# BIWEEKLY OBSERVATIONS ON ASSET ALLOCATION . . . . . . . . .
# DECEMBER 13th, 1986

## WHY THE ECONOMY IS UNRESPONSIVE TO STIMULATION

or

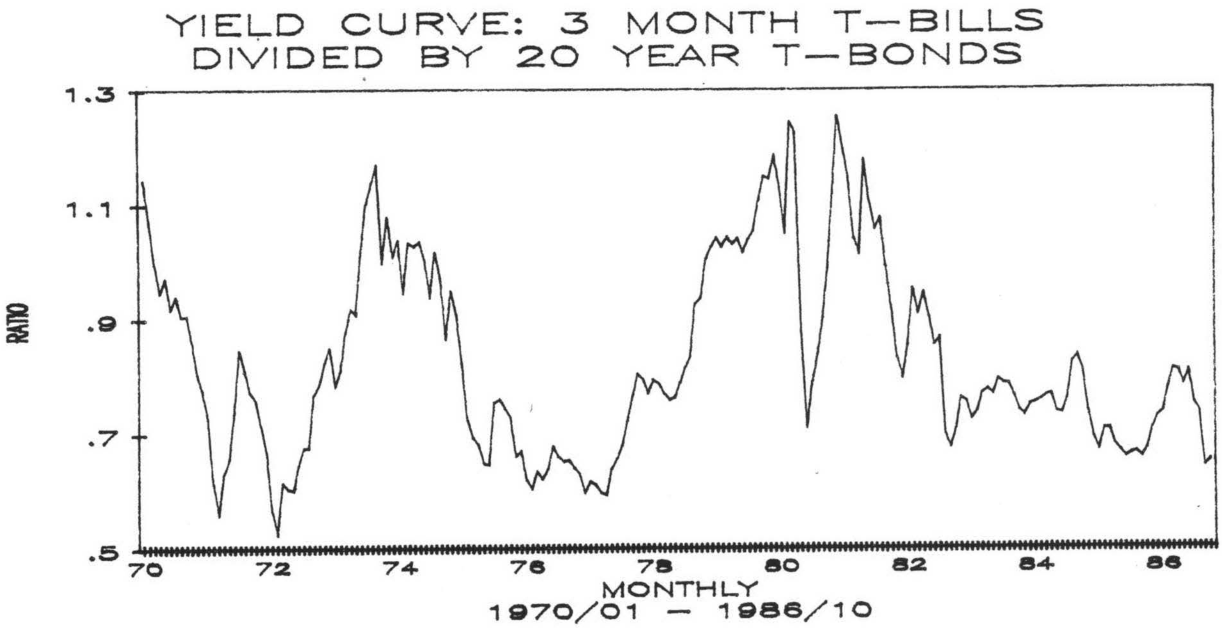
## THE DECLINE OF THE AMERICAN EMPIRE

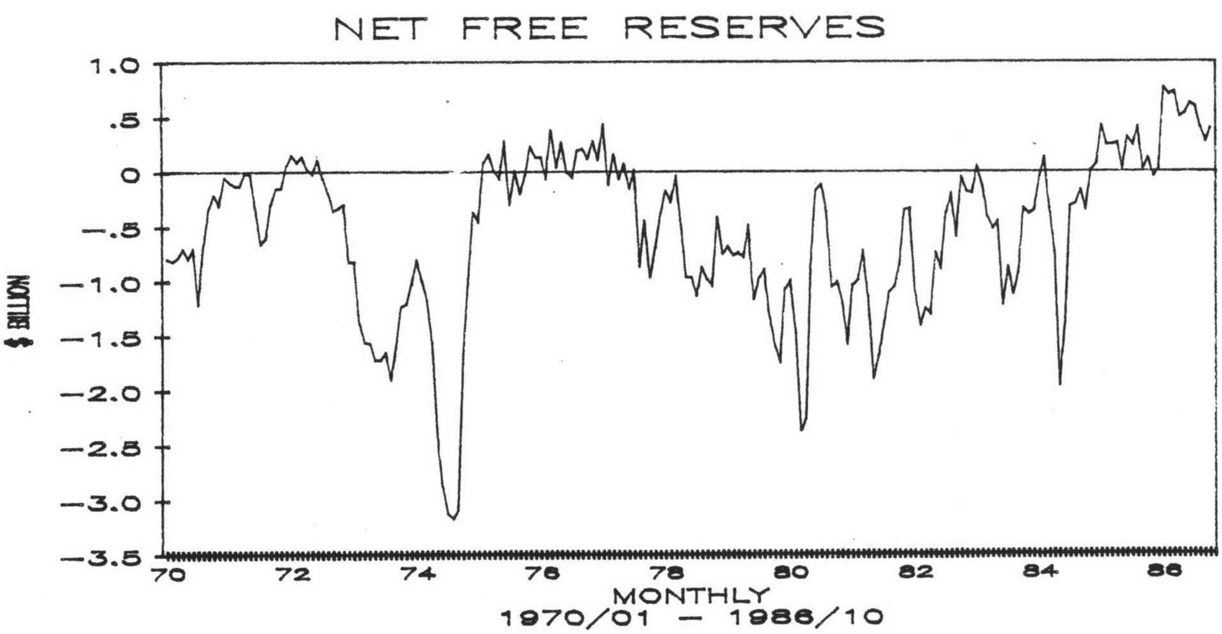
Most of the markets around the world remain trendless as their major influences -- economic growth, inflation, and central bank policies -- are, in virtually all countries, pretty flat. There are of course some exceptions (particular in the Far East); but flat (and choppy) is norm. We therefore can shift our attention from recent developments and their implications for the best and worst market plays to the longer term influences behind the current environment of relative stagnation, without feeling that we've neglected to report on something important.

In attempting to put economic/market behavior within a context, the differences between the current cycle and prior cycles are at least as interesting as the differences. In looking at the U.S. economy/ markets (which are still the most important, both in terms of size and effects on other economies and markets), probably the most significant difference is that the economy has been so unresponsive to stimulation. As we don't think most people realize just how unresponsive it has been, or the reasons for this unresponsiveness, we thought it would be helpful to show you a few charts to help put this into perspective.

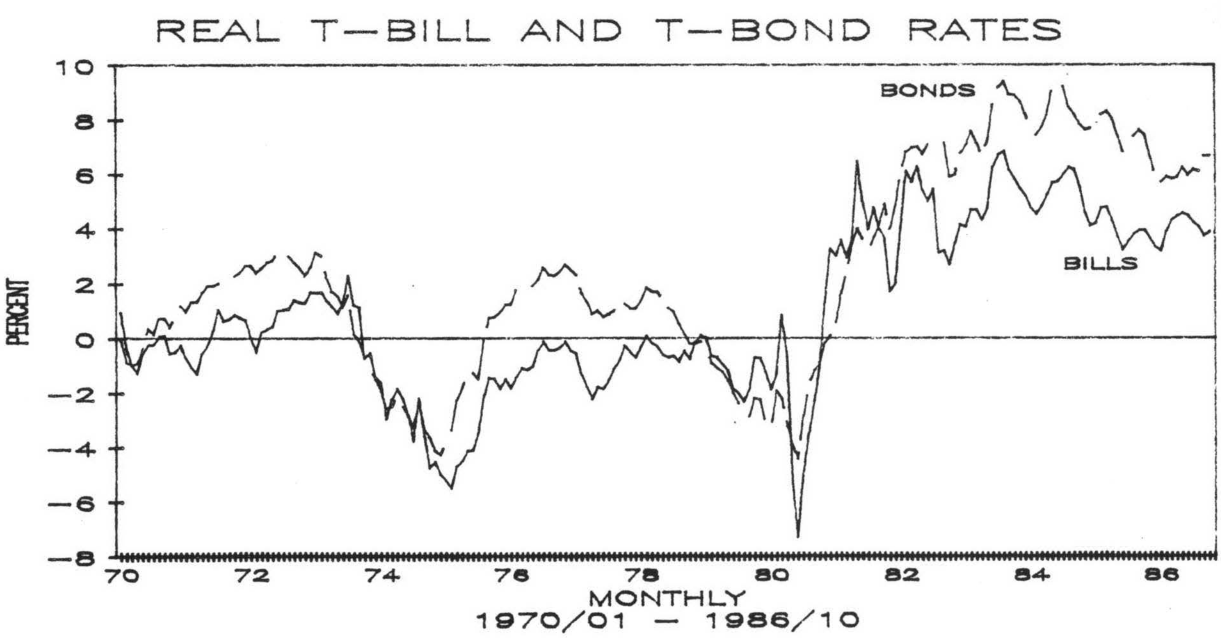
### THE FED HAS BEEN STIMULATIVE:

There are lots of ways of measuring Fed stimulation. However, the level of free reserves which the Fed is leaving at commercial banks and the slope of the yield curve are two of the most reliable. Judging from these (see the following chart), the Fed has been quite stimulative. You'll note, by comparing these two charts with those which follow that, large net free reserves and positive sloped yield curves have preceded pick-ups in monetary growth which has accompanied or preceded increases in economic growth. It is interesting to observe that during all prior expansions, net free reserves declined and the yield curve flattened until recessions began, at which point net free reserves rose and the yield curve steepened until expansions began. However, *throughout this expansions net free reserves have been rising and the yield curve has become more positive, which is extremely unusual.* This reflects the Fed becoming increasingly stimulative rather than more restrictive, which is not coincidently tied to the inflation rate falling rather than rising. In other words, *while in prior expansions, increased economic activity was accompanied by increased inflation which prompted the Fed to tighten, in the current expansion, increased economic activity has been accompanied by declining inflation, which has prompted the Fed to ease.*


YIELD CURVE: 3 MONTH T-BILLS
DIVIDED BY 20 YEAR T-BONDS
RATIO
1.3
1.1
.9
.7
.5
70
72
74
76
78
80
82
84
86
MONTHLY
1970/01 - 1986/10

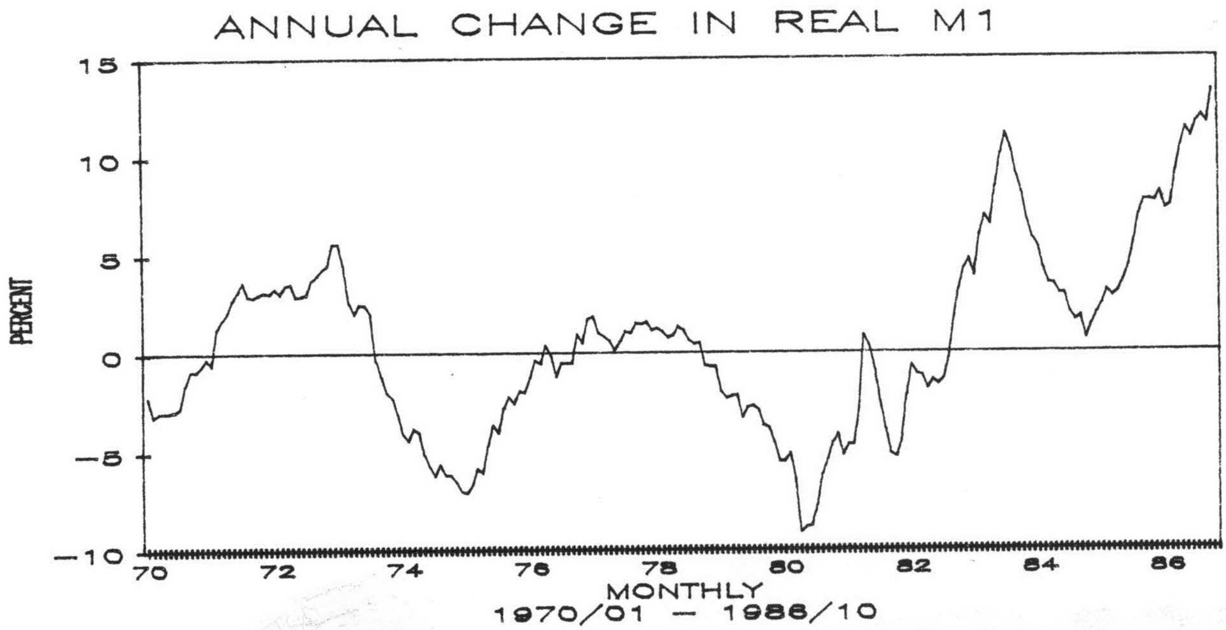

NET FREE RESERVES
$ BILLION
1.0
.5
0
-.5
-1.0
-1.5
-2.0
-2.5
-3.0
-3.5
70
72
74
76
78
80
82
84
86
MONTHLY
1970/01 - 1986/10

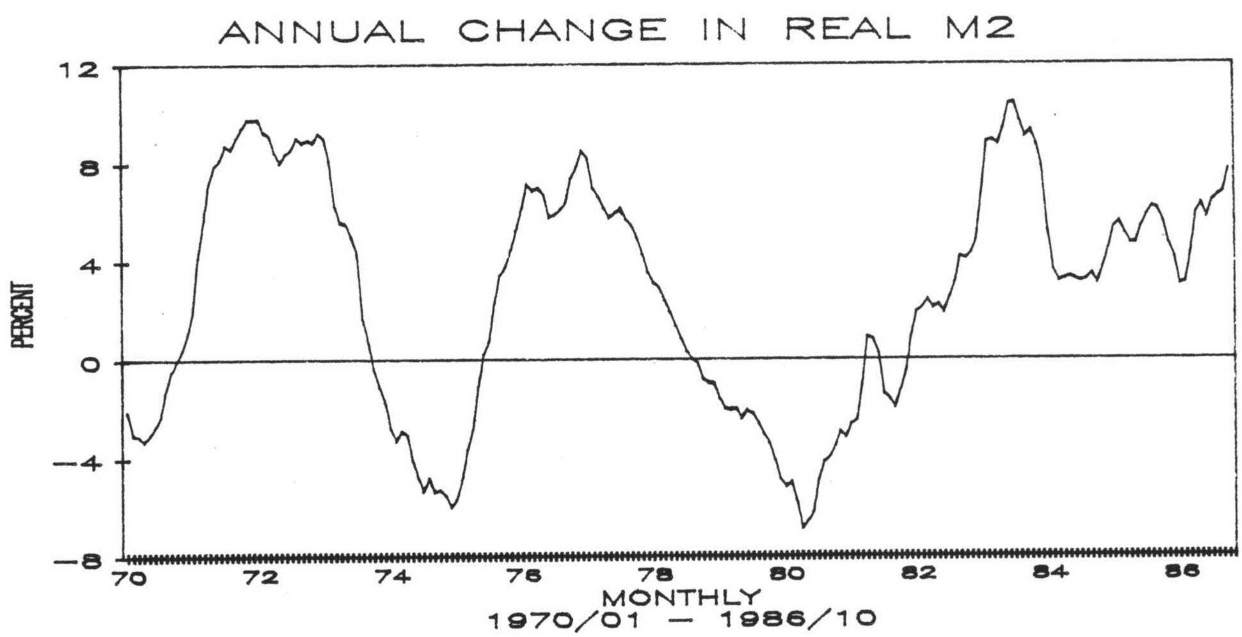
The next chart shows real T-bill and T-bond yields. Some might argue that the Fed hasn't been stimulative since these rates have remained high. However, the track record of real interest in leading past changes in economic growth has not been good and the rates of monetary/debt growth which have occurred during this expansion show that Fed stimulation has certainly been successful in producing the rapid credit expansion which finances economic expansion. Still, *whenever real interest rates are above the economy's real growth rate, a real transfer of wealth from debtors to creditors occurs. In such an environment, borrowing is uneconomical; borrowing in large amounts over extended periods of time is potentially ruinous. Therefore, while the high level of real interest rates hasn't yet slowed the rate of debt growth, it is producing a real transfer of wealth from debtors to creditors (which are increasingly non-American).*



**THE FED'S STIMULATION HAS CAUSED RAPID MONETARY/DEBT GROWTH:**

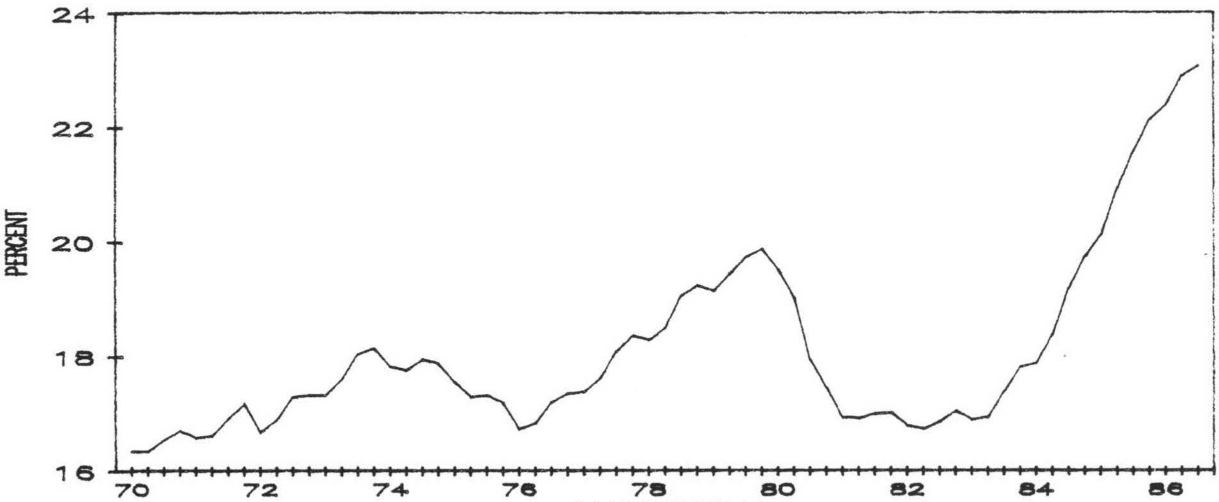
As shown in the next two charts, real M1 and real M2 have been growing rapidly.



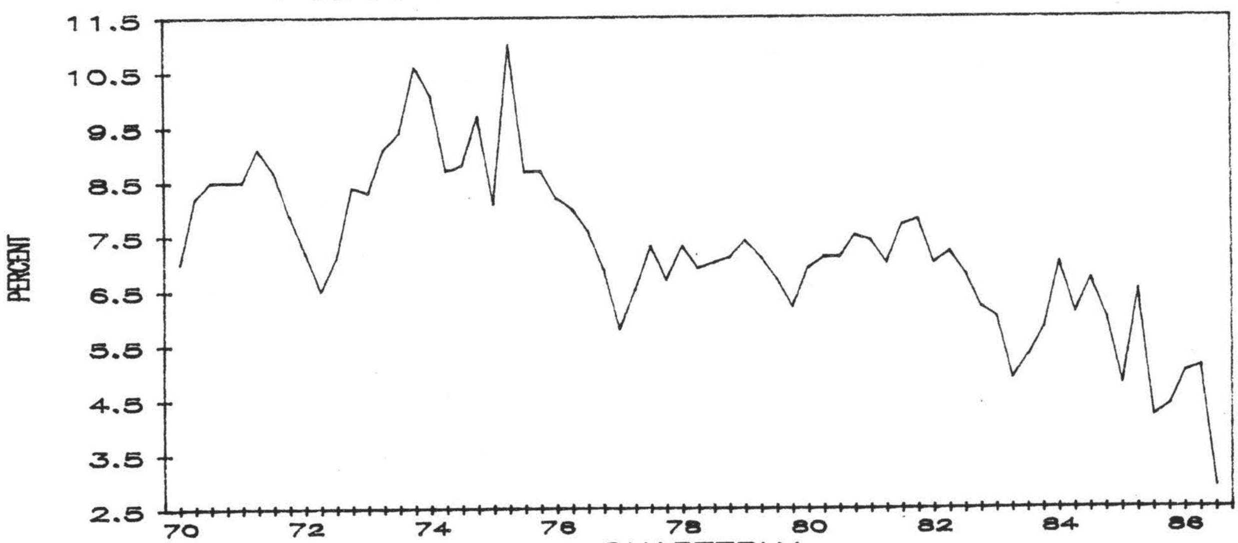
Also, as shown in the next two charts, American consumers have been borrowing more and saving less. While one can argue which measure of monetary/credit growth is best, or whether real or nominal measures are preferable, such disagreements only obscure the point -- any way you measure it, American's are getting themselves into debt at an historically unparalleled rate.

CONSUMER INSTALLMENT DEBT AS A PERCENT OF WAGE DISBURSEMENTS




QUARTERLY
1970/01 — 1986/03

PERSONAL SAVINGS RATE

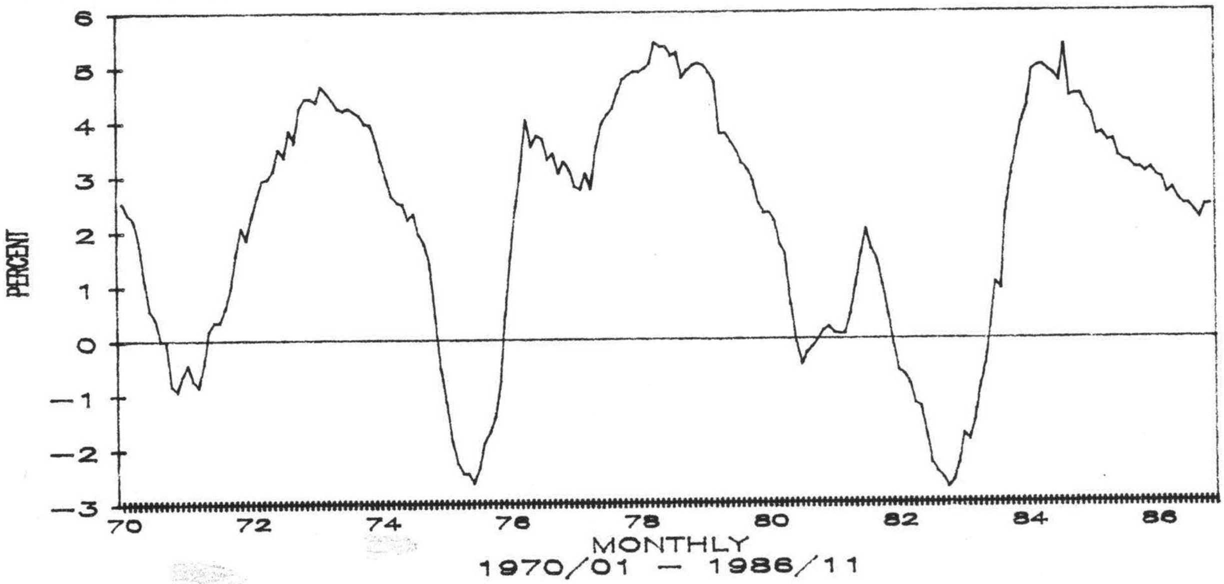



QUARTERLY
1970/01 — 1986/03

**YET ECONOMIC AND EARNINGS GROWTH HAS BEEN SUB-STANDARD:**

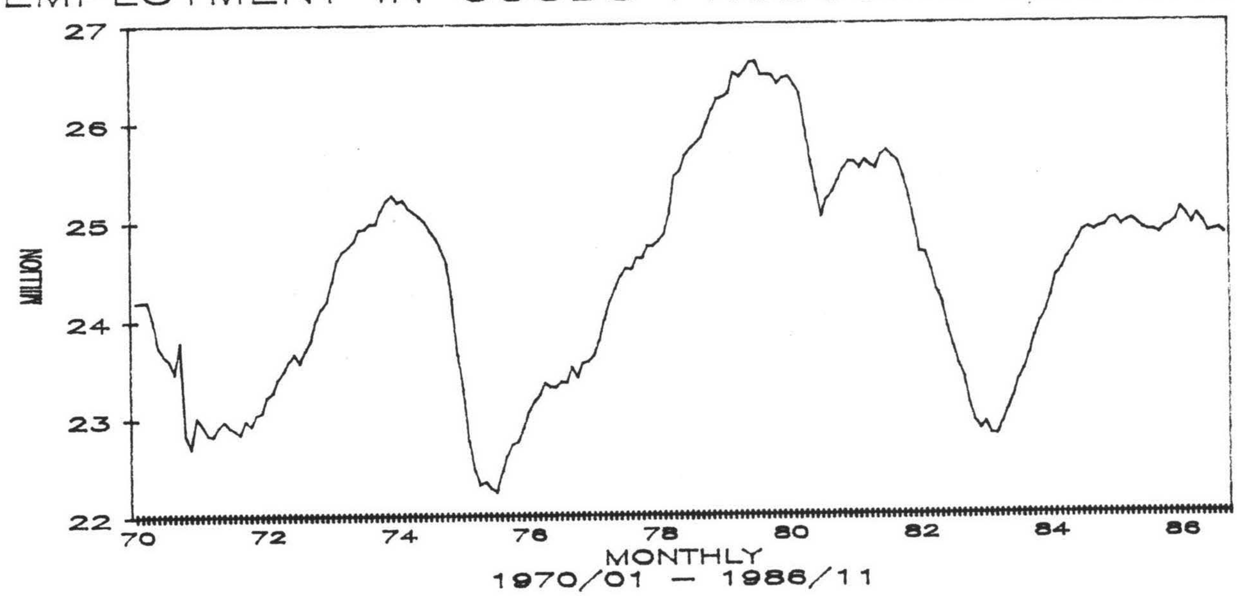
As shown in the next chart, the growth rate of total employment peaked in 1984 after increasing a rates comparable to those which occurred in the prior two expansions. However, by comparing this chart with the first two, you will note that *the tapering off in the growth rate which we have seen since 1984 has, unlike in any of the other prior cycles, occurred while the Fed has been increasingly stimulative and money/credit growth has been rapid.*

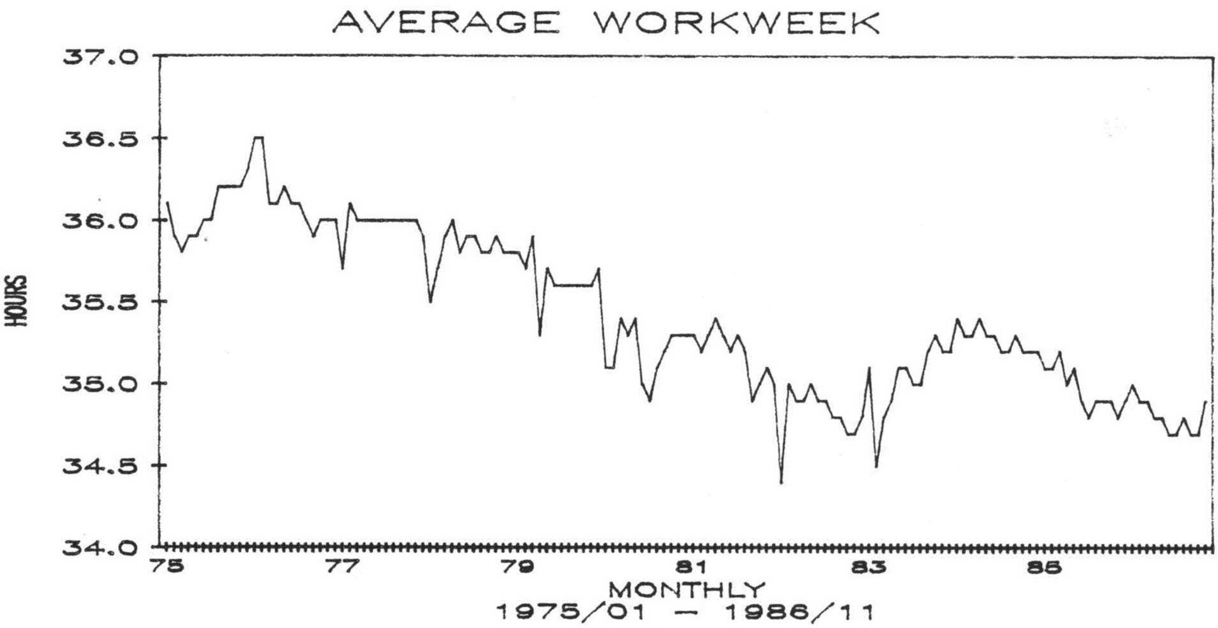
ANNUAL CHANGE IN PAYROLL EMPLOYMENT



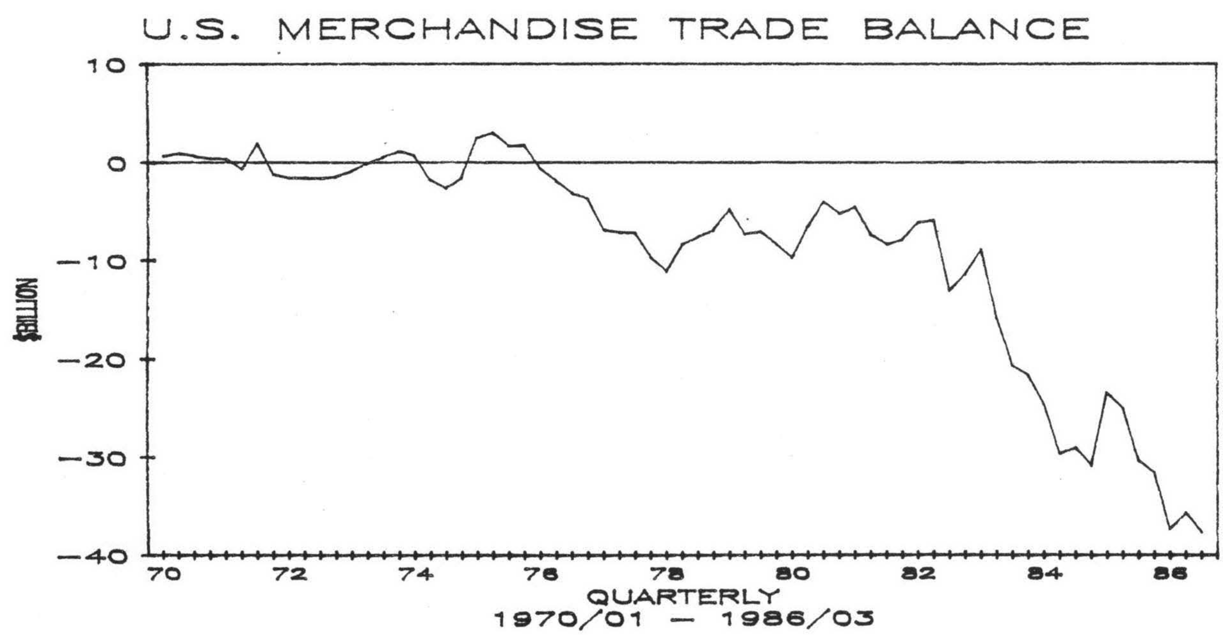

The substantial slow-up in growth has largely occurred because the goods producing sector in the economy has stopped growing.

EMPLOYMENT IN GOODS PRODUCING SECTORS

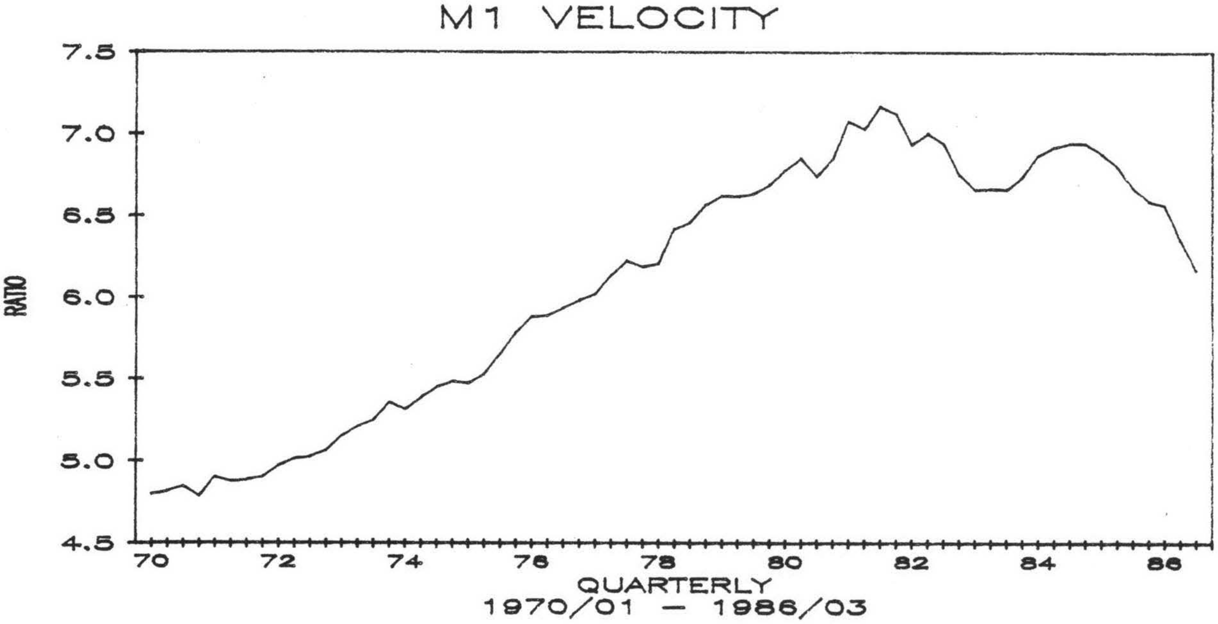





Very simply, the demand for American goods, and the labor which goes into producing them, is declining. This is probably most apparent in the hemoraging of our trade account.

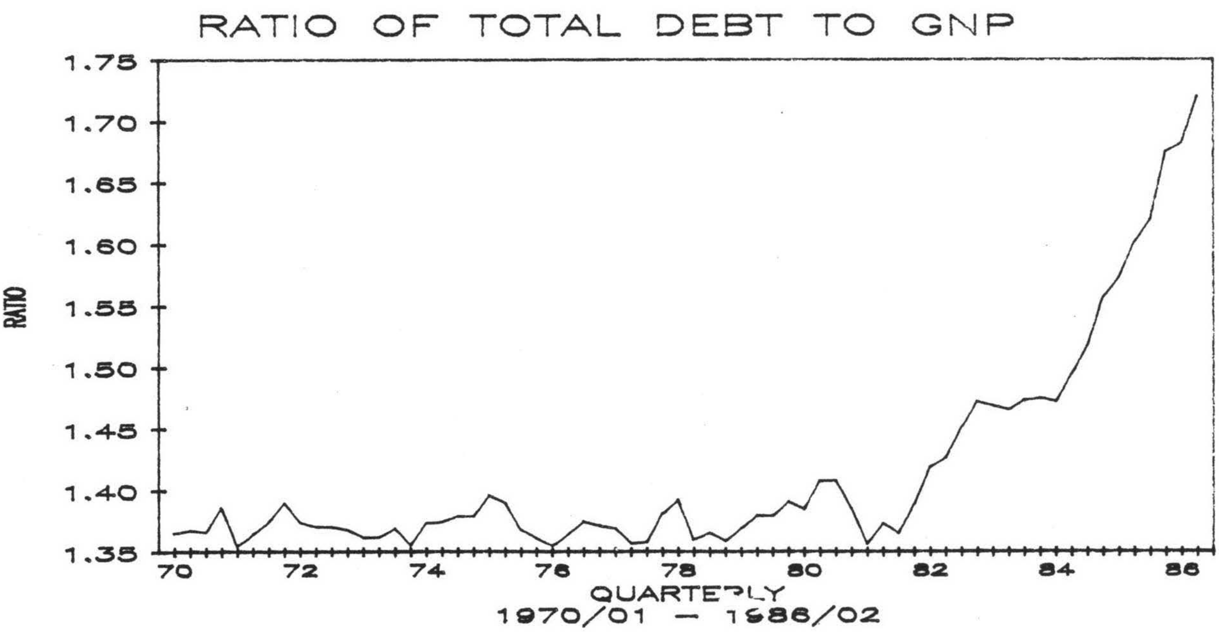


While in the past, increases in monetary/credit growth have been associated with increasing demand and increasing demand has been associated with increased production, this linkage has broken down. This is reflected in the falling velocity of money shown in the following chart.




**AS A RESULT, THE AMERICAN'S DEBT BURDENS HAVE SKYROCKETED:**

When debts rise faster than incomes, debt burdens will obviously increase. The extent of the recent increase is probably best reflected in the ratio of debt to GNP shown below. Basically, this pattern is a mirror image of those which we are seeing in countries where export growth has been rapid relative to domestic growth, (particularly in less developed countries which experienced rapid debt increases in the seventies and are now in the process of paying back).



Just as it is true for individuals, it is true for countries that when debts increase faster than earnings, it raises living standards over the short-term and lowers them over the long-term. It is also a trait of human nature that people find it difficult to imagine the future being much different from the present. Therefore, most people tend to perceive the ability to increase debt financed consumption as being sustainable, which encourages them to borrow and consume more. However, debt burdens aren't really felt until the economy (i.e. real incomes) turn down, which is reflected in the ratio of debt to GNP rising even more rapidly. As a result, we can't help but be concerned about the debt service problems which will arise when the economy turns down.

**THE VICIOUS CIRCLE**

These few charts paint a pretty clear picture. Americans are increasing their debts and consumption much more rapidly than they are increasing their production and earnings. They are using money borrowed from abroad to finance goods purchased from abroad, thereby exchanging debts for income. Foreign investors lend to the U.S. because real interest rates are high and the U.S. still has a good credit rating. Americans borrow because they have leaned to respond to the availability of credit, rather than the cost of it. The Federal Reserve encourages this debt growth by keeping credit readily available, because the consequences of turning restrictive are unacceptable (principally because of the enormous amounts of debts which have already been incurred). *While this vicious circle pushes problems into the future, it also makes the longer term consequences more ominous.*

Recognizing the unsustainibility of this, both the administration (via the Treasury) and the Federal Reserve are attempting to increase U.S. economic activity and incomes growth while not constraining consumption, by reducing the value of the dollar and encouraging increased consumption abroad. In our opinion, one's degree of optimism should largely be a function of one's assessment of the extent which this policy will be successful prior to the next downturn in the economy. As we very much doubt that the trade deficits will be meaningfully improved by increased exports arising from significantly faster growth in consumption abroad, we feel that it is unlikely that American's real incomes growth will even approach their rate of real debt growth, prior to the economy's next down turn. We're therefore not optimistic concerning the long run.

We believe that the enormous debt burdens accumulated by Americans and their reduced competitiveness will be long- term drags on economic growth. As a result we feel that, except for a couple of quarters' pick up in growth due to unsustainable contributions from inventories and trade, the economy will largely remain unresponsive to stimulation. The Fed can of course work even harder to reflate; however, the longer term trend in Americans living standards won't hinge on the Fed's willingness to produce credit as much as 1) American's willingness to work a lot harder at lower real earnings (i.e. to become more competitive) and 2) world consumption picking up while it slows in the U.S. We believe that the odds of this are slim to nonexistent.

**THE LIFE CYCLE OF A COUNTRY**

We believe that the assendancy and decendancy of civilizations can be traced to their attitudes about work and debt. At the earliest stages of the productivity cycle, *countries are poor and think of themselves as poor*. Like the U.S. in the fifties (after two decades of depression and war) or China now, the desire to secure the "basics" (eg. food, clothing, shelter, etc.) encourages the willingness to work and save hard. As a result, credit growth goes into capital formation rather than consumption and productivity rises. While we tend to think that productivity gains almost exclusively result from having bright, spanking new equipment, it's important to realize that ha ving a labor force which is willing to work harder for less compensation than the competition's is at least as important. This is currently reflected in the Chinese being able to buy "obsolete" factories from the U.S. and use them to produce goods which undercut us in our own markets. Capital spending and cheap labor are both key ingredients in achieving economic advancement; however, a shortage of one can be made up by an over abundance of the other.

After years of doing things right, *countries become rich, but still think of themselves as being poor*. Japan until recently, or the Far Eastern industrialized countries today, are good examples of this. At this stage they work just about as hard as when they were poor and plow their wealth back into capital formation. While labor rates rise, they don't rise enough to make them uncompetitive, particularly since the accelerated rate of capital spending in turn gives them the spanking new equipment which further supports their competitiveness. It is during this stage that their trade surpluses grow most rapidly and investing in these countries is most rewarding.

Then *they become rich and start thinking of themselves as rich*. They increasingly want to enjoy "the good life" and divert more money to consumption at the expense of capital formation. The savings rate begins to taper off and real debt growth begins to pick up. Labor costs rise in comparison to those in competing countries. Japan is entering this stage and the United States is leaving it.

Eventually, *they become poorer and continue to think of themselves as being rich* . During this stage, consumption is financed at the expense of capital formation; real debt growth accelerates and real savings falls; labor is priced uncompetitively and plant and equipment becomes obsolete. Since economic problems become more apparent, numerous theories develope to explain them. The optimists describe the economy as being in transition to something better, while the pessimists acknowledge the problems, but usually underestimate their scope and the painfulness of the process required to eliminate them. Few people are willing to acknowledge that, in order to regain their competitiveness, they will have to work a lot harder and earn a lot less; they refuse to consider the work hours and incomes of those in the "newly industrialized countries" as meaningful points of comparison. The United States, the U.K. and Australia are currently at this stage. Argentina is well passed this and approaching the next -- i.e,, when *they are poor and think of themselves as poor,* at which point the cycle is complete.

This cycle usually evolves gradually, typically taking three or four generations. As a result, it is generally not appreciated by investors who tend to be reactive rather than pro-active; in turn, money tends to follow rather than anticipate these trends. This slows the transition to subsequent stages; at the extremes, those which are poor and think of themselves as poor find it difficult to attract in the money which hastens their development, while those which are rich and think of themselves as rich, find it all to easy to borrow the money in order to finance their excessive consumption. Still, the cycle is apparent to those who are looking for it. For example, we believe that it is currently being played out in the shifting relative positions of the United States, Japan, the newly industrialized countries of Asia (eg. Hong Kong, Taiwan, Korea and Singapore) and China. In our global investing, we find it helpful to try to identify where in this cycle each of the major countries are; for example, our investments in the newly industrialized countries of Asia are to a significant extent influenced by our belief that they are evolving toward what Japan was over the last twenty years (i.e., rich and thinking of itself as poor), while Japan is evolving toward what the United States has been during this period (i.e. rich and thinking of itself as rich) while the United States is evolving into what the U.K. has been (becoming poorer while thinking of itself as being rich).

RAY DALIO

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