The Grind Ahead

Growth in the US has been resilient and markets are pricing that to continue. We disagree. As past supports fade and rates stay high, we expect balance sheets to deteriorate and growth to gradually grind down.

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The US economy has proved remarkably resilient to the biggest tightening in over 40 years. Markets are now extrapolating this strength—in effect, believing that with the economy having held up so far and the Fed unlikely to tighten much more, we are largely out the woods. We disagree. Alpha is always hard, and we approach the current pricing with humility in part because we underestimated the resilience of the economy so far. One of the benefits of the systematic process that we use at Bridgewater is that we can precisely diagnose what we got wrong down to the individual cause/effect relationships at play. For us, in terms of growth, we appropriately measured that private sector credit would decline significantly due to the rise in interest rates, but we missed some major offsets to growth that allowed aggregate spending to stay strong despite the collapse in credit. This breakdown of the normal relationship between credit growth and demand, while rare, is understandable.

When we dissect the reasons that growth remained strong despite the tightening and decline in credit creation, they look to be fading (we describe these in detail below). At the same time, higher short and now long rates continue to flow through to credit and interest costs. This is setting up a dynamic that we are calling **"the grind"—a gradual decline in growth and in the health of corporate and household balance sheets**—that we expect to be a dominant driver of economies and markets over the next 12–18 months.

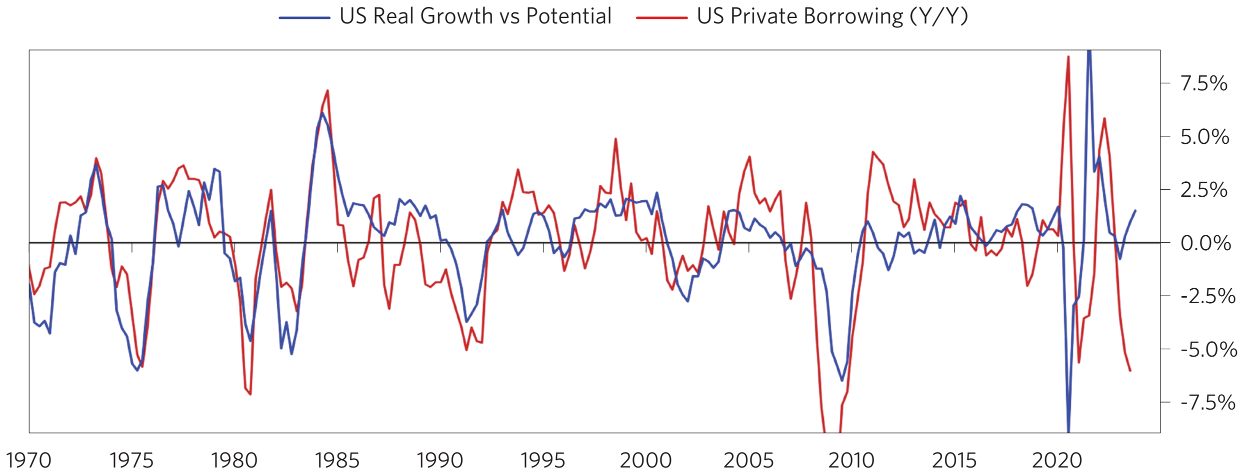
The discounting and likelihood of higher-for-longer interest rates mean that debt service costs for households and corporates, which so far haven't risen nearly as much as the rise in interest rates, will gradually creep higher as the new rate structure flows through to new and outstanding borrowing. We are already seeing some signs of stress and defaults in the most marginal corporate borrowers. **The longer rates stay high, the more the pain will accumulate and spread, such that time itself is now a headwind.** Though there's always an error band around any of our estimates, with the tightening that has occurred so far and the path of rates that is now priced in, we expect US growth to decline to zero or negative in the next year or so. This scenario and the associated hit to corporate margins don't look priced into US equities, which are pricing in modest growth and are offering little risk premium over cash or bonds to compensate for the range of likely outcomes.

We expand on these thoughts below.

The Forces That Have Cushioned the Impact of the Tightening So Far Are Unsustainable

The past two years have seen the largest monetary tightening since the Volcker era, as measured by the speed and the degree of rate hikes and quantitative tightening. But while the normal economic linkage of monetary tightening causing a collapse in private sector credit growth did play out, economic growth has held up in a way that is atypical.

The Tightening Has Hit Credit Hard but the Economy Has Remained Resilient

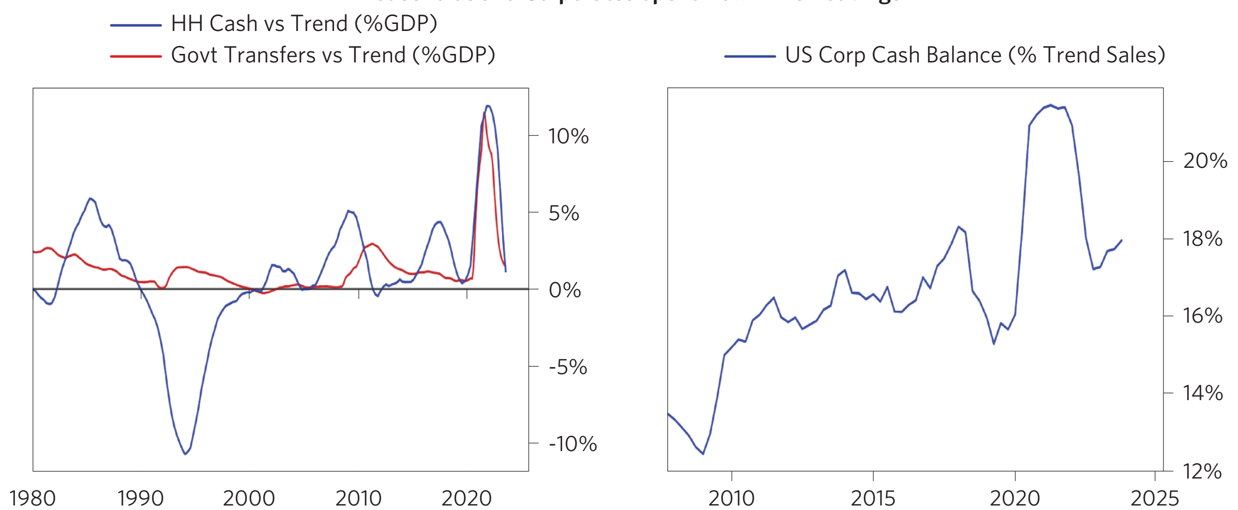


When we dig into what allowed for recent economic strength despite the massive tightening, we see three main factors, all of which look unsustainable:

1. Households and corporates were able to spend down their excess savings.
2. Nominal demand was so far above supply that real economic activity was still catching up.
3. There was a reprieve in the “liquidity hole” as a surging budget deficit was funded without bond issuance, delaying what would otherwise have been a drag on assets and spending.

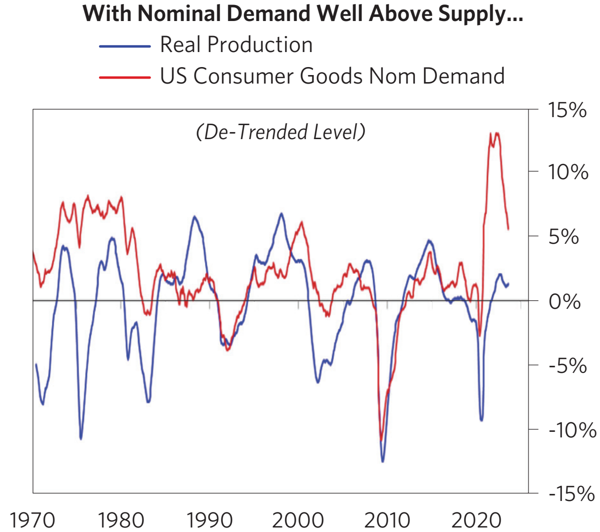
Taking these forces in turn, despite the decline in credit, which usually would have created a significant contraction, we actually saw a rapid spending down of cash on balance sheets. Households received a one-off, massive government transfer during COVID, and they spent it down, allowing them to spend well in excess of income. Corporates also saw a massive pop in their cash balances during the COVID stimulus, and even when profits started to decline a bit last year, they didn't cut back on spending. Instead, they spent down their cash buffers to finance capex, resulting in a pop in corporate profits. These dynamics are inherently unsustainable and, as cash balances have reverted to more normal levels, they are unlikely to continue supporting growth.

Households and Corporates Spent Down Their Savings

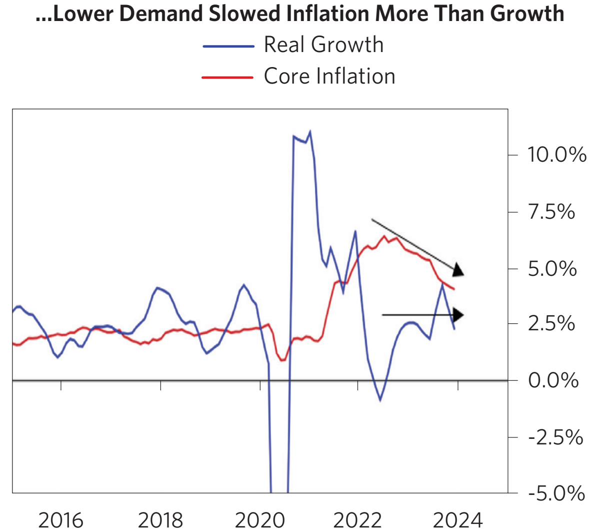


Another major support was the gap between supply and demand that opened up as economies reopened post-COVID. The MP3-fueled surge in incomes resulted in a corresponding surge in nominal demand once that income could be spent in the real economy. This pulled up real growth, but supply couldn't keep up with demand, resulting in the high inflation we've had. The tightening has started to slow nominal demand, but growth hasn't dropped nearly as much, in part because it's still catching up to demand. The result is that slowing demand has flowed through mostly to lower inflation, as opposed to lower growth. That can't go on forever, and as demand continues to fall and inflation approaches a stickier level, we expect real growth to decline as well.

With Nominal Demand Well Above Supply...

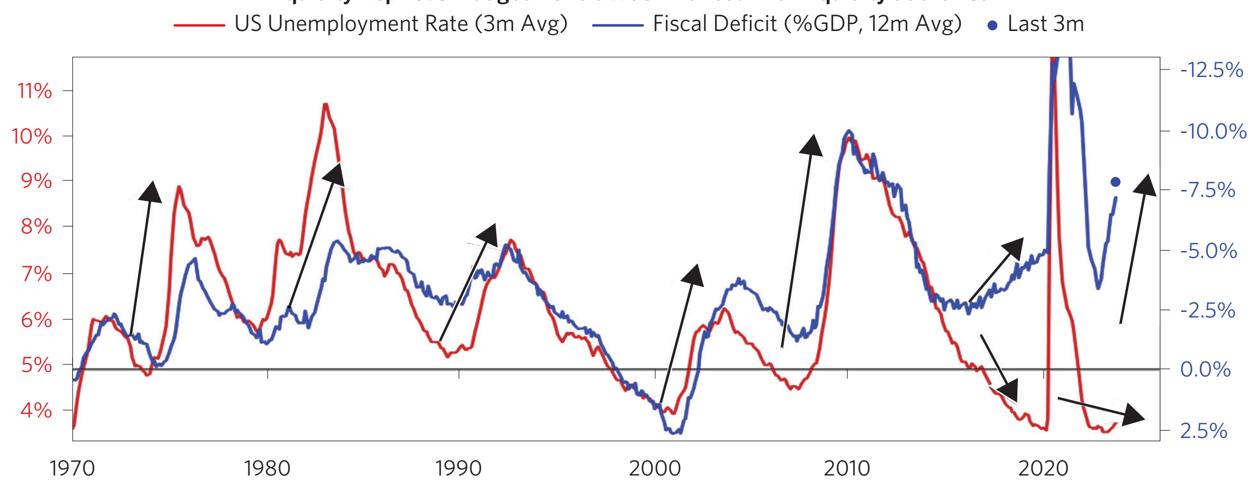


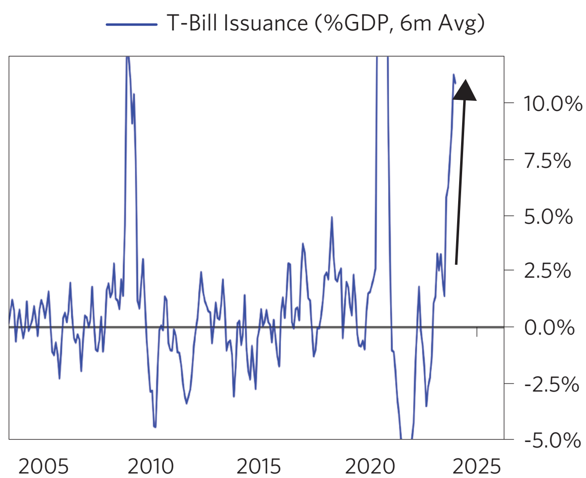
...Lower Demand Slowed Inflation More Than Growth

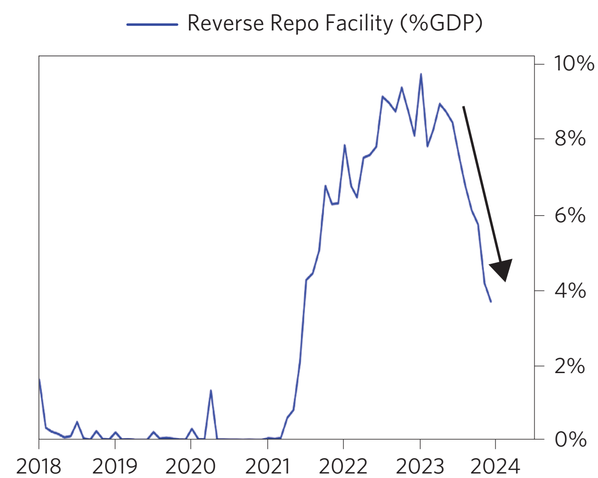


Finally, the drag on assets and spending that we expected to play out this year but that has only recently started to be felt is the "liquidity hole." As the Fed continues its quantitative tightening and the government continues to run large deficits (despite record low unemployment), we expected a gap to open up in the bond market that would suck money in from other assets. Until the last several months, though, that largely didn't play out, and a significant factor was that the Treasury made the rather unusual choice of funding the deficit almost entirely by issuing T-bills versus longer-duration bonds. The money to purchase the T-bills that were used to fund the deficit largely came from inert cash that had been parked at the Fed's reverse repo facility, allowing the deficit to be funded without absorbing capital that was in productive use. The result was a greater amount of money available to purchase risky assets and finance spending than there would have been otherwise. The government doesn't want the whole bond market to be T-bills, and over time the Treasury's normal debt management practices will result in rising bond issuance to finance the deficit, though at a modestly slower pace than previously expected in light of last week's announcement.

Liquidity Reprieve: Budget Deficit Was Financed with Liquidity at the Fed

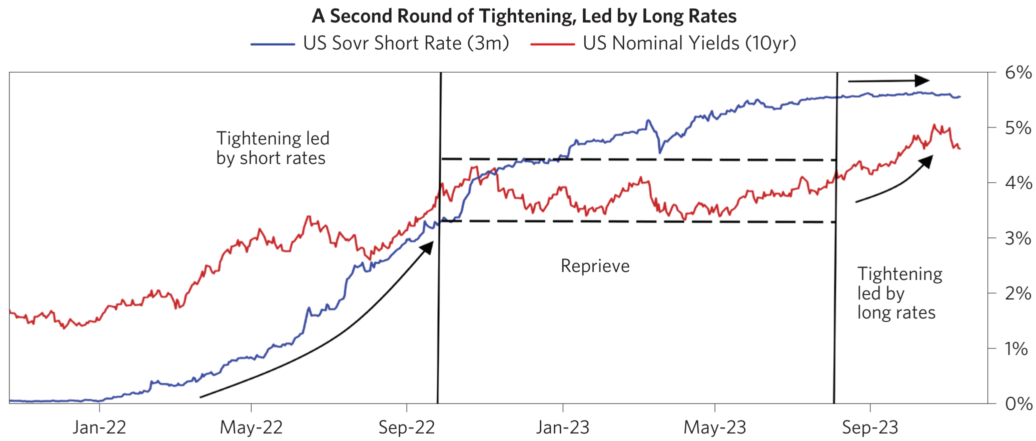






We Are Entering the Second Stage of Tightening

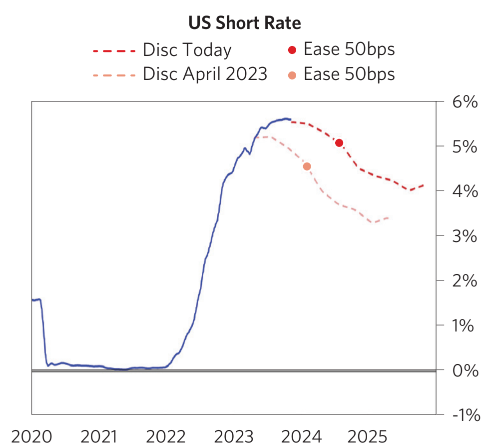
The fading of the forces that have insulated the economy from the impact of the tightening so far together with the impact of the recent surge in long rates is setting up a second wave of the tightening. Earlier in the tightening cycle, short-term interest rates rose and dragged long-term interest rates higher. Then, beginning in October 2022 and lasting almost a year, there was a reprieve. Hikes in short-term interest rates continued, but bond yields traded sideways, reflecting market expectations for future easing combined with the Treasury circumventing the pressure on long rates by issuing T-bills. In recent months both conditions have shifted, initiating the next stage of the tightening cycle, led by long rates.

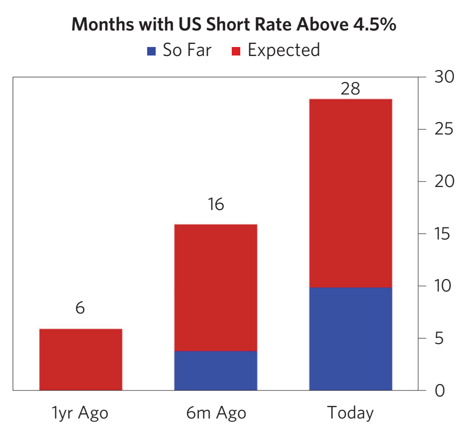


With Rates Already High and Likely to Stay There, Time Is Now a Headwind

When short rates were lower and significant easing was still priced in, it was easy to think that higher short rates would cause some pain for entities with shorter-term or floating debt, but that the pain would be transitory. With short rates priced as they are now, this is no longer the case. In addition, entities more sensitive to longer-term rates (e.g., corporates with longer-term debt) feel the impact of rising rates with a lag. It takes time for their debt to mature and to be reset at new long-term rates. With long rates now high and priced to stay that way, debt service will gradually grow over time as this plays out.

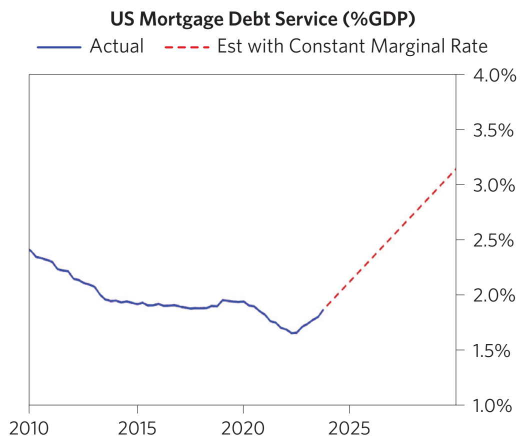
The recent shifts in market pricing for short rates illustrate the challenge ahead. At the beginning of the year, US short rates were priced to decline to 3% fairly quickly. This implied 16 months of short rates above 4.5% (up from just 6 a year ago). Today, markets are still pricing in a bit of a decline, but down to only 4.25% in 2025, implying 28 months of rates above 4.5%.

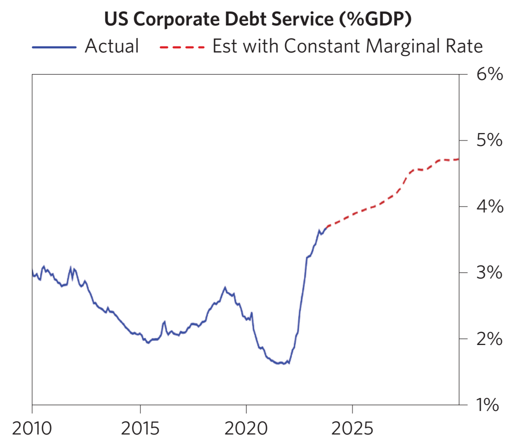




High Rates Will Be a Steady Drag on Household and Corporate Cash Flows

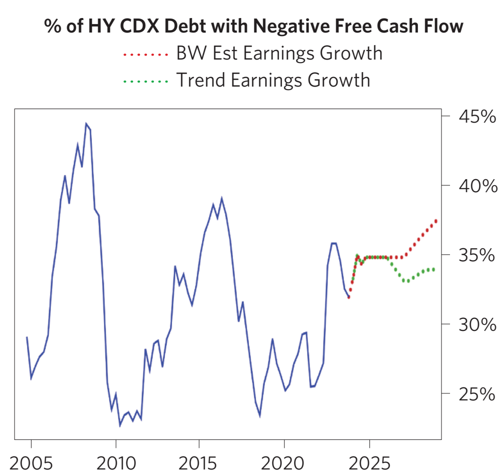
The effect of higher-for-longer rates on debt service will be a gradual but growing drag. The chart below on the left shows the impact of high rates on household mortgage debt service. Mortgage rates have skyrocketed, but, so far, the impact of higher rates has been small, as households haven't been moving. As higher rates persist, we expect a steady rise in mortgage debt service as a percent of GDP. Similarly, corporate debt rates have surged, but the impact on margins has been muted because corporates did such a good job of lengthening their duration, with only about 45% of corporate debt short-term now. But as higher rates persist and debt has to be rolled over, debt service will begin to rise materially.

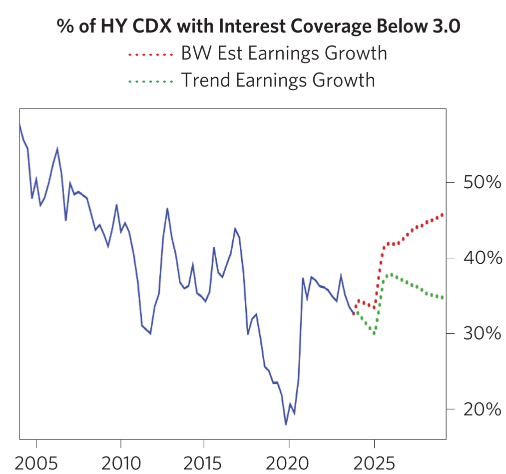




A Tail of Vulnerable Companies Will Be the First Impacted

In addition to the aggregate grind we expect on corporates, there is a tail of weaker companies that could see their financial situation deteriorate more rapidly. For example, in the high-yield debt sector, even without a recession and with moderate growth in earnings, we see companies representing an additional 5% of high-yield debt going from positive to negative free cash flow just from the effect of higher interest rates. The strain of unprofitability would be compounded by an inability to access capital markets; those marginal companies are at risk of breaching an interest coverage ratio of 3.0, below which lenders become hesitant to extend credit. These pressures are exacerbated by the characteristics of the companies facing near-term maturities (and thus needing imminent refinancing). These companies are more likely to be in the consumer cyclicals sector (and thereby more sensitive to slowing spending and growth) and are more likely to have lower-rated debt. We already see some of these dynamics playing out in the leveraged loan market, where durations are shorter, and, despite resilient growth to date and the loans' relative seniority in the debt stack, defaults have been ticking up.

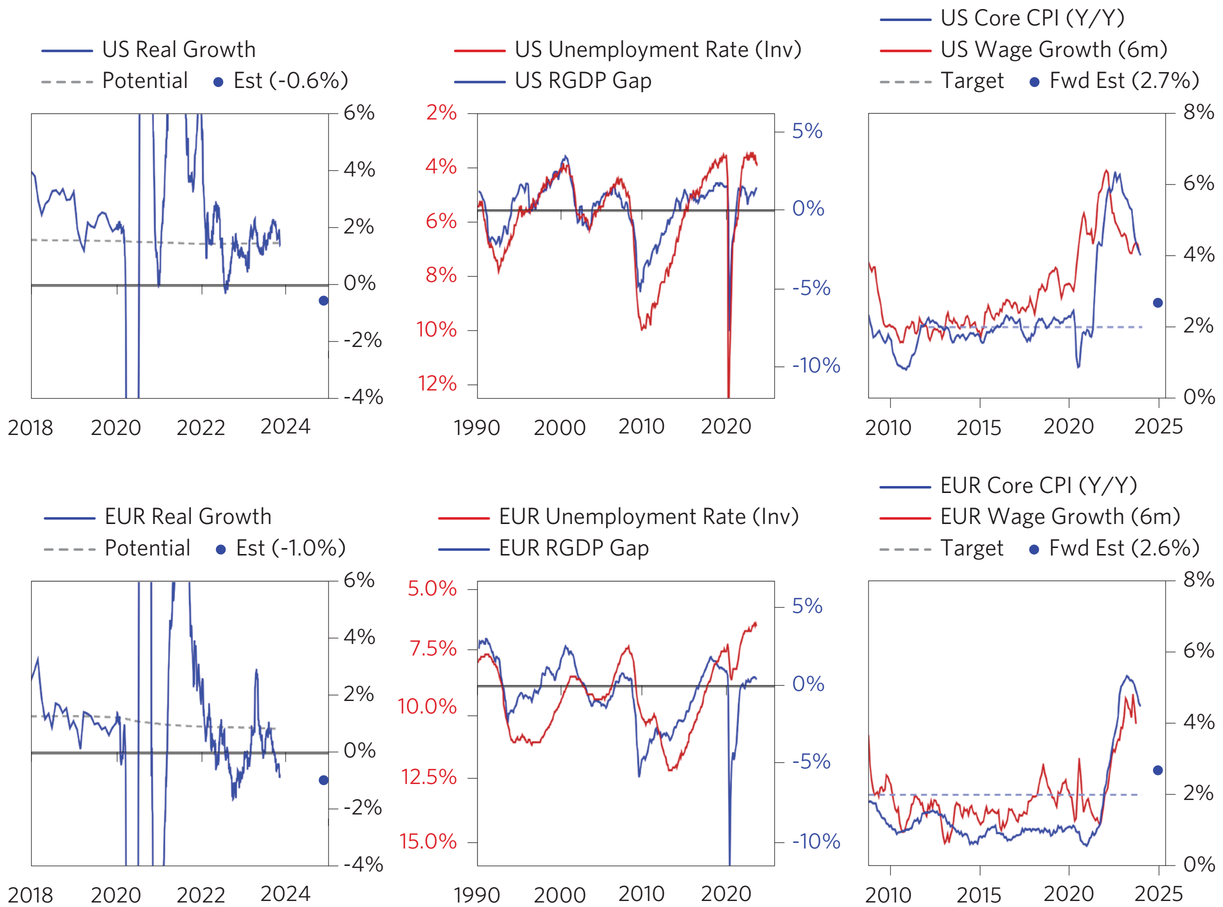




A Grind Down in Growth as the Labor Market Remains Tight and Inflation Lingers

Given the dynamics we have been describing, we expect growth to grind gradually down over the next 12–18 months. The left column of charts below shows coincident growth in the US and Europe, along with our forward estimates. As shown, our base case is that growth declines to slightly negative in the US and more deeply negative in Europe. At the same time, labor markets are historically tight. This is likely due to secular factors like shifting demographics, limited immigration, and the decoupling from China. As such, we expect labor market tightness to persist even as cyclical conditions decline. Overall, we expect inflation to continue to fall as cyclical conditions weaken, but to remain above target due in part to the likely continued strength of the labor market. The right column below shows core CPI and wage growth, along with our forward inflation estimates. It's important to note that these inflation estimates bake in that we get the decline in growth shown in the leftmost charts—if we get less economic weakness, we're likely to have problematic inflation for longer.

A Grind Down in Growth with Labor Remaining Tight and Inflation Remaining High

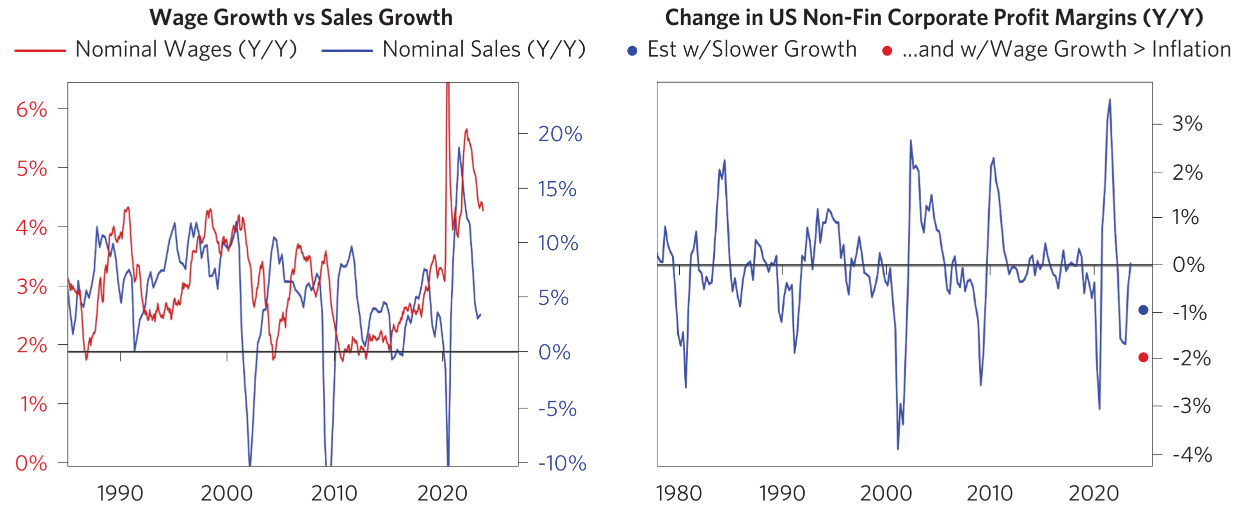


With a grind down but no outright collapse in growth and with inflationary pressures lingering, we would be wary of relying on the same central bank reaction function of easing into every downturn that we have become used to over recent decades.

The Grind Is Not Fully Reflected in Market Pricing

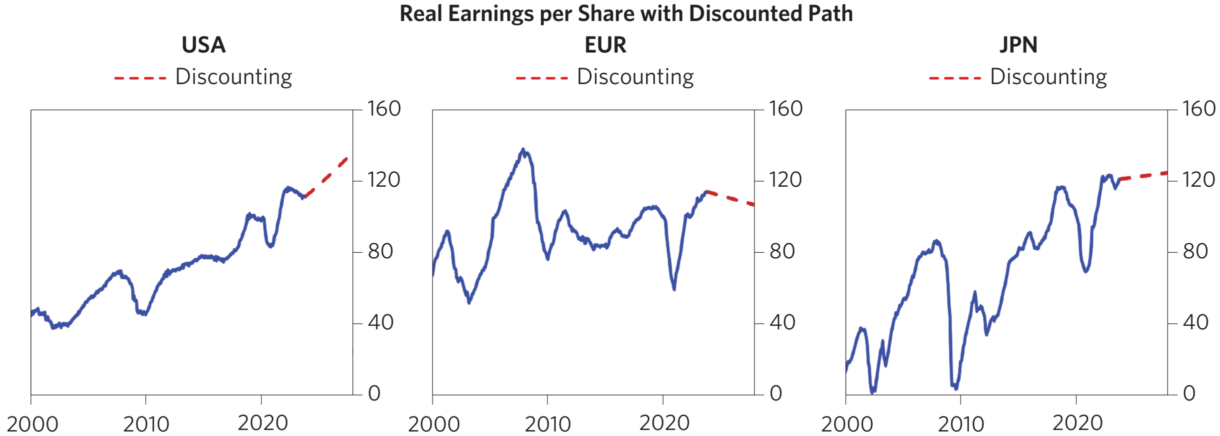
The intersection of the growth grind and lagging strength in labor markets is particularly problematic for equities. As growth grinds down and slowing spending flows through to corporate revenues, margins are poised to contract, with additional downside if wage growth outpaces inflation.

US Corporate Profits Face a Challenging Road Ahead



Current discounting does not reflect the risks facing US equity earnings and margins. The charts below show actual real earnings along with our rough estimate of what is discounted going forward. These estimates are imprecise and reflect the long-term earnings growth needed for an equity investor to earn a normal risk premium over bonds. As you can see, markets are discounting continued robust US earnings growth, not a grind down. The pricing in Europe is quite different: European equities are discounting a significant decline in real earnings growth. Japan's pricing is in between.

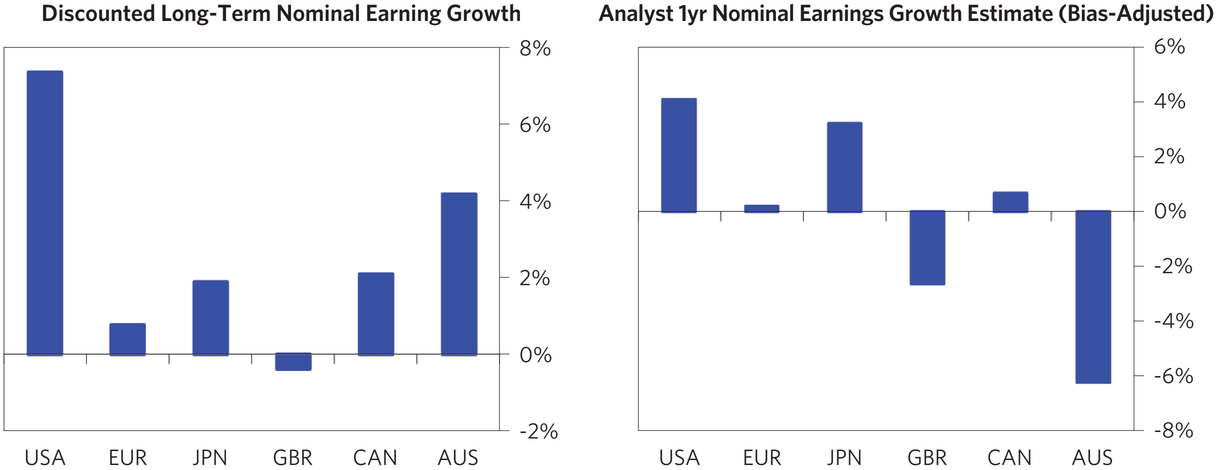
Real Earnings per Share with Discounted Path



Note: 100=level at the start of 2020

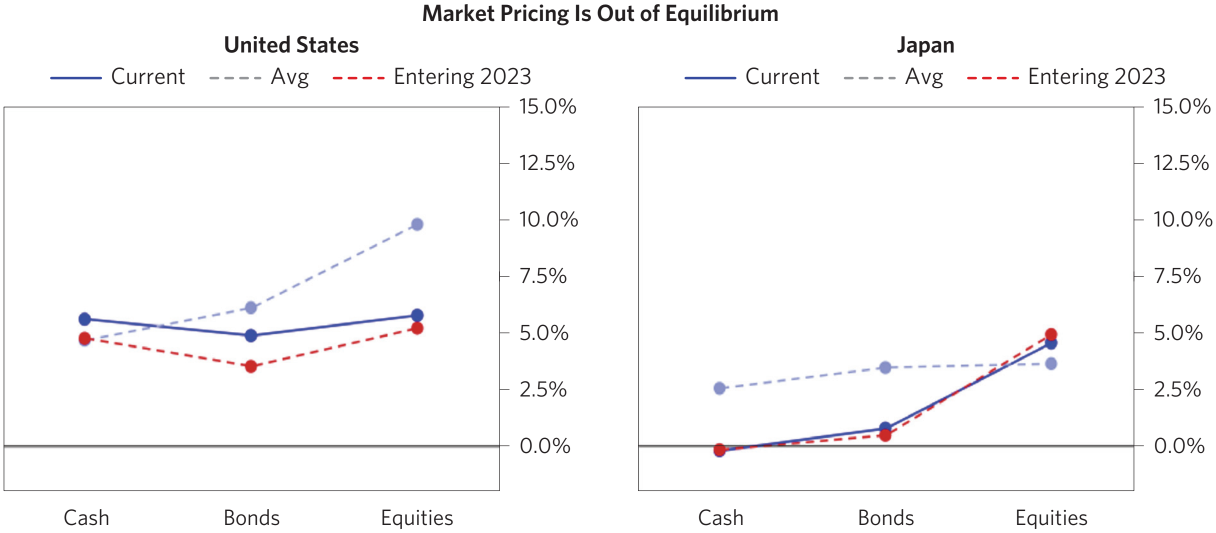
This picture of strength in the US and weakness in Europe being extrapolated into the future is consistent with analyst expectations for the next year. Below on the left left, we show what the estimates in the charts above imply for nominal (as opposed to real) earnings growth, and below on the right, we show analyst expectations for earnings growth over the next year, adjusting for their typical bias.

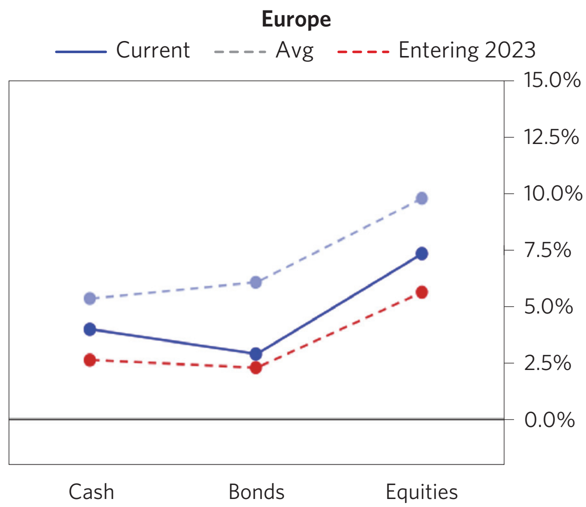
Discounted Long-Term EPS Growth vs 2024 Analyst Estimates



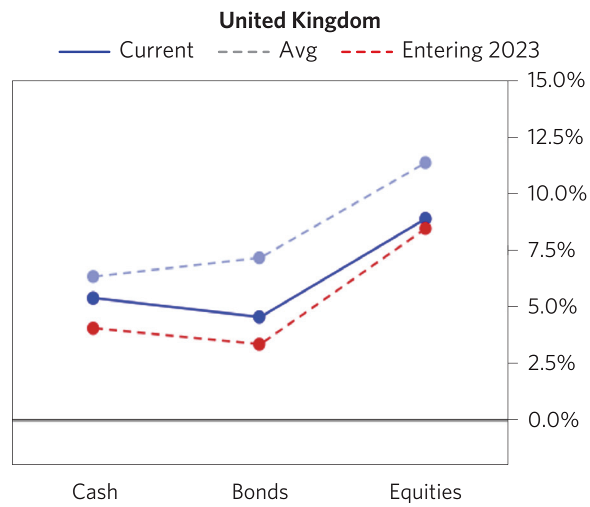
In addition to the risks from pressured margins, equities—along with other assets—face the risk of a reversion of squeezed risk premiums to normal levels. Below, we show the "risk curve" across countries—the yields of cash, bonds, and equities—which in equilibrium would fall roughly on a line sloping up to the right. As shown, markets were far from equilibrium pricing entering the year (the red lines), and, in some cases, were pushed further out of equilibrium over the course of the year. The risk curve in the US is now essentially flat, with bonds offering no premium over cash and equities offering very little premium over bonds. In Europe, Japan, and the UK, bonds look unattractive relative to cash and don't appear to offer a premium for the risk of higher-for-longer rates.

Market Pricing Is Out of Equilibrium





Europe
Current
Avg
Entering 2023
15.0%
12.5%
10.0%
7.5%
5.0%
2.5%
0.0%
Cash
Bonds
Equities



United Kingdom
Current
Avg
Entering 2023
15.0%
12.5%
10.0%
7.5%
5.0%
2.5%
0.0%
Cash
Bonds
Equities

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