

# Bridgewater®

## Daily Observations

April 16, 2021

©2021 Bridgewater Associates, LP

(203) 226-3030

Ray Dalio  
Bob Prince  
Greg Jensen

### Managing Money in an MP3 World

*Excerpts from Our Quarterly CIO Client Update*

Over the past year, the COVID-19 pandemic has accelerated the shift to a new paradigm for economies and markets, characterized by near-zero interest rates, coordinated monetary and fiscal policy (Monetary Policy 3/MP3), and heightened internal and external conflict. While the pandemic was an accelerant, we believe a shift to this new paradigm was inevitable over time and that the key elements of this new environment will remain long after the virus passes.

#### Among the more significant impacts of the shift:

- **The usage of MP3 will likely be pushed to its limits** until it results in excesses of some kind—whether inflation, currency weakness, and/or asset bubbles. In addition to the fact that other conventional levers are not available, the flexibility of MP3 offers the potential to deal with such problems as the income/wealth gap, low productivity, and strategic economic development. Initial uses of the tool have proved to be effective and popular with voters, particularly in the US, so expect more until constraints are faced.

MP3 brings with it a new set of dynamics. Fiscal spending financed by money printing routes money and credit to new areas of the economy that are not otherwise reached by an interest-rate-driven monetary policy (MP1) or a QE-driven policy (MP2)—for example, checks to middle- and lower-income groups. This creates more potential for good and more potential for bad, depending on the quality of the decisions made and the quality of this new set of economic decision makers.

- **There is a need for an investment alternative to nominal government bonds.** With yields near zero, nominal bonds are limited in their ability to provide either return or diversification. Wealth is being destroyed through the holding of cash and bonds via negative real yields, favoring debtors and debt relief in these latter stages of the long-term debt cycle.

The inability of discount rates to fall makes all assets riskier, including equities, heightening the need for an alternative diversifier to nominal bonds. By favoring debtors in relation to asset holders, central banks have made bonds more of a funding vehicle for investors than an investment vehicle.

- **Cash is not safe.** Investors moving to cash in response to these risks will experience near-zero nominal returns and potentially terrible real returns (i.e., cash could destroy wealth in a big way). Policy makers are actively trying to diminish the value of cash relative to other things to stimulate spending and have every incentive to generate inflation while keeping nominal rates low.

In the near term, the devaluation of cash raises asset returns as money moves out the risk curve. Over time, this lowers their cash flow yields and expected returns and increases the risks of wealth destruction from a subsequent reversal of liquidity conditions and rise in real yields.

- **The ongoing need for MP3 in the US and the strength of China through the recent crisis bring us closer to the decline of the dollar as a global reserve currency.** The printing of money and the rebalancing of global economic power call for a deeper consideration of currency as a separate source of return and risk, which can be managed independently.

---

© 2021 Bridgewater® Associates, LP. By receiving or reviewing this Bridgewater® Daily Observations, you agree that this material is confidential intellectual property of Bridgewater® Associates, LP and that you will not directly or indirectly copy, modify, recast, publish or redistribute this material and the information therein, in whole or in part, or otherwise make any commercial use of this material without Bridgewater's prior written consent. All rights reserved.

In forming an investment response to these conditions, it is important to recognize that the sequence of linkages related to policy moves is quite different and in some important respects the opposite of the world that we are accustomed to.

**In an MP1 world, you have an interest-rate-driven monetary policy.** The central bank changes interest rates enough to alter the economics of borrowing and lending, leading to a change in spending, leading to a change in incomes. In order to have a significant impact on spending, interest rates need to change by hundreds of basis points. The average interest rate cut required to reverse a downturn has been about 500 basis points, and it's taken rate rises of more than 300 basis points to slow an overheating economy.

**In an MP2 world, you have a QE-driven monetary policy.** It works in similar sequence as MP1, with QE driving up asset prices in order to impact people's economics and stimulating spending in order to raise incomes. Again, the action is taken on markets, which changes the economics of wealth and sentiment, which impacts spending, which impacts income.

**In an MP3 world, the sequence reverses and the key decision makers change.** Fiscal policy and monetary policy are coordinated. The fiscal authority borrows money, typically funded by the central bank's money printing. Then the government directs the money into the economy to achieve their goals—raising incomes in order to raise spending or spending directly on their own. Interest rates are suppressed by the central bank so that a rise in interest rates does not offset the fiscal stimulation until either conditions change or something snaps and the central bank loses control.

**These conditions raise big questions regarding asset allocation and active management.** For example, the level of yields is distorted and wealth is destroyed rather than increased by holding cash and bonds, making cash and bonds an attractive funding vehicle rather than an investment vehicle. The pricing of assets may or may not properly reflect their cash flow yield. And monetization calls into question the value of one currency in relation to another and in relation to tangible assets. Inflation is an imminent risk.

**Given the potential for distortions, we think that it makes sense to give explicit, separate consideration to a portfolio's cash flow stream, the pricing of that cash flow stream, and its currency denomination.** You can think of active management as a matter of engineering these three components to achieve a desired return and risk objective.

**This approach diverges from the traditional approach, which starts with a market-cap-weighted index and then defines active management as alpha relative to that index.** Whether you explicitly recognize it or not, that world is based on a CAPM view of markets, which is based on what is now a deeply flawed assumption that "all investors are rational and profit-maximizing." In an MP3 world, and especially in the US where fiscal action has been strongest, the biggest players impacting markets are policy makers who drive income, spending, and interest rates based on policy objectives. When the market cap of bonds rises because policy makers drive the yield to zero or negative, does that mean that you should hold more of them? The same question applies to other assets that are impacted by these policies. It is a matter of mechanics that market caps rise when yields fall. Thus, market-cap-based investing can lead to a portfolio that generates a low cash flow yield over time and is therefore reliant on continued price appreciation driven by incremental declines in yields and the policies that have driven yields down to where they are now.

**On the other hand, an MP3 world creates other opportunities.** The production and distribution of liquidity is likely to sustain a higher level of nominal spending in the pockets of the economy that receive those funds as income, and the expansion of fiscal deficits raises nominal spending in aggregate. Recognizing where those cash flows will occur can be a reliable source of return over time. And funding them with devalued cash can be a source of additional "spread" up to the point that MP3 policies hit constraints. An equity portfolio can be actively managed, not just to beat a distorted index but as a targeted total or real return portfolio. Through this process, a higher probability of achieving a portfolio's required return can be achieved.

**It is important to recognize that the characteristics of this MP3 world are not the same everywhere around the globe. They are far more prevalent in the West than in the East, calling for better balance between the two.**

**The secular divergence between East and West existed before the pandemic and has been accelerated by it.**

Whereas the economic damage of the virus in the West was addressed through massive, monetized government deficits, the East managed their way through it faster, and with less damage to balance sheets, by altering human behavior. In our view, this step change in balance sheet conditions and policy orientation has brought forward what was already an unfolding decline in the attractiveness of US dollar bonds and US dollars as a reserve currency. And as a rising alternative, China is now more actively promoting their assets and investment markets to international investors, with these goals recently communicated in their 14th Five-Year Plan.

**As for our own response to this environment**, over the past year we have developed a number of new investment strategies designed to align with this world and to profit from it, with more coming. For example, tactically funding diversified assets with cash when wealth is being destroyed in cash, continuing our research into an “alt-cash” portfolio that is designed to protect against wealth destruction, creating stable cash flow streams from equities and then hedging the residual price volatility, achieving better balance between East and West, and building better balance between longer-term yield-based alphas and shorter-term price-based alphas are logical responses to this new world that we all live in.

Bridgewater Daily Observations is prepared by and is the property of Bridgewater Associates, LP and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives or tolerances of any of the recipients. Additionally, Bridgewater's actual investment positions may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment restrictions, portfolio rebalancing and transactions costs, among others. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This report is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned.

Bridgewater research utilizes data and information from public, private and internal sources, including data from actual Bridgewater trades. Sources include the Australian Bureau of Statistics, Bloomberg Finance L.P., Capital Economics, CBRE, Inc., CEIC Data Company Ltd., Consensus Economics Inc., Corelogic, Inc., CoStar Realty Information, Inc., CreditSights, Inc., Dealogic LLC, DTCC Data Repository (U.S.), LLC, Ecoanalitica, EPFR Global, Eurasia Group Ltd., European Money Markets Institute – EMMI, Evercore ISI, Factset Research Systems, Inc., The Financial Times Limited, GaveKal Research Ltd., Global Financial Data, Inc., Haver Analytics, Inc., ICE Data Derivatives, IHSMarkit, The Investment Funds Institute of Canada, International Energy Agency, Lombard Street Research, Mergent, Inc., Metals Focus Ltd, Moody's Analytics, Inc., MSCI, Inc., National Bureau of Economic Research, Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, Renwood Realtytrac, LLC, Rystad Energy, Inc., S&P Global Market Intelligence Inc., Sentix GmbH, Spears & Associates, Inc., State Street Bank and Trust Company, Sun Hung Kai Financial (UK), Refinitiv, Totem Macro, United Nations, US Department of Commerce, Wind Information (Shanghai) Co Ltd, Wood Mackenzie Limited, World Bureau of Metal Statistics, and World Economic Forum. While we consider information from external sources to be reliable, we do not assume responsibility for its accuracy.

The views expressed herein are solely those of Bridgewater as of the date of this report and are subject to change without notice. Bridgewater may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.