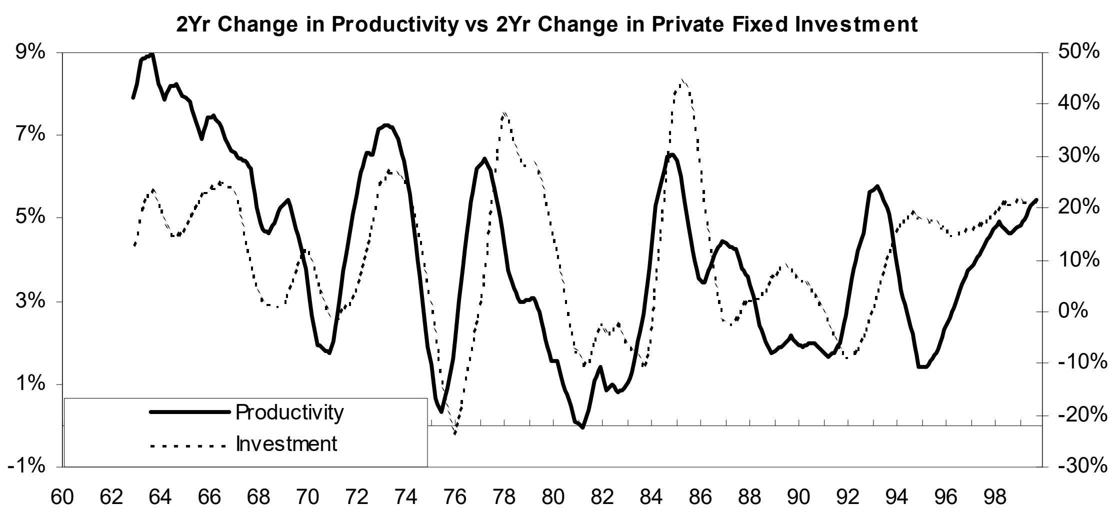
Demand:

The first observation is that demand is very strong. This simple observation triggers a string of questions: What is stimulating that demand? How is that demand being financed? What resources are being used to meet that demand? What are the inflation implications of meeting demand in that way? How is that demand affecting corporate revenue? How much of that revenue is going to workers vs. corporate earnings? What type of equity market returns would be justified by those earnings? P/E's are rising. How much future earnings growth is implied by that and how does that compare to actual earnings growth? How much different would the future have to be in order to justify that level of earnings growth? Who is buying the equities, pushing those P/E's up? How are they financing their equity purchases? We won't answer all of these questions today but we will hit the first few.

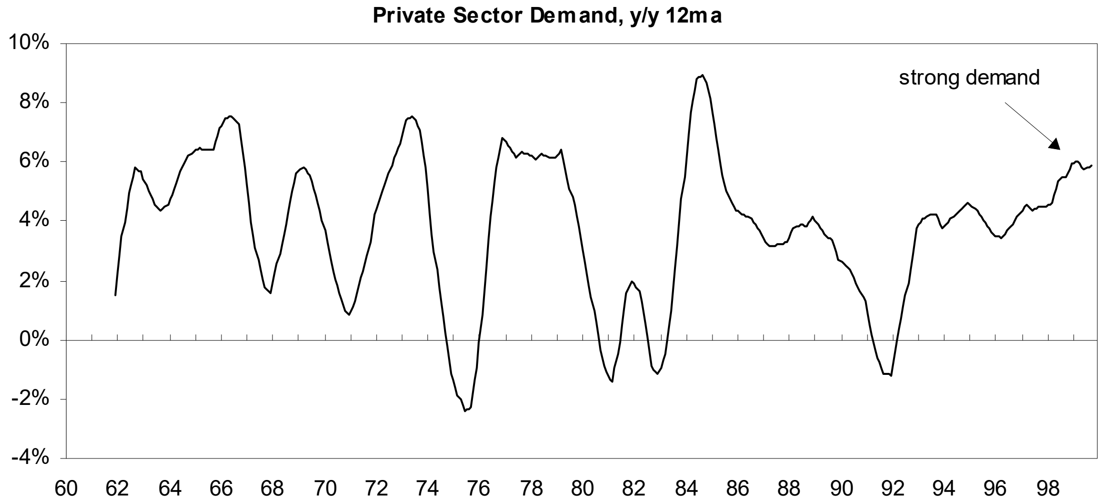
Certainly, demand is strong, especially private sector demand, which is the bulk of total demand (the other sources of demand are government and foreign). The following chart shows the smoothed annual growth in the two major sources of demand, personal spending and business fixed investment. Each is shown according to its contribution to total GDP growth. While both sources of demand are strong, it is also interesting that they move together. We tend to think of business fixed investment as something that is unique relative to personal spending. And that fixed investment is something that provides for a better future by way of higher productivity. But it looks a lot more like businesses spend money on fixed investment in response to consumer demand and either directly or indirectly respond to the same forms of stimulation that influence consumer demand.



We also see that fixed investment tends to systematically lag productivity rather than lead it. We see the same across all countries. Based on this, it is hard to argue that strong fixed investment has caused productivity, although the argument could still be made over longer time frames.



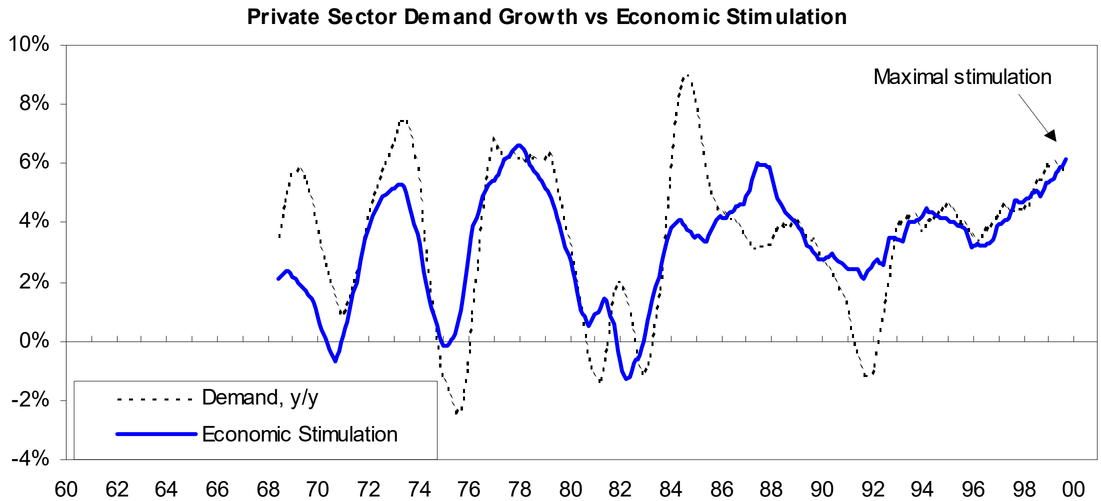
Because the two forms of demand are so similar, we combine them into a single measure of total private demand. This is shown below. Real private sector demand growth has been very strong, just below its 40 year peaks set in 1968, 1972, 1978 and 1985.



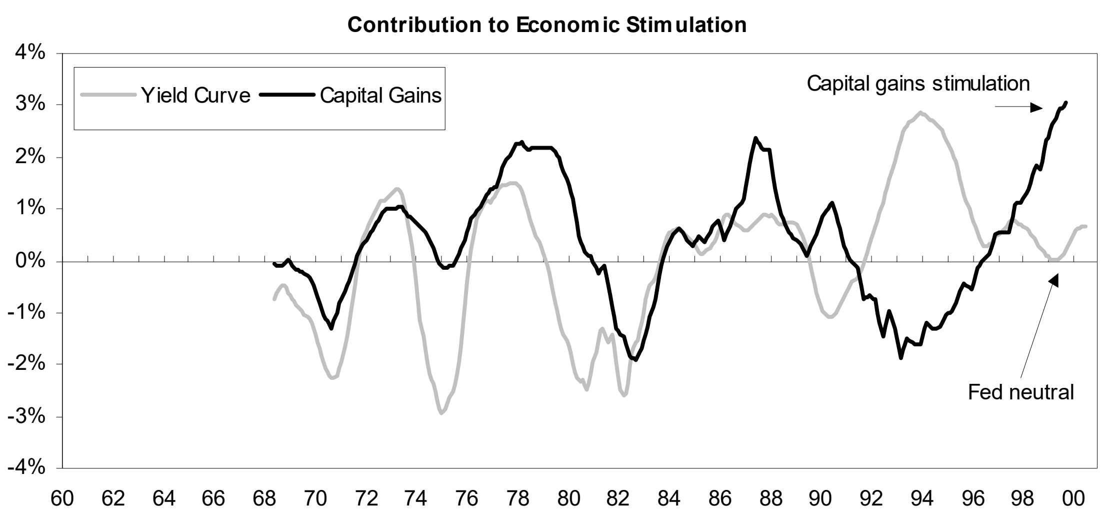
Stimulation of demand:

One of the things that makes this strong demand unique is that it is occurring independent of Fed stimulation. It is as if the economy has achieved a self-perpetuating higher level of output on its own. But when you look a bit further you see that other sources of stimulation have provided the juice the Fed has not. Two of these are capital gains on mutual fund holdings and capital gains on home appreciation. These are important sources of stimulation because they represent two sources of household cash flow that occur in addition to current income. Greenspan has clearly identified these two forces as important drivers of recent strong demand. In his November 2, 1999 testimony to America's Community Bankers he said the Fed economists estimate that 40% of the recent growth in household mortgages outstanding represents the extraction of capital gains from home appreciation.

It is also important to note that while the Fed is not stimulative, it is also not restrictive. The best measure of this is the slope of the yield curve. Because the Fed controls short term interest rates, but not long term interest rates, a steep yield curve indicates a stimulative Fed policy while an inverted yield curve indicates a restrictive Fed policy. The average yield curve, the ratio of short term to long term interest rates, has been 0.85. Currently that ratio is 0.80 and over the past three and five years it has been 0.79. By this measure the Fed has actually been a bit stimulative over the past few years. And this has been sustained while the stimulation from mutual fund capital gains and home capital gains has accelerated. In combination, these three influences are exerting as much stimulation to the U.S. economy as at any time in the past forty years. Furthermore, these measures of stimulation have been highly reliable indicators of the growth in demand. The current strong growth of demand is completely explained by this immense amount of stimulation. The following chart shows private sector demand and the combined stimulation of Fed policy, capital gains distributions from mutual funds and capital gains on home ownership that is extracted by way of mortgage financing.

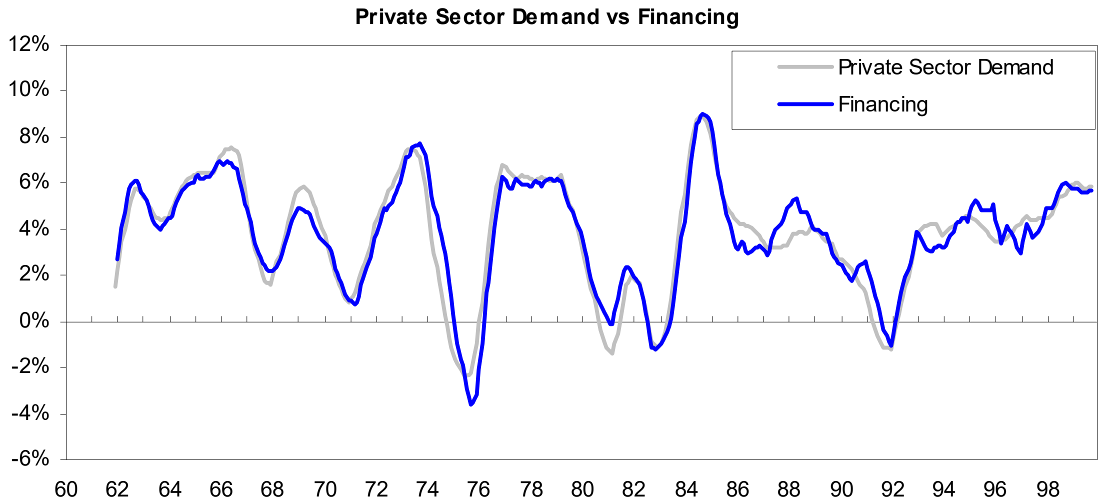


Most of the stimulation is now coming from capital gains. The following chart shows the contribution of the yield curve and the contribution of the combined influence of capital gains on total stimulation. The Fed gave the economy a big push in the early 1990's and then shifted to neutral in the mid-1990's. Since then, capital gains have kicked in and the Fed has allowed the momentum to build.

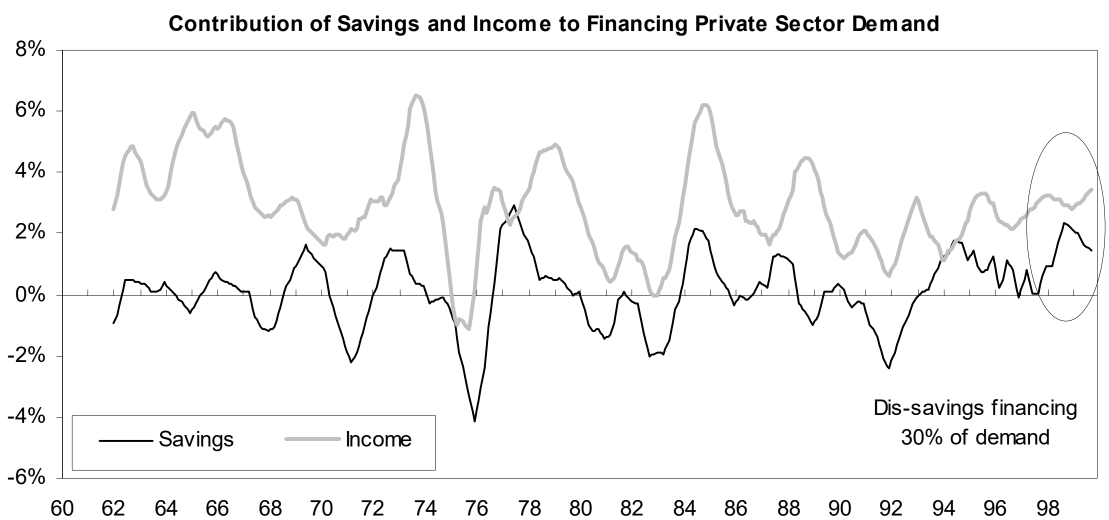


Financing of demand:

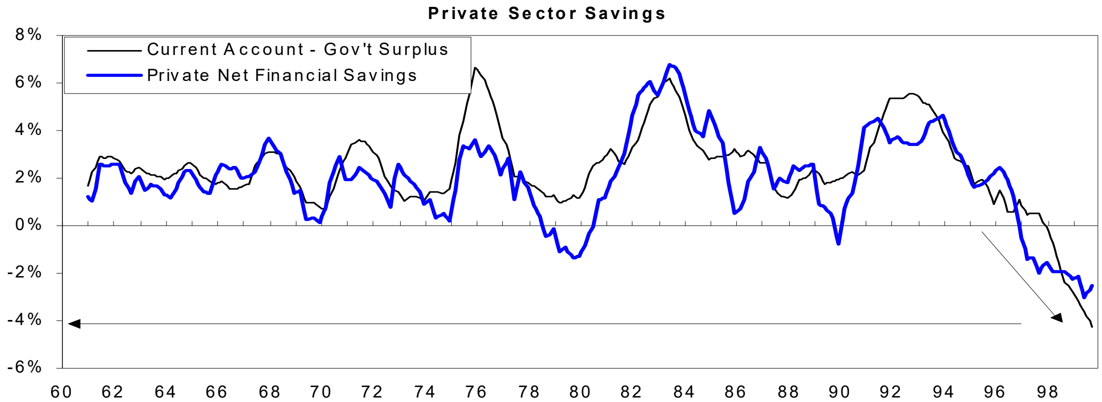
Businesses and individuals are buying a lot. How are they paying for it? They have two primary sources of payment, income and savings. Households generate after-tax personal income. Businesses generate net cash flow. And for both households and business we measure savings by way of their net financial investment according to the Fed's flow of funds statement. This measurement of savings gets around definitional problems because it literally looks at whether households and companies are accumulating financial assets or liquidating financial assets, the bottom line of a cash flow statement. As shown below, income growth plus the change in savings fully accounts for the financing of demand.



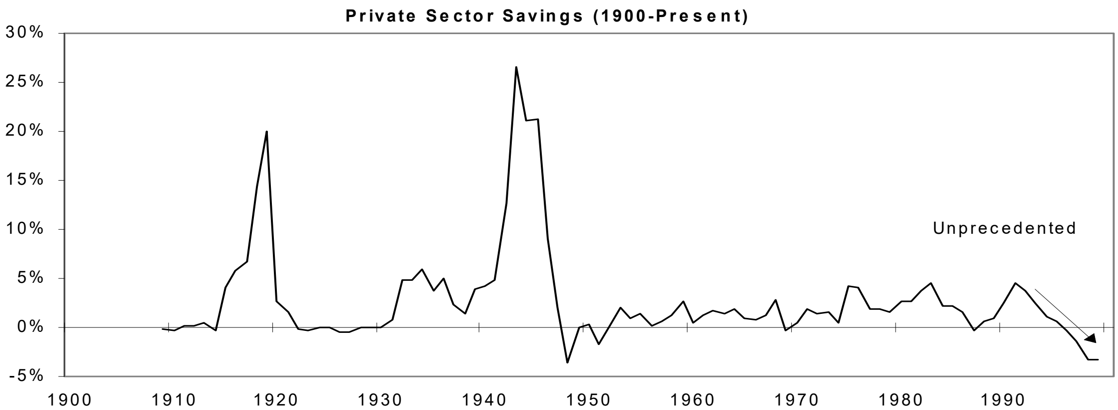
Splitting out these two source we see that private sector income is financing about 70% of demand. The rest, about 30%, has been financed by a reduction in savings. Recent dis-savings has been among the highest of the past 40 years. Connecting this observation with the observations about stimulation we might surmise that households are spending their mutual fund and home capital gains as if they are income. But these transactions represents a consumption of wealth, a spending of assets. Companies in turn are joining in with a reduction in their own savings rates.



We are always a bit suspicious of savings numbers. As a double-check on the flow of funds numbers we created an alternative back-door private sector savings figure. We estimated private savings by the U.S. current account balance minus the government budget balance. We show both measures of savings below as a percent of GDP. As you can see, they confirm one another. The fact that these two measures of savings match one another and that they reconcile with demand, even though we have not sourced them from national account data, implies that they are pretty accurate. Any way you look at it, private sector savings is severely negative. It represents the consumption of expected future income today.



And by using the current account and government budget data we can see that this private sector savings rate is also the lowest of the century. This degree of dis-savings is unprecedented.



So what we have so far is massive stimulation, primarily through capital gains, leading to strong demand which is financed 70% by income and 30% by a contraction in savings. That is enough for now. In a few days we will look at how this demand is being supplied and in turn how those forms of output are affecting inflation.

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