Reflation in Warp Speed

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The policy response to the current crisis is unprecedented in its speed and magnitude. As a result, we have asset reflation in warp speed. In this research, we illustrate how the linkages occurring through this crisis are the same that occurred in past crises of this magnitude (namely, the Global Financial Crisis and the Great Depression) but at a totally different speed. While this may be intuitively obvious, we thought the visuals were still worth sharing, as they bring to life just how vital the policy response is in driving financial and economic outcomes. We will also ruminate a bit on what that might mean going forward.

What took three years and seven months in the Great Depression took one year and six months in 2008, and only one month in the current crisis. In the Great Depression, it took three years and seven months from Black Thursday before President Roosevelt broke the peg to gold, allowing the Fed to print enough to stop the free fall in equities and the economy, and the reflation continued for four more years before the next downturn. In the Global Financial Crisis, the turn came with the start of QE in March 2009—a year and a half after stocks began to fall—and it wasn’t until a pause in QE2 that equities had another sell-off of more than -20%. This time, when the pandemic hit, the stimulus from the Fed and fiscal authorities was so swift and so massive that the equity downmarket lasted only a month, and stocks are now approaching their pre-crisis peaks once again. In other words, time is not the right concept; what is critical for investors to focus on today (as always, but today in particular) is the cause-effect sequence, which is happening so much faster. The biggest cause-effect drivers are the degree and speed of the policy response and its effectiveness.

This warp-speed response in part reflects the warp-speed nature of the crisis, with the economy seizing up overnight as the virus spread. But it also reflects the evolution of the policy makers’ approach. The lesson from the last recovery is that the risk of doing too little is much greater than the risk of doing too much. While it took several months for the Fed to step back in with QE2 and then QE3 a decade ago, today, the Fed is much more inclined to keep pushing on the gas. As we’ve begun to see, policy makers have also become more willing to embrace fiscal stimulus, though given the political nature of fiscal policy and the lack of experience with relying on fiscal support, the reliability of fiscal policy going forward is more murky. All in all, we expect that policy makers will keep pushing to do whatever it takes to achieve their goals, but perhaps with some gyrations (especially in fiscal policy) along the way.

With policy makers driving the car so much faster, are the risks of a crash higher? We think it’s more that the nature of the risks has changed with the shift in policy maker approach: we’re less concerned that policy makers won’t do enough and more concerned about how much room there is to keep stimulating before running into limits—in the form of inflation or a loss of faith in the currency. Our guess is that over time, extreme fiscal and monetary coordination will bring markets and economies together: the nominal returns in the economy will rise as inflation is pushed higher and as asset returns are diminished in real terms, but probably positive in nominal terms.
In the timeline below, we look at just how this movie has played out so far compared to past reflations.

**Time from Crash to Money Printing**

**Great Depression**
- Stocks Crash
- QE / Debt Monetization
- Stocks Approach New Peak
- 46 months
- 43 months
- 18 months
- 13 months
- 1 mo.
- 2.5 mos.

**Global Financial Crisis**
- Stocks Crash
- QE / Debt Monetization
- Stocks Approach New Peak

**COVID-19 Pandemic**
- Stocks Crash
- QE / Debt Monetization
- Stocks Approach New Peak

In the chart below, we collapse the different time scales to show the sequence of events across the cases.

**Warping Time: Lining Up Equity Returns across the Typical Sequence**

(Cumulative Excess Equity Returns)

- Stocks Crash
- Rates Hit Zero
- QE / Debt Monetization; Stocks Rally
- Peak QE
- Stocks Approach New Peak

Great Depression:
- Oct 1929
- Dec 1929
- Jan 1933
- FDR breaks gold peg
- Mar 1933
- Feb 1935
- Mar 1936
- Dec 1936

Global Financial Crisis:
- Oct 2007
- Dec 2007
- Mar 2009
- Jun 2009
- Unemployment peaks at 10%
- Dec 2009
- Jul 2011

COVID-19 Pandemic:
- Feb 19
- Mar 18
- CARES Act introduced
- Mar 19
- Mar 23
- May 22
- When will we see the next peak?
Next, we take a closer look at the drivers of reflation—monetary and fiscal stimulation—and then follow that through to the markets.

The Warp-Speed Policy Response to the Crisis

In the following charts, time is warped to align the period between pre-crash stock highs and the date on which QE begins, which tends to also be the date on which stocks bottom. We maintain this same time-warp through the reflation. You can see that the support policy makers delivered, this time in a matter of weeks, is equivalent to what they doled out over the course of years in the past. This support helps fuel a reflation in asset prices as long as it’s sustained; below, we indicate the new high-water mark in equities on the charts to highlight the relationship.

In each case, first the Fed eases by making short-term liquidity more available and lowering short rates, up until they hit the zero bound. (In the Great Depression, the Fed’s ability to ease was inhibited by the need to defend the gold standard. It took years of intense economic pain and difficult reckoning before FDR broke the peg.)
Then, they move to longer duration asset purchases. In the past few months, the Fed has printed about as much as it did in all of 2008 and 2009.

**Monetary Stimulus (Cumulative M0 Printing, % GDP)**

- Great Depression
- Global Financial Crisis
- COVID-19 Pandemic
- Stocks Approach New Peak

Start of money printing

Note: Indexed to start from 0

Marking next equity peaks across charts

On the fiscal side, deficit spending ramps up, backstopped by the Fed's purchases.

**Fiscal Stimulus (Cumulative Deficit Spending, %GDP)**

- Great Depression
- Global Financial Crisis
- COVID-19 Pandemic
- Stocks Approach New Peak

Start of money printing

$2 tln fiscal stimulus announced May 2020

Note: Fiscal deficit is shown as % GDP (fiscal balance inverted); indexed to start from 0
The Flow-Through of Stimulus to Asset Markets

As soon as policy makers step in to print and spend, there is an immediate reflation across asset markets. The stimulus puts a floor on equity declines, kicking off a new rally.

Credit spreads begin to compress from elevated levels.

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Long rates drift down as the Fed eases more than was priced in. In this crisis, rates were starting from particularly low levels and are now at historic lows.

The effect on commodities tends to be more gradual. Compared to longer duration financial assets shown above, commodity prices are more reflective of real economic activity and investment, and as such the support from stimulus takes longer to flow through.
In currency markets, the initial easing and liquidity production tends to be dollar bearish. Over time there is less of a clear pattern, as currencies reflect relative differences across countries.

The speed of this cycle is a bit disorienting, and the divergence of the markets from the real economy as a result will be an important thing to monitor. The recovery in markets and the liquidity sloshing around everywhere will help pull the economy up once the virus recedes, but the hole in the economy will require capital that will pull the markets down. In the end, they will reconcile, but the nature of that reconciliation will depend on how policy makers pull their levers. Our guess is that over time, extreme fiscal and monetary coordination will bring markets and economies together: the nominal returns in the economy will rise as inflation is pushed higher and as asset returns are diminished in real terms, but probably positive in nominal terms.
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