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Daily Observations

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(203) 226-3030

Greg Jensen
Jason Rotenberg

United States

Dollar Risks are Skewed:

There is a much larger risk of a major dollar sell-off than of a significant dollar rally. On a day-by-day basis sentiment about the war in Iraq is overwhelming all other factors in global financial markets, but the cloud created by the war is only obscuring the fundamental picture for the dollar. As we see it, positive news in the war will only lead to a short and unsustained dollar rally, while negatives could help trigger a major sell-off that is likely going to occur anyway.

In the 1990's the US was the beneficiary of a virtuous circle of foreign investment in which a strong dollar and strong financial markets led to further foreign investment in the US, which led to a stronger dollar and stronger financial markets. This virtuous circle flooded the US with foreign capital. As a country the US got used to its privileged status as the home of the world's reserve currency. Foreigners' savings became more and more heavily dollar denominated. At this point, the US makes up only 30% of the world economy but sucks up 80% of the world's savings.

If for whatever reason foreigners change their mind about investing in the US, the outlook for the dollar and the US economy darkens significantly. If the rest of the world decided instead of investing 80% of the world's free capital in the US it would only invest 30% (consistent with the US economy as a % GDP), US consumption would have to contract by almost 3% all else equal. All else is never equal, and in this case consumption would be forced to slow somewhat but the dollar would absorb most of the impact, falling to levels that would allow US consumption to continue. If foreigners don't just cut the flow of dollars to the US, but start actively redistributing the dollar positions they already have to create more balanced exposures, the picture is much grimmer. We believe movement in this direction is virtually inevitable.

The relative attractiveness of US capital has deteriorated to the point where it is extremely unlikely the US will be able to maintain the market share of world capital it needs to break even. The war news may obscure this picture, but the war is unlikely to change it for the better for the US.

This is not just a problem for the dollar because declining foreign demand for US assets will ripple through all US financial markets and market participants trading those assets without a global perspective will likely be blindsided. The great-unsung hero of the US economic boom of the late '90's was foreign capital. Foreigners' desire to throw money at the United States provided the fuel for the most massive private borrowing spree the US has ever seen. The performance of the US economy and financial markets are now intricately tied to foreigners' faith in the US. This faith has worn thin.

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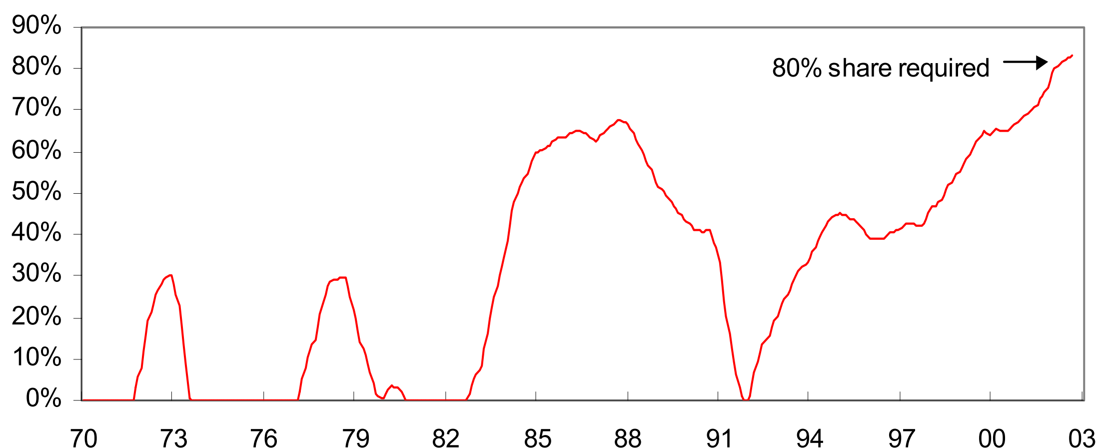
The following chart illustrates the percent of world capital the US is absorbing. It is at a new record, and one thing is for sure, it is capped at 100% but could fall to 0%.



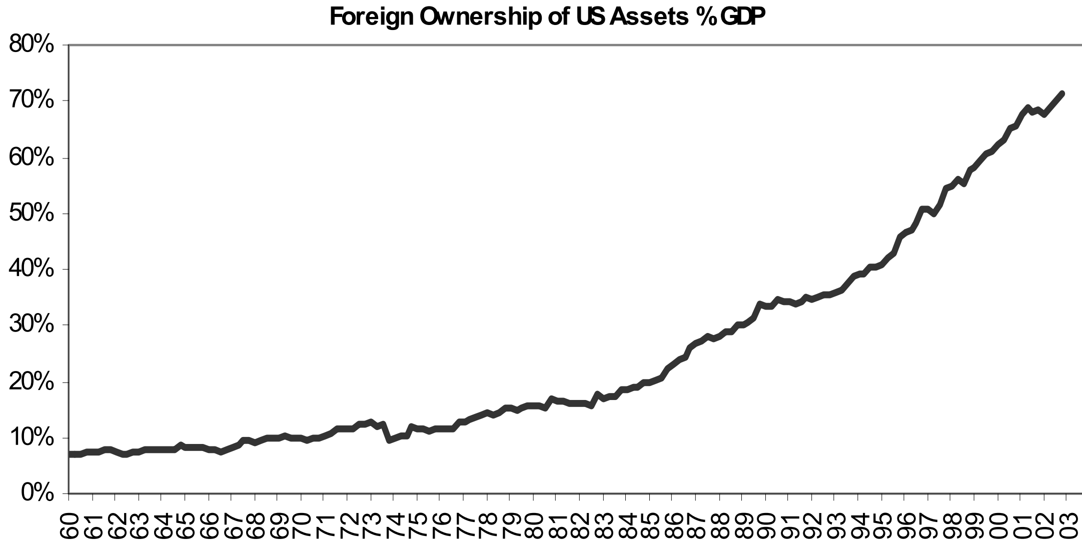
US assets are not attractive:

Is it realistic that global market participants will continue to throw this much money at US assets? We doubt it. For a long time the US had higher interest rates and higher earnings growth rates than the rest of the world, so it made sense that the world was dying to buy US assets. Currently US assets may well be the least attractive in the world. US interest rates are the second lowest in the world (only above Japan) and expected earnings growth rates in the US are the lowest. **This perspective is over simplified**, but roughly captures the picture that investors across the world will see when deciding whether to continue to add to grossly over-weight US positions. The following table shows some simple gauges of asset attractiveness across the major developed markets. We combine these measures into a simple asset attractiveness rank, and the US ranks dead last. With the least attractive assets in the developed world is it realistic that the US will attract 80% of the world's capital next year at current exchange rates? No matter how the war goes in the long term we suspect the answer is no.

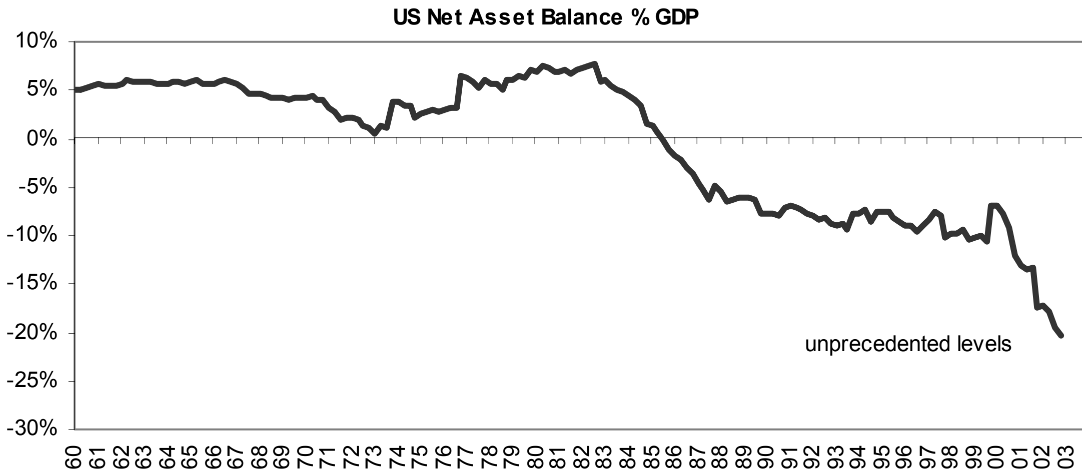
Asset Attractiveness							
	Consensus 1yr Earnings Growth Expectation	Bond Yields	Short Rates	Bond Yields Minus Inflation	Short Rates Minus Inflation	Inflation Linked Bond Yield (Real Yield)	Asset Attractiveness Rank
Australia	21.3%	5.6%	4.7%	2.6%	1.7%	3.4%	1
Canada	26.8%	5.2%	3.2%	0.6%	-1.4%	3.1%	4
Euroland	47.7%	4.3%	2.5%	1.9%	0.1%	2.3%	2
Japan	44.9%	0.7%	0.2%	1.0%	0.4%	-	5
UK	32.4%	4.6%	3.7%	1.6%	0.8%	2.1%	3
US	16.1%	4.0%	1.2%	1.0%	-1.8%	2.2%	6

Foreigners are massively overweight US assets:

In terms of real flows, world investors are massively overweight the dollar. Even a moderation in the demand for US assets would lead to a significant decline in the dollar. Outright selling of US assets would be devastating. The following charts tell the story. Foreign ownership of US assets has recently risen dramatically. In 1990 foreign owned assets amounted to 33% of US GDP, but today they are valued at over 72% of US GDP.

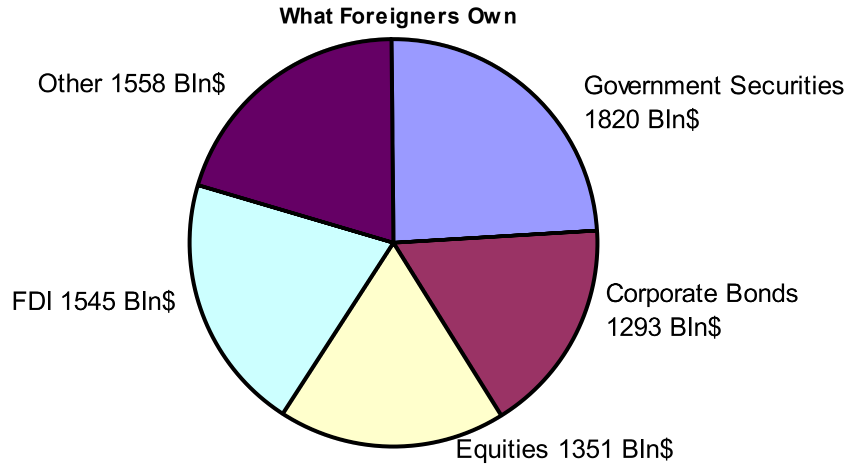


The previous chart is affected by the general trend towards globalization in which cross border ownership of assets rose across the globe. The next chart is more telling because it shows the net US holdings of assets abroad relative to foreign holdings of US assets. Foreigners own over $2 trillion (20% of US GDP) more in US assets than we hold of theirs.

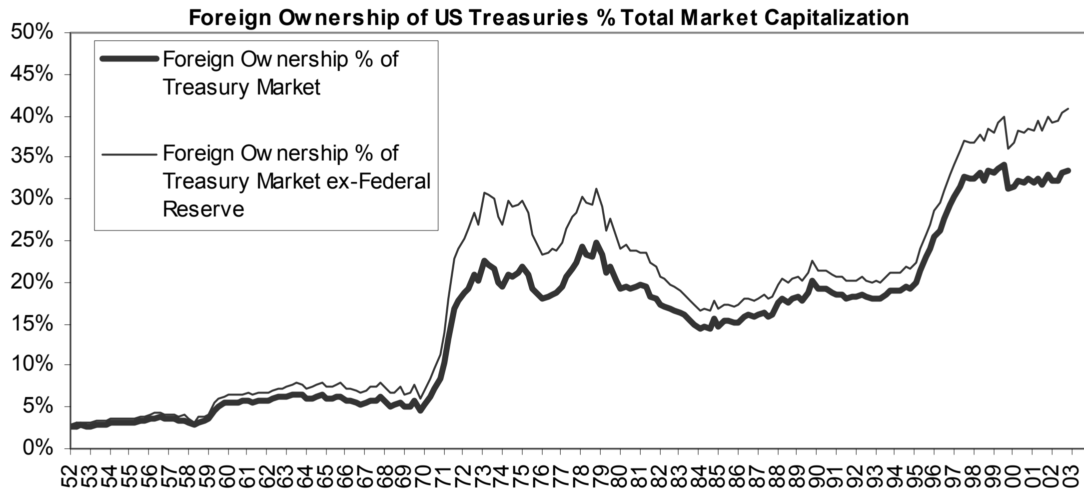


All US Markets Have Been Supported By Foreign Investment:

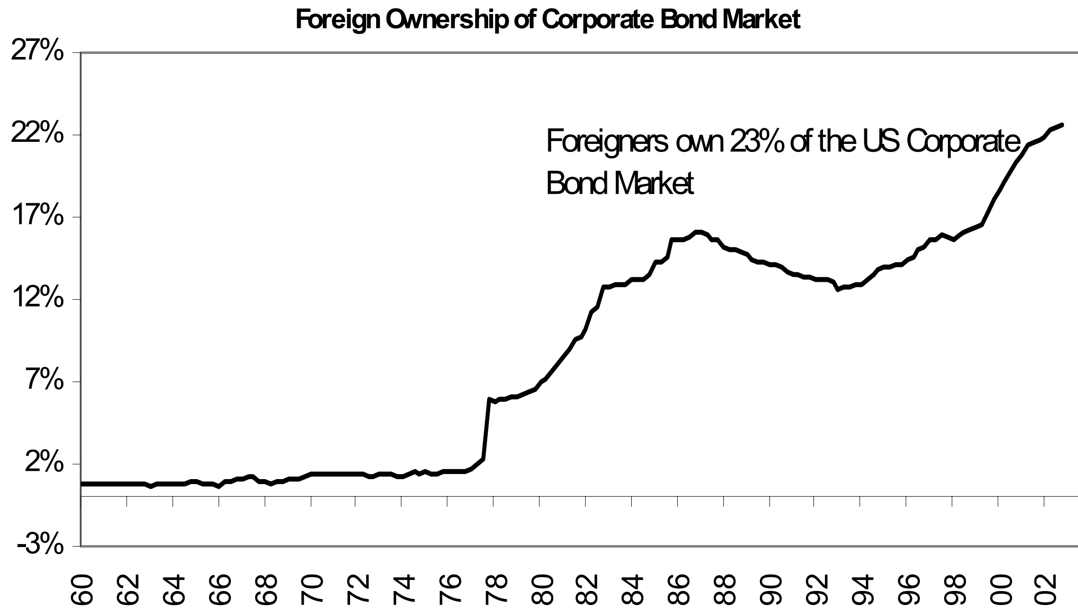
The following pie chart breaks down what US assets foreigners now hold. Foreigners now own huge stakes across all major US assets classes, and any shifts in these holdings will ripple through US markets.



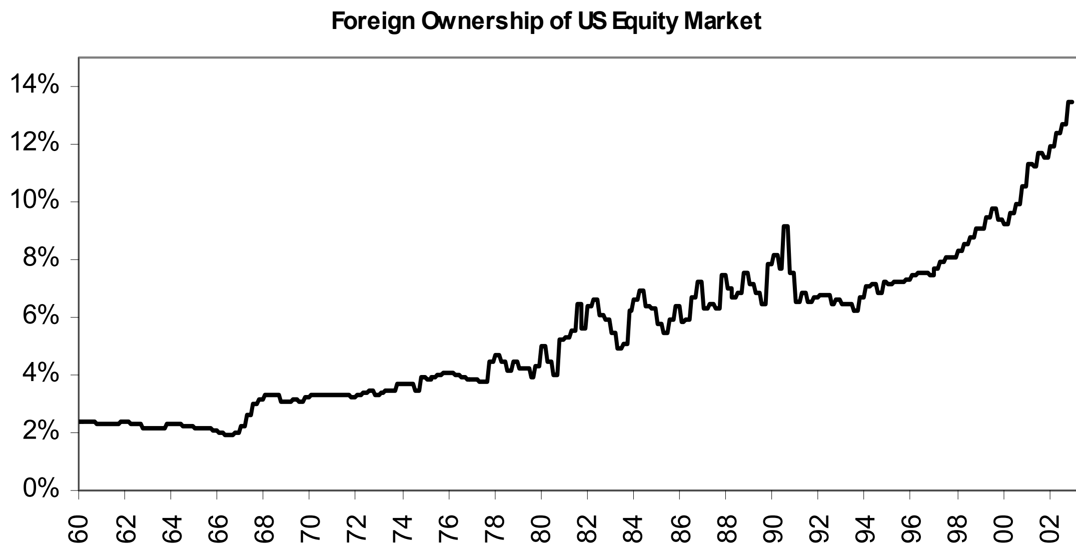
Foreigners' purchases of government securities have brought foreign ownership to over 33% of the total US Treasury market. If you take out the US Treasuries held by the Fed, which are not really in play, foreign ownership rises to 41%. Either way it is clear that foreigners are far and away the most significant holder of US Treasuries.



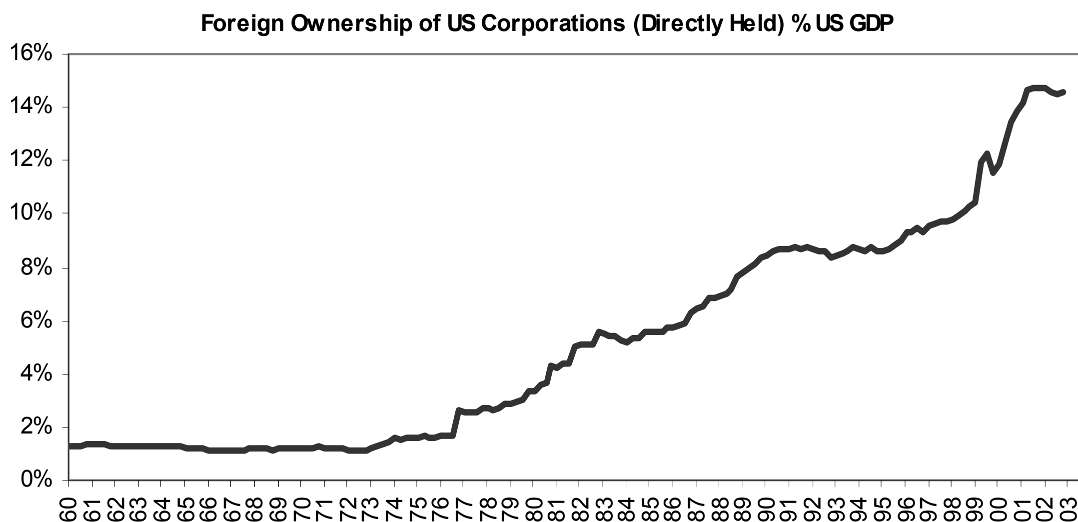
Foreigners also own a record 23% of the corporate bond market.



Foreign ownership of the US equity market has risen as well and is now above 13% of the total US equity market.



Foreigners also directly hold massive stakes in US companies. The value of these direct investments is estimated at 15% of GDP.



The willingness of foreigners to fork over hundreds of billions of dollars to the US helped feed the massive spending spree that US households and corporations embarked on in the 1990's. Now foreigners hold a high percentage of all US assets, and these assets are not attractive relative to those of the rest of the world. Even if the war goes well, we doubt it will lead to a large enough sentiment change to support the current dollar level. If foreign sentiment towards US assets sours, whatever the cause, a vicious cycle of foreign selling of US assets would likely ensue. These holdings are so big and so much larger than US assets abroad that they are a long-term risk to all US financial markets, but the dollar most directly.