

Bridgewater®

Daily Observations

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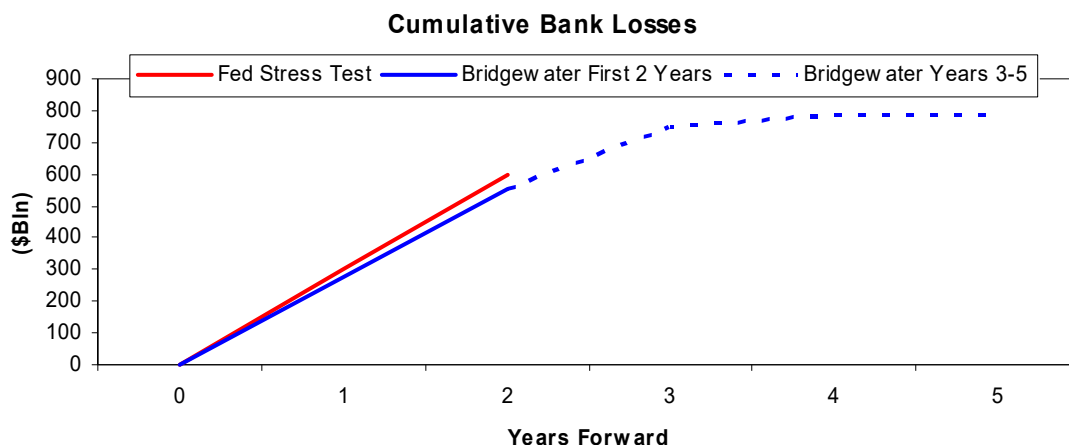
We Agree!

The Stress Test numbers and ours are nearly the same!!! The regulators did an excellent job of explaining exactly what they did for this stress test, and showing the numbers that produced the results. They did virtually exactly what we did since we started putting out our loss estimates nearly two years ago, and their numbers are essentially the same as ours. The differences between our numbers and theirs are more a matter of terminology than of substance. For example, the biggest difference between their estimates and ours is due to the number of years they and we are counting – i.e., their loss estimate is for the losses that will occur over the next two years and ours is for the total amount of losses that will be taken on these assets over the lives of these assets. As there will be losses in years 3, 4, etc., in addition to those in the first two years, naturally the total losses (i.e., ours) will be greater than the losses incurred over the next two years (i.e., theirs). We won't conjecture why they did it that way, though we do know from our projections that the maximum capital needs (i.e., when earnings fall short relative to losses) is probably at the end of two years. Anyway, that accounts for most of the difference in our total loss estimates, and in addition we may also have a slightly worse economic scenario than they do. Once these adjustments are made, we see essentially the same picture.

The table and chart shown below convey the reconciliation.

Two Year Loss Estimate and Capital Needs (\$Bln)		
	<u>Fed Stress Test</u>	<u>Bridgewater Estimates</u>
<i>Losses Over Next Two Years</i>	-600	-552
<i>Gross Capital Raises Needed</i>	-185	-177
<i>Plus Adj. for Asset Sales and Conversions</i>	110	110
<i>Net Capital Needs</i>	-75	-67
<i>% of Banks Needing Capital</i>	47%	68%

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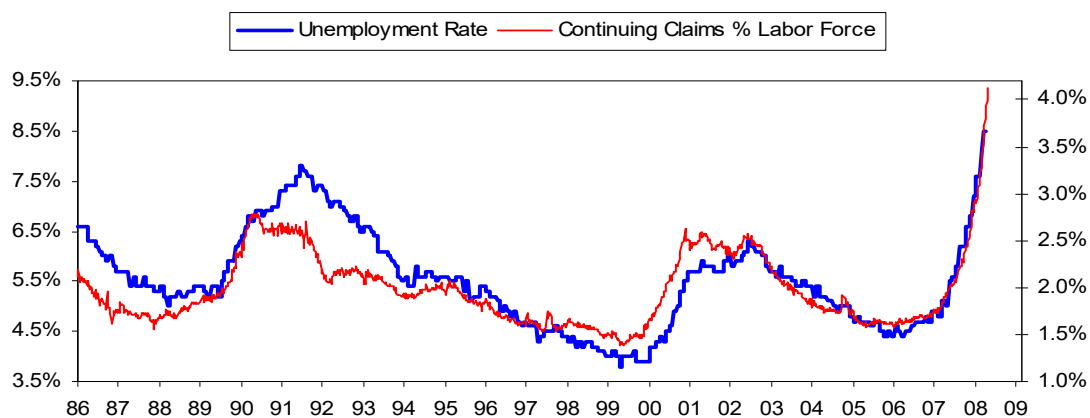
What a relief!!!! For the first time in the last two years we are confident that the regulators really do understand the scale of the banking problem! Our only concern now re the banks (and it's not a big one) is that they will focus too much on the amounts of capital the banks will have to raise (\$75B in common stock) to meet the regulators' requirement rather than look at the amount they have to raise to support lending in the amounts that the economy needs to be healthy. Banks were over-leveraged before, and they held many more assets off their balance sheets than they will in the future, and the non-banking sector's contribution to credit creation was in the past less than it will be in the future. So they will need more capital now to produce a given level of credit than they did in the past. What is needed is to work backwards from the total amount of credit that needs to be provided economy-wide, to the share that will come from banks, to their capital ratios to the amount of capital they need to raise. The capital requirements for this are a lot more than the minimum they will need to raise to avoid being controlled by the government.

Downward Pressure on Labor Markets Remains

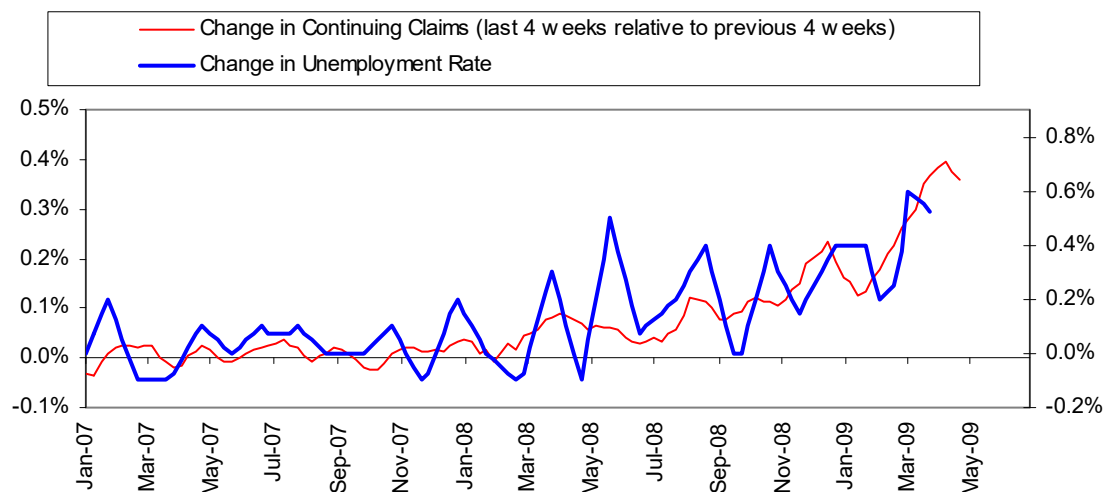
While there are some tentative signs of employment conditions deteriorating a bit less quickly, labor markets are still one of the major drags on spending. Even taking into account some minor improvement, employment still is likely contracting at a 5% annual pace. Perhaps the turn in employment will come as demand measures stabilize, but the self-reinforcing relationship in the other direction remains significant.

Also as we look at the corporate picture, the pressure to cut costs remains intense. The first quarter saw the greatest quarterly contraction in employment in almost thirty years, and the cut backs in capital expenditures were actually the largest in over fifty years. But revenues fell even faster, so labor costs as a share of revenues rose, and the drop in cash flow for non-financial corporates was extremely steep. In other words, while better demand numbers as a result of short-term stimulation is good, and squinting at the labor numbers may indicate some improvement, there is good reason to expect a more prolonged contraction in employment. This in turn will continue to feed back to spending.

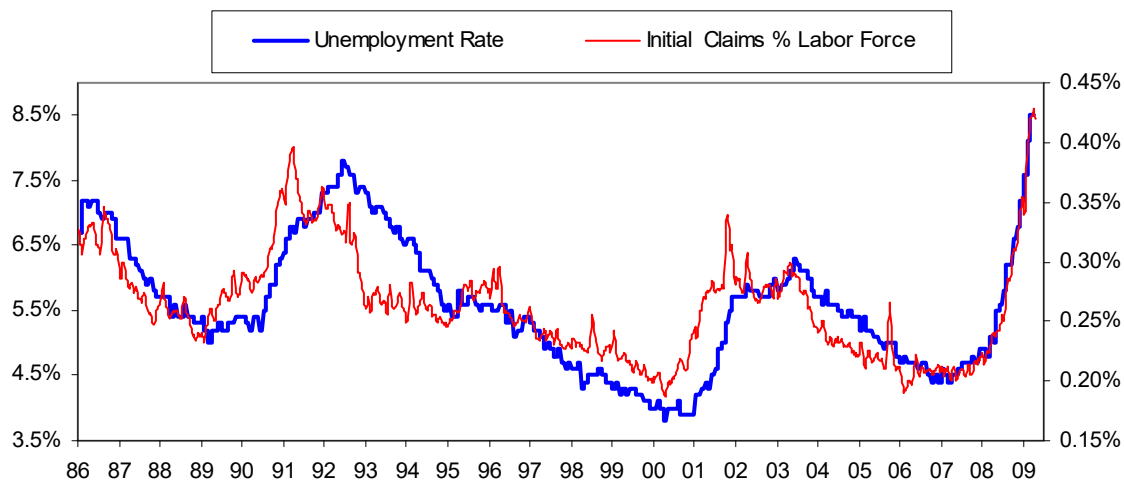
The first chart below shows continuing claims as a share of the labor force against the unemployment rate. These are conceptually similar, and continuing claims has typically led unemployment. Continuing claims rose modestly in the last week, but over the course of April it has risen faster than earlier in the year.



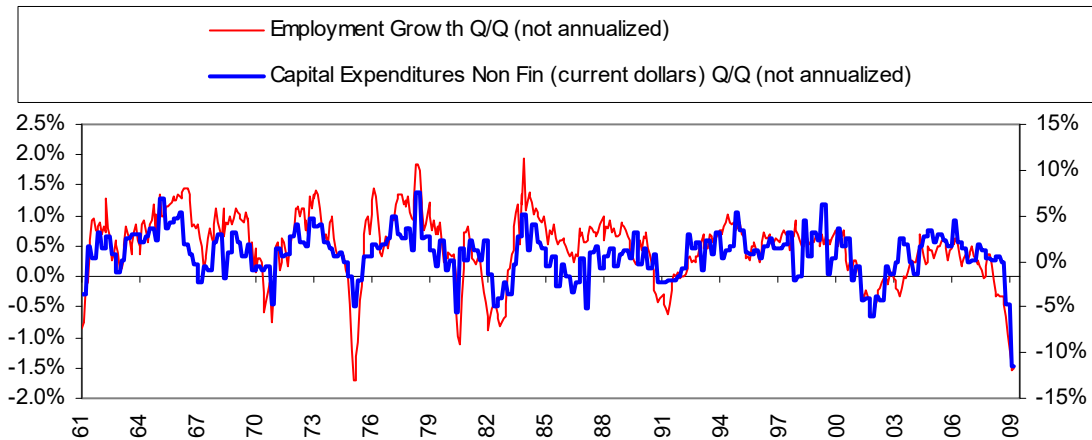
Below we zoom in on changes in continuing claims against changes in the unemployment rate. Companies are not hiring and are still firing at a fast pace (even if that pace has peaked), so the unemployment rate should still be rising quickly.



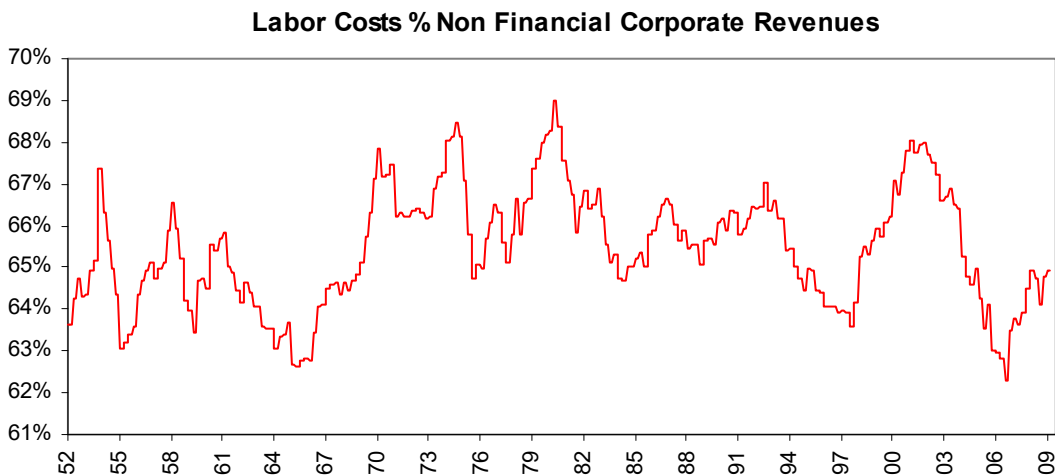
Initial claims have improved a bit more, and had its best reading since late January this week. Initial claims captures firings (it is more of a change in unemployment rate rather than a level), and leads both unemployment and continuing claims as companies stop firing before there is a significant pick up in hiring. The drop in initial claims takes some squinting to see, however, and the current pace of firings remains very high.



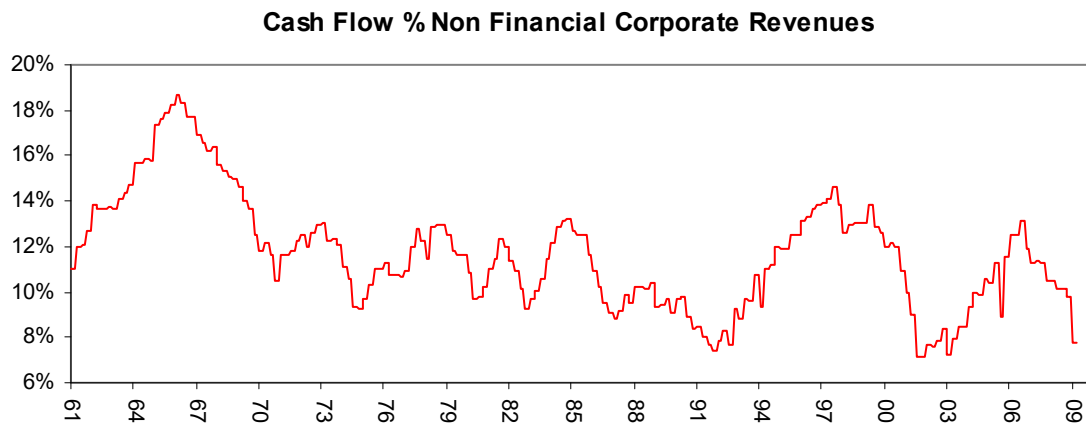
Aside from squinting at the actual short-term employment measures, as we look at the situation of non-financial corporates there is good reason not to expect that a stabilization in employment is imminent. The recent pace of cutting back on labor and fixed investment costs has been very rapid. But it still has not caught up with the deterioration in revenues. Even if demand is contracting less quickly now, companies still have catching up to do. The next chart shows changes in employment and capital expenditures (in current dollars). The pace of change in the first quarter was historically bad.



But despite aggressive cuts, the share of labor costs as a share of revenues actually rose in the first quarter, as revenues fell faster. The next two charts include estimates for the first quarter government numbers, but should be close to the mark (we know a lot of the pieces already; a lot of companies have reported first quarter numbers, etc.).



Cash flow levels also fell very rapidly and are at low levels.



There is obviously wide variation by industry in the numbers shown above, with companies more reliant on sale of capital equipment for example significantly more squeezed for cash flow. Also companies with high levels of debt and debt rollovers are more pressured to cut costs. The aggregate does not look good and at the extreme there are a lot of companies that need to continue to cut expenses fast. Even if aggregate demand stabilizes somewhat, companies are still in the process of adjusting to a lower level of sales. Labor markets will remain a major drag on growth for some time.

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