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M&A and Currency Imbalances: An Interview with Ray Dalio, Chairman of Bridgewater Associates

by,

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There are few people who trade and analyze the financial markets as astutely from a purely fundamental orientation as does Ray Dalio. Dalio is the founder and chairman of Bridgewater Associates, a Wilton, Conn.-based money manager who, through his successful trading of the foreign exchange and fixed income, now has $30 billion under management.

As a follow-up to our September article, “Where the Excess Lies” that focused on a growing amount of debt underlying the clear bubble in the U.S. telecom overbuild (now already coming undone – witness the 30% decline in Lucent just this past month), we recently sat down with Ray Dalio and asked him for a few of his macro perspectives. His views jibe reasonably well with our own, albeit he speaks for more diplomatically and carefully than we normally do.

Dalio is particularly concerned with all the European-financed debt that has been thrown at the U.S. in merger and acquisition activity. We find the chart presented below in support of his arguments most amazing. It is important to note that every time the U.S. equity market now goes down at the same time that the euro rallies, many leveraged European M & A positions are being hit with a double whammy of pain.

We offer to you here a few snippets of our chat with Dalio not as our normal monthly article, but simply as a supplemental fundamental perspective well worth considering.

BTL: Ray, are we at the end of a typical late cycle – with an inverted yield curve, strong dollar, and strong oil market, with the economy ready to roll over an die? Is it a typical late cycle or an atypical late cycle, or not a late cycle at all?

RD: Late cycles are reflected most importantly by the magnitude of inflation pressures you’re actually feeling. Late cycles are due to Fed tightening monetary policy enough or over-tightening monetary policy so that it actually causes a recession. But the magnitudes of everything going on now indicate that, if it is a late cycle, it’s a very early late cycle. The magnitude of the inflation and the tightenings are not such that they suggest being the cause of a recession/contraction right now.

BTL: But it seems that the market is so hypersensitive to every little interest rate move. Couldn't a final incremental pea-shift topple the entire mountain?

RD: There are many things that convey a speculative bubble in certain investments in equities and capital flows into the dollar.

If you had asked me a year ago, I wouldn't have been as concerned because there wasn't as much leverage in the system. Recently, there has been a major step up in leverage, and particularly in M&A activity. The stock market has gone up while individual household sectors have been sellers. We estimate that 60% of the stock market gains are attributed to company purchases of other companies or of their own stock. What we have seen in the last 18 months in M&A is heavily debt financed, particularly European purchases of American business. Because of that, there is a greater sensitivity to a rate change. If you have twice as much debt, and your raise interest rates by 1%, it has twice the impact than if you had half-as much debt, and you raised interest rates by 1%. So not only do you have the speculative element, but because of these equity merger activities, a tightening of Fed policy will have a greater sensitivity and impact.

BTL: Is the corporate proclivity to repurchase stock and finance with debt, going to end up as a fiasco sometime?

RD: It is creating very large asset-liability mismanagement, particularly when it exists between countries. European purchases of American companies have not been on a currency-hedged basis. Systematically through history there has been a tendency for companies to borrow wherever interest rates are lowest, particularly if that currency has been weak. People say, 'I'm going to borrow in this trashy currency that goes down all the time, and I'm going to pay a lower interest rate.' This has probably been the basis of more debt problems than any other single factor. We're setting ourselves up maybe to a riskier situation that could prove problematic -- maybe not right away, but likely a few years from now.

BTL: With regard to Japan, how do you somehow get that economy back to more normalized interest-rate levels without hurting the rest of the world?

RD: I assume that they will only get to those higher level of interest rates if the balance between the current and capital account considerations become consistent with that. With such a large surplus in national savings, the real question is what is the Japanese predilection to buy foreign investments? For the most part, the Japanese are risk-averse investors. All the foreign investing that came from Japan and went elsewhere, never emanated from individual investors or pension funds. All of that investment came from asset-liability mismatches at banks and trust and insurance companies -- taking yen-denominated deposits and putting them offshore. And that doesn't work, because the size of the exposures relative to the size of the capital base are too large, so a loss in that particular position wipes out capital. It's not a sustainable set of circumstances. The average individual investor in Japan is much more risk-averse than that.

Now, in the current environment, you don't even have these banks playing as many of these asset-liability mismatches much anymore. This leaves a challenge to reinvest the current account surplus. You need to induce the pension funds to come out of Japan.

BTL: But isn't there a huge rollover of maturing JGB debt to contend with?

RD: If you have strong growth, you can handle that. There's plenty of money in Japan to buy JGBs, particularly at naturally higher yields.

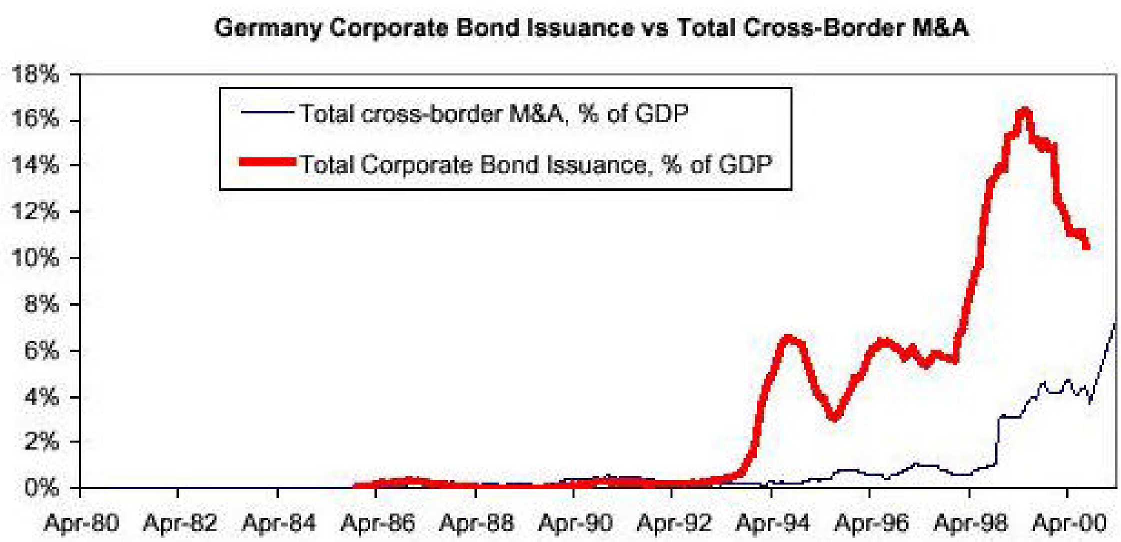
If on the other hand, you have a situation where Japan weakens again, and now the BOJ has to ease, but rates are already at zero, so they print money instead and create monetary inflation, now that's a different situation.

With monetary inflation, fear can start to drive investors outside the country. Under that set of circumstances, we have a risk. But that whole monetary inflation situation has to get outside the bounds of just neutralizing deflationary pressures. You can get there, and maybe that happens, but you have to have a whole sequence of things that have to occur first before we get to monetary inflation being the basis of a buyer's strike in JGBs. We're dealing with scenarios and probabilities here that maybe more people should pay attention to, but it's just one of a number of possible paths from where we stand now.

Japan is certainly an unstable set of circumstances, with many of their insurance and pension funds effectively broke. It's a source of instability that you have to look at closely. If and how they recycle their savings is an important issue.

BTL: If you were to look at one country, and say there is something that could undermine the U.S. economy, would Japan be where you would point to?

RD: No, I would start in Euroland, where so much of the recent U.S. financing is coming from. We have a negative household savings rate here in the U.S. We have companies borrowing foreign money to buy other businesses here. These flows are abnormal and literally not sustainable. You can't have German M&A purchases equal to 8-10% of their GDP each year. Germans have gone bezerk -- they're on a buying binge. When I look at the history of institutions that have gotten into asset-liability mismatches because they're local interest rate is low, and they bought into businesses because of this, that history has not turned out to be very pleasurable.



Source: Bridgewater Daily Observations

BTL: Thanks, Ray. We'll try not to forget those pearls of common sense wisdom in these otherwise rarified times.

Send us your comments at info@Sandspring.com.

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