

Bridgewater®

Daily Observations

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The Peripheral Country Debt Problem

We are pessimistic about the Euroland debt problem because we are looking at Spain, not Greece, and visualizing how Germans are inclined to treat Greeks and Spaniards.

While questions pertaining to Greece are getting most of the attention, we don't think they're the important ones. We think that the single most important question pertaining to Europe is what are the debt risks of the bigger peripheral countries (iconically represented by Spain). If their risks are small, it won't matter much to the rest of the world how the Greece debt problem is handled, because the handling of such a small country probably won't destabilize the region. And if these countries' debt problems are bad, it also won't matter much to the rest of the world how Greece is handled because, however it is handled, it won't prevent the other countries' problems from coming to a head.

We believe that if there was no country called Greece, Spain (and other peripheral debtor countries, with the possible exception of Italy) would probably have a big debt problem because the amounts they have to roll forward and the amounts of new debt they have to borrow to fund their deficits are too large for the amounts that sensible, profit-motivated buyers are likely to provide in light of their current debt burdens and the rates at which they are being added to. So, the most important question is, is that true? We will explain our thinking below, but first let's look at the interesting Greece questions.

Regarding Greece, we are paying attention to those questions more because we are enthralled by the group dynamics and the choices that the big players (Germany, France, the ECB, the IMF, etc.) might make. That is because these dynamics make for great drama and reflect what the big players value and how they will operate in the future. It will be fascinating to see what they choose to do and why. While we have our guesses, they are only guesses, which we will share with you, as long as you recognize that we aren't confident enough in them to bet on them.

Based on 1) what we know of Germans, 2) what we know of "Mediterranean people" (Greeks, Italians and Spaniards), and 3) what we believe they think of each other, it is difficult for us to imagine that Germans will generously dig deep into their pockets, or let the printing presses work overtime, to save the Greeks. That is because the Germans are pretty tight-fisted, and the Germans and Greeks don't like or respect each other. In fact, most Germans are probably secretly saying to themselves that the Greeks deserve what is happening to them, and that they will be damned if they will support them. As a result, we think that it will be both politically difficult and repugnant to the German leadership to provide much help to Greece. Also, based on our memory of how the Germans in the West dealt with financial problems of the Germans in the East after the Wall came down, and what we know they think the lessons of that experience were (i.e., that such support is terribly costly), we find it difficult to imagine that their per capita support to the Greeks will be more than a fraction of what they would now be willing to provide fellow Germans.

If these were the only considerations, we think that the Germans would probably turn their backs on the Greeks, but they are not. We know that the Germans, like most others in Europe, worry that a debt problem in Greece could lead them to be faced with the same questions for Spain (and other

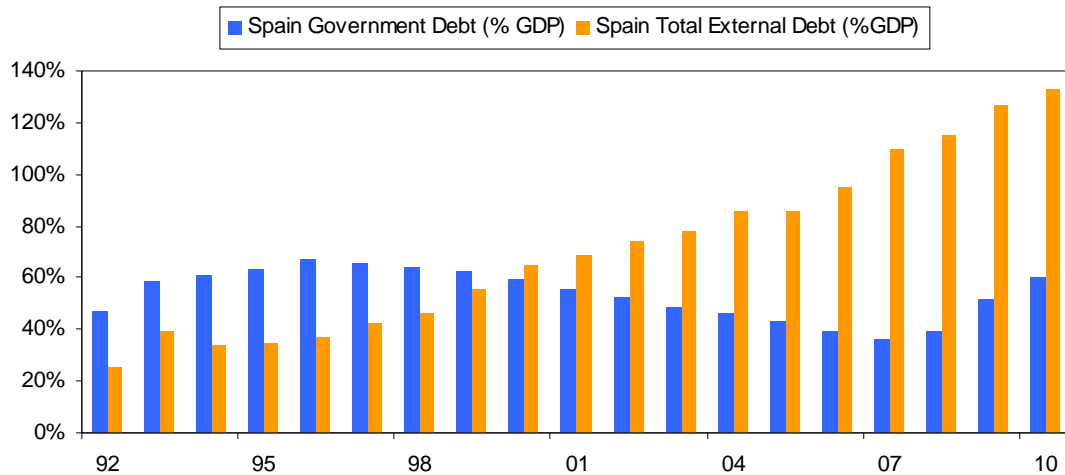
Mediterranean countries), so they are motivated to reduce the risks of the Greek situation causing "contagion" elsewhere. Also, they know that German and other lenders relevant to Germany's well-being have debt exposures to the Greeks, though that isn't a big consideration because it would be more efficient to provide assistance to the relevant creditors directly.

Also we judge the decision-making process in Europe to be fragmented, so there is no clarity about who should bear what share of the burden and how; while everyone wants to do as little as possible. For these reasons and a few others that we don't care to discuss, it is difficult for us to imagine that the Germans will provide enough to allow the Greeks to keep doing anything like what they were doing. For this reason, it seems probable that something more structural will have to take place that will cause pain for both the debtors and creditors. Said differently, we doubt that this crisis is about to be resolved through the support of the Germans. Concerning what form of assistance will be forthcoming, we think it will be mostly guarantees. That seems the least offensive way of providing assistance, because the Germans then don't have to ship the Greeks cash that either the ECB would have to print or the German government would have to get from the German people via taxes. In short, for these reasons, our guess is that the Germans will provide relatively paltry loan guarantees. However, as mentioned, that's just our guess. And we don't think that however it turns out will, in and of itself, be all that important (because it appears to us that saving Greece from a debt crisis won't save the others from their debt crises).

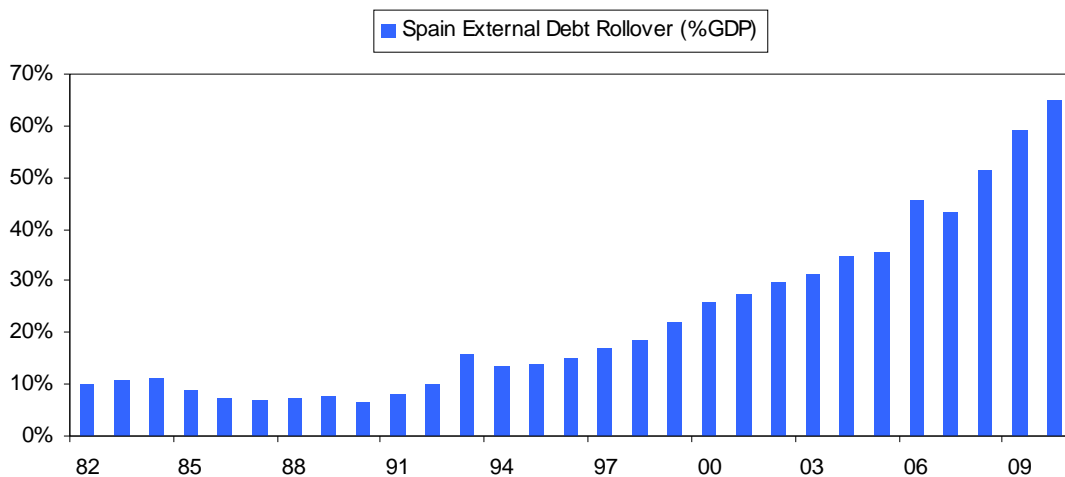
So now, for a moment, let's forget that there is a Greece and just look at Spain's debt situation. As mentioned in other *Observations*, Spain had experienced very fast debt growth that fueled its economic growth and asset bubbles and led to its over-indebtedness, which led its economy to contract and asset values to fall, which caused private sector credit growth to fall and the economy to contract. In a fiat monetary system in which the country (in this case, Spain) can print money, the central bank inevitably creates enough money to make up for the reduced amount of debt growth, and the central government runs budget deficits which are largely funded via money printing. However, in Spain's case (and in the case of other Eurozone debtor countries) this is not possible; so the choice is between severe austerity and borrowing a lot of money -- i.e., Spain's having the euro as its currency is akin to its being on the gold standard. As expected, the Spanish government decided to run big budget deficits that have been funded with big borrowings, but the more the debt increases, the closer this approach is to coming to an end. As of now, conditions are tenuous but acceptable because most investors a) are used to thinking of Spain as being safe and not having wide credit spreads and b) have been inclined to pick up yield by holding debt that was generally considered safe, so they funded these deficits with narrow credit spreads.

We do a lot of work estimating what a country's credit spreads should be in light of its cash flows and asset values and have made more than a few bucks doing this. Based on these criteria, we judge Spain's actual credit spread to be just about the narrowest relative to what it should be on the basis of its fundamentals -- i.e., the spread is 1.4%, and we would assess the fundamentals to warrant it to be 6.5%, on the basis of fundamentals alone. We judge Spanish sovereign credit to be much riskier than is discounted because it seems to us that there is a high risk that Spain won't be able to sell the debt that it needs to fund its deficits, and there is virtually no chance that the government can cut spending (nor does it want to). That is because a lot of debt is coming due; the Zapatero government is weak, very socialist and supported by a collection of factions (e.g., those in states seeking independence); and the Spanish people are now politically fragmented and only care about what money the government is going to give them. Also, the private sector debt problems have largely been kept under the rug rather than dealt with via restructurings. In other words, 1) Spain has big debt/deficit problems; 2) it is not dealing with these problems by doing the tough, forthright things to alleviate them; 3) it doesn't have the printing press to avoid the risk of default (unless the ECB helps them); and 4) it has a narrow credit spread. Situations like this, in the past, have been associated with both debt rollover and capital flight problems.

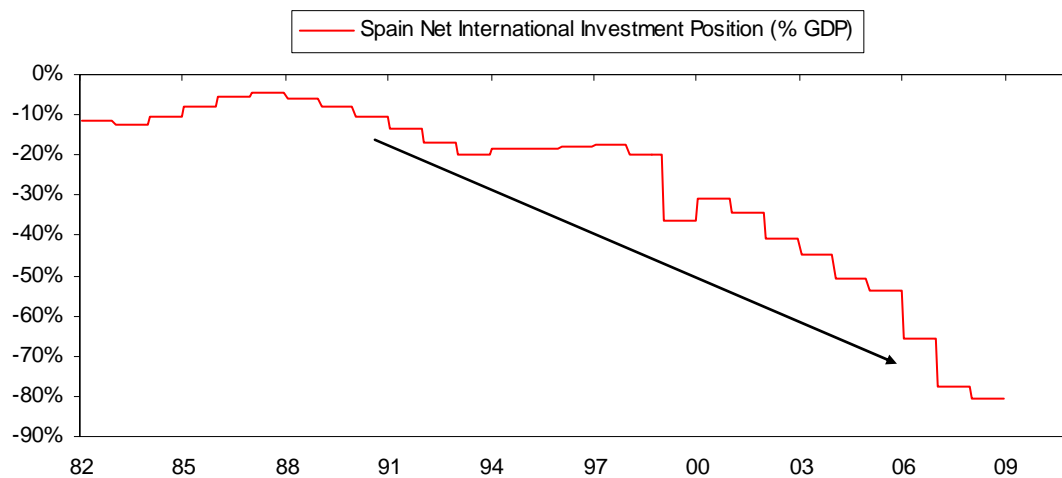
The following charts convey this picture. First we show the surge in external debt that has financed the boom in Spain and is now necessary to prevent a collapse. The debt is quickly shifting from the private sector to the government.



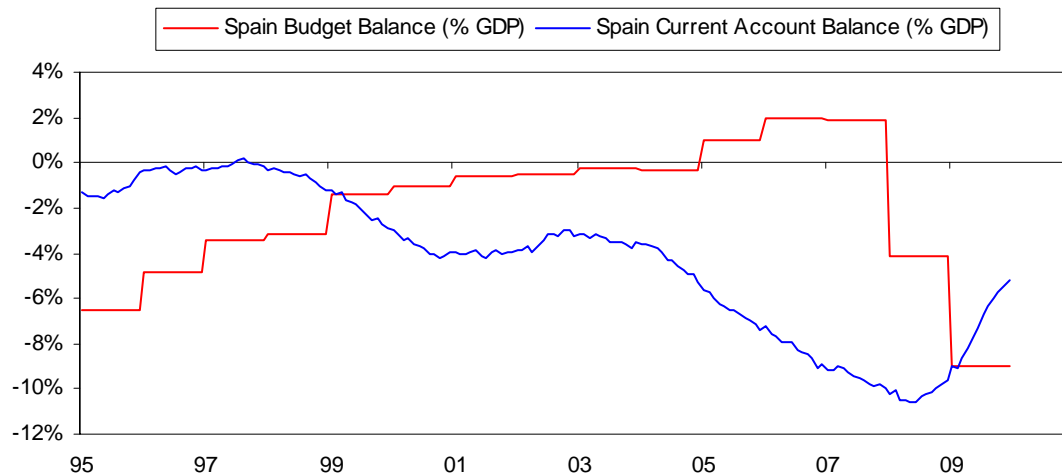
The size and nature of this debt requires a huge burden to be rolled over the next 12 months, and this burden is surging.



Spain's external debts, have exploded without a significant offset of external assets. On net, Spain owes the world about 80% of GDP more than it has external assets. As a frame of reference, the degree of net external debt Spain has piled up in a currency it cannot print has few historical precedents among significant countries and is akin to the level of reparations imposed on Germany after World War I. We don't know of precedents for these types of external imbalances being paid back in real terms.



On top of the debt that needs to be rolled, Spain's cash flows (current account and budget deficit) are extremely bad. Spain's current living standards are reliant not just on the roll of old debt, but also on significant further external lending.

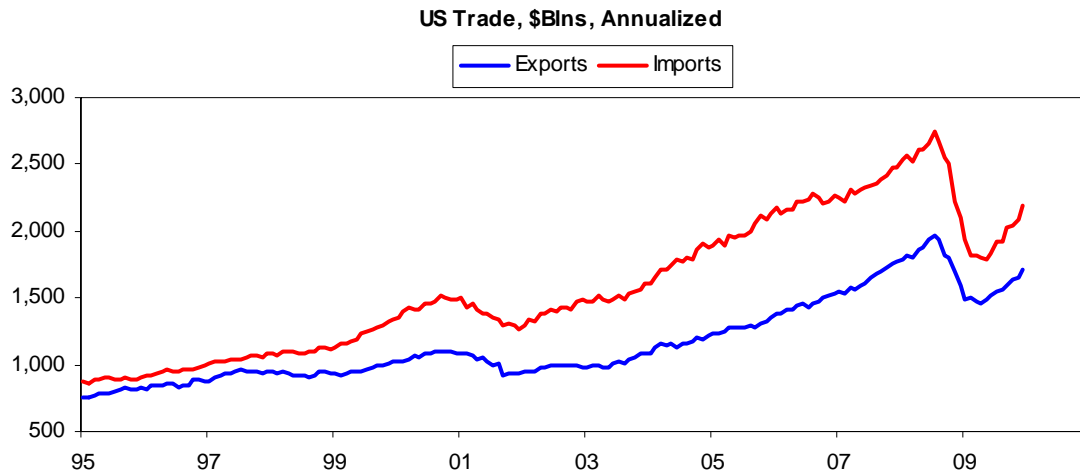


For these reasons, we don't want to hold Spanish debt at these spreads.

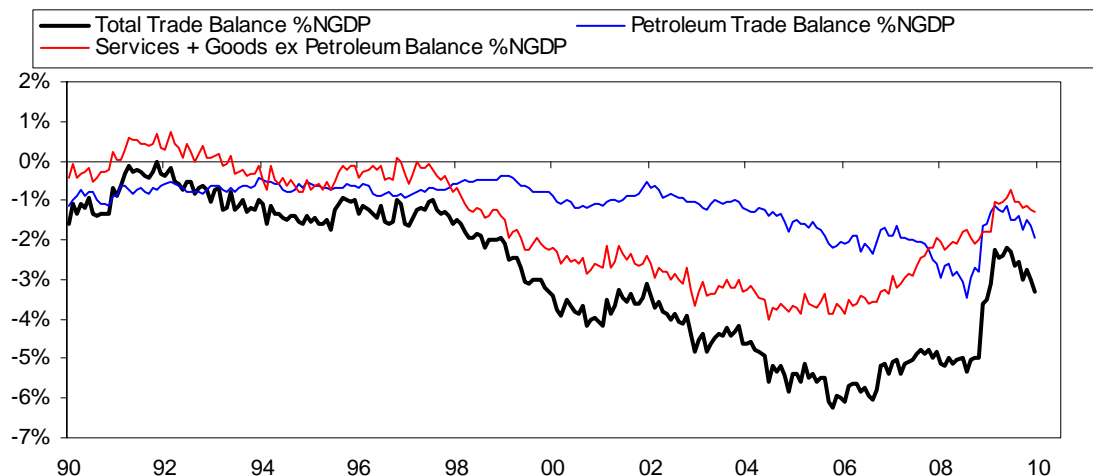
United States

Figures released Wednesday showed that the US trade balance continued to deteriorate in December to minus 3.3% of GDP, in line with the deterioration seen in the past six months from the deficit lows of near minus 2.2% in May. Most of the decline so far has come from an increase in the oil deficit, which explains roughly 0.85% of the decline since the peak improvement point in the deficit. The level of exports and imports has rebounded over the last six months, consistent with improved growth for the US and its export partners and rising commodity prices. Figures continued to show strong growth in December, though most of the increased demand from the US was in real oil imports which unexpectedly jumped 14%. Despite the rebound in demand, the level of trade for the US and globally, however, remains at depressed levels relative to the peak.

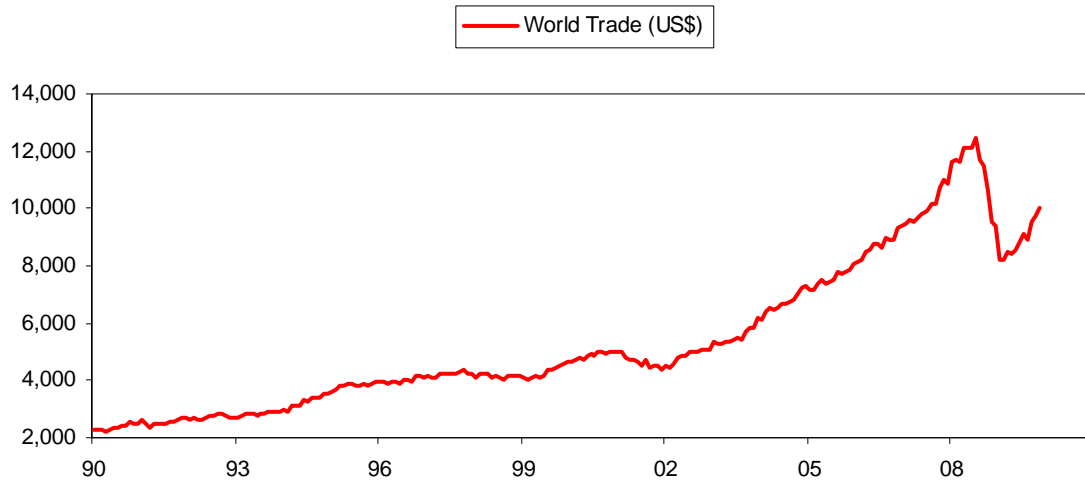
The first chart gives a picture of the level of imports and exports in dollar terms. Both imports and exports have recovered roughly half of the drop from pre-crisis levels. In the US, most of the rebound in imports has been driven by the rise in oil prices over the last six months (in fact real oil demand declined 7% over the period) and other commodities, along with a rebound in the real demand for autos, which has yet to moderate despite the rolling off of the cash-for-clunkers programs. On the other hand, increases in US exports have been relatively broad-based.



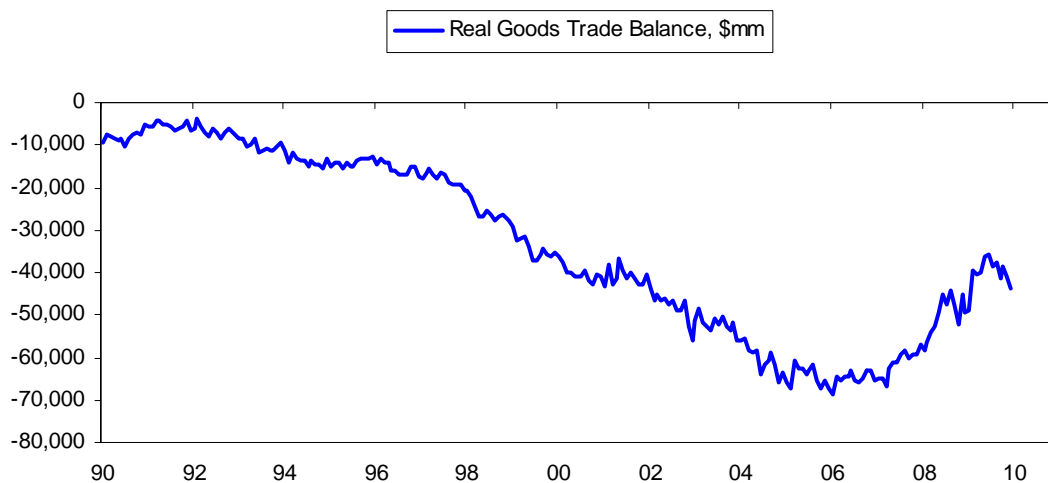
On a net basis, the trade balance has deteriorated by more than 1% of GDP from the bottom of the deficit. The chart below breaks out the drivers of the headline balance figures into oil and non-oil trade. As mentioned above, most of the decline is due to the oil balance.



On a global basis, the level of trade picture looks roughly the same as in the US. Improving global demand and the rise in commodity prices over the last six months have driven trade levels up quickly though from significantly depressed levels. So far, global trade in dollar terms has only recovered about 40% of the post-peak decline.



Similar to the nominal trade balance, the real trade balance continued to deteriorate in December, in line with the last several months. In addition, with the figures released on Wednesday, we have a complete picture of the impact of the real trade balance over the fourth quarter. From a technical perspective, it does look like net exports subtracted from real GDP growth over the fourth quarter, which is in contrast to the advanced GDP report released a few weeks ago, which showed a contribution of 0.5% of real GDP due to net exports. This doesn't materially change our view of underlying demand (as overall demand was reported in the GDP report), though it is likely to cause a modest downward revision on the next release of the GDP report.



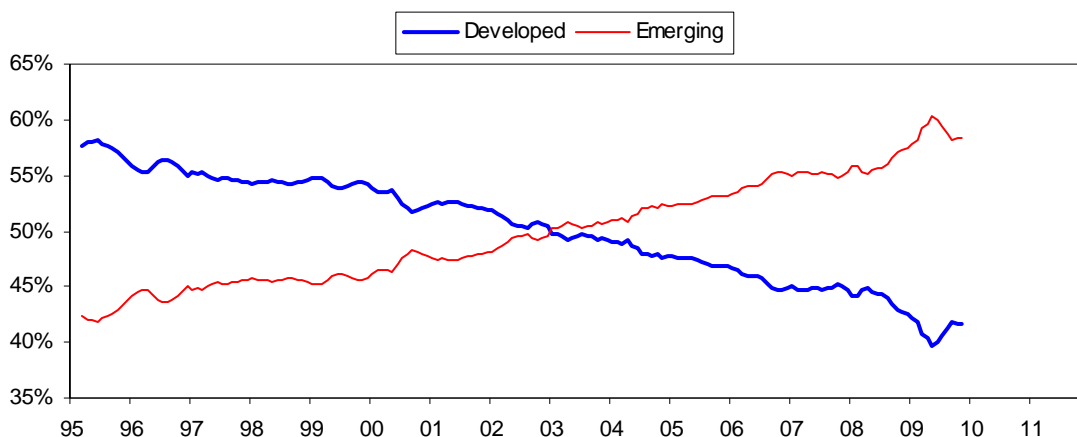
US import figures also provide some insight into the global competitiveness picture through time, since the US is such a material global consumer. The table below shows the import market share of the US by country. Developed countries' market share of US imports has deteriorated by 6% over the last five years, roughly representing the flip side of the increase in Chinese import market share of roughly 6%.

Market Share of US Non Commodity Imports

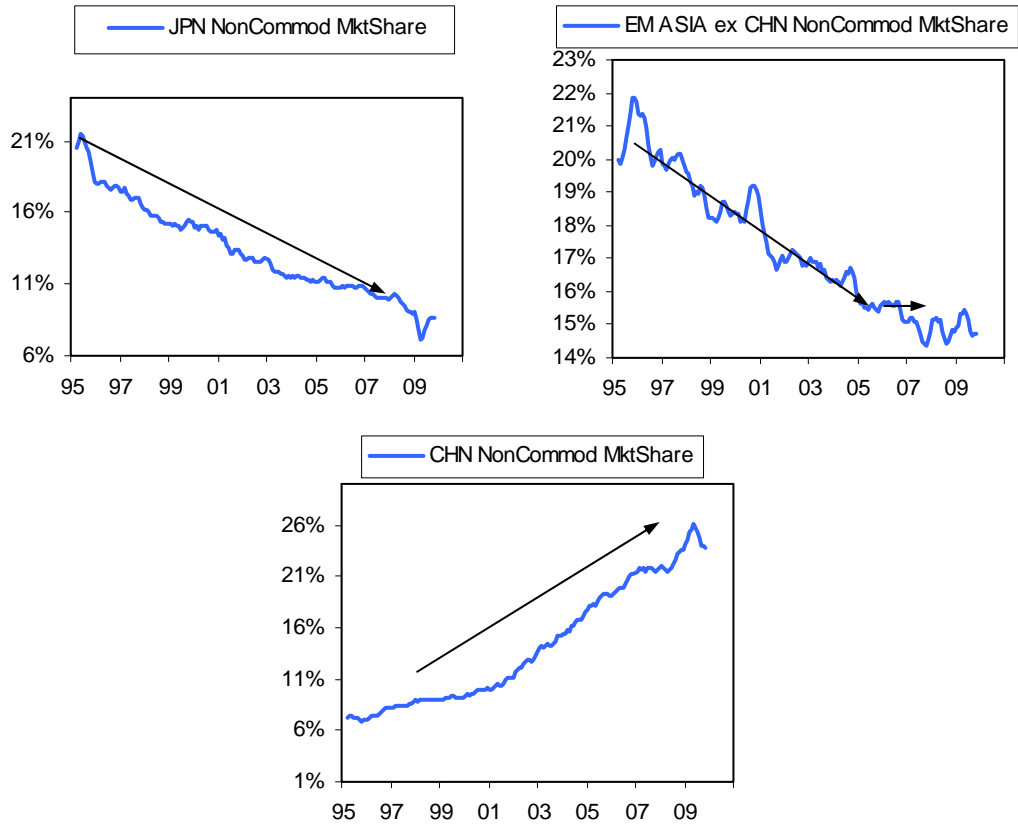
Region	Current	2 yr Chg	5 yr Chg
Developed Total	42%	-3.5%	-6.2%
EUR	16%	-0.3%	-0.3%
CAN	11%	-2.2%	-4.0%
JPN	9%	-1.3%	-2.6%
GBR	4%	0.2%	0.4%
Non-EUR W. Europe	3%	0.2%	0.2%
EM Total	58%	3.5%	6.2%
CHN	24%	2.1%	6.6%
EM ASIA ex CHN	15%	0.2%	-1.7%
MEX	12%	0.7%	1.3%
LatAm ex Mexico	2%	0.1%	-0.5%
EM Europe	1%	-0.1%	-0.1%
Other	4%	0.5%	0.7%

The emerging world gains in market share seen over the last 5 years have been roughly in line with the secular trend of the last 15 years.

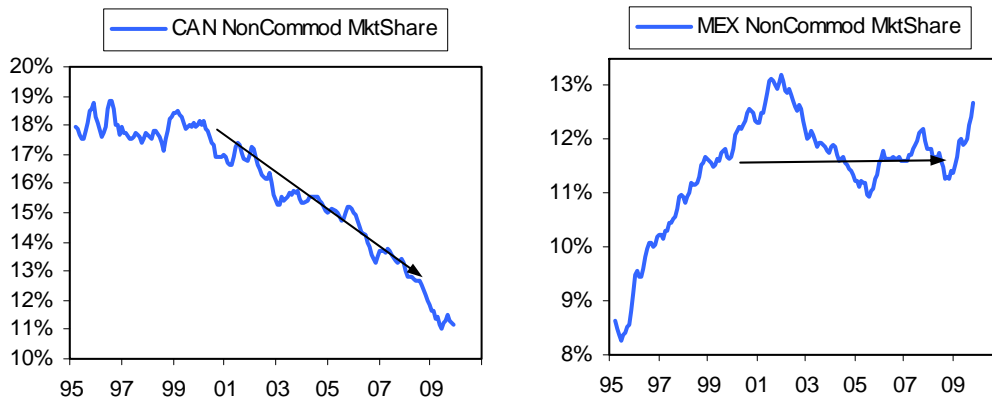
Country Share of US Non-Commodity Imports

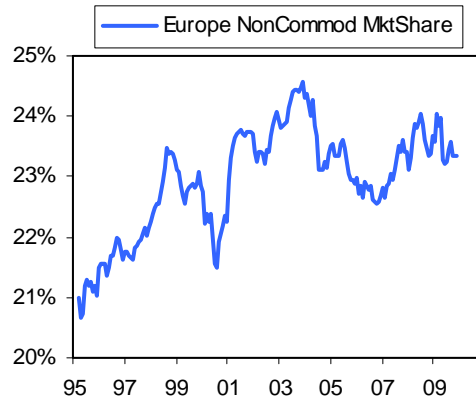


Part of what is allowing China to gain overall market share is taking it from its Asian counterparts. Both Japan and emerging Asia have experienced relatively significant declines in market share over the last 15 years, as China has rapidly gained share. These figures modestly exaggerate the picture as EM Asia's export pipeline drives more end-produced goods through China. There have been some signs of stabilization in the market share for the rest of emerging Asia over the last two years, which has been supported by the sharp declines in many of their currencies during the crisis period.



Scanning the rest of the major US import partners shows that Canada is losing market share relatively rapidly, which reflects just how uncompetitive their non-commodity export sector is relative to that of their competitors. Both Mexico and Euroland have continued to hold their market shares relatively steady over the last five years.



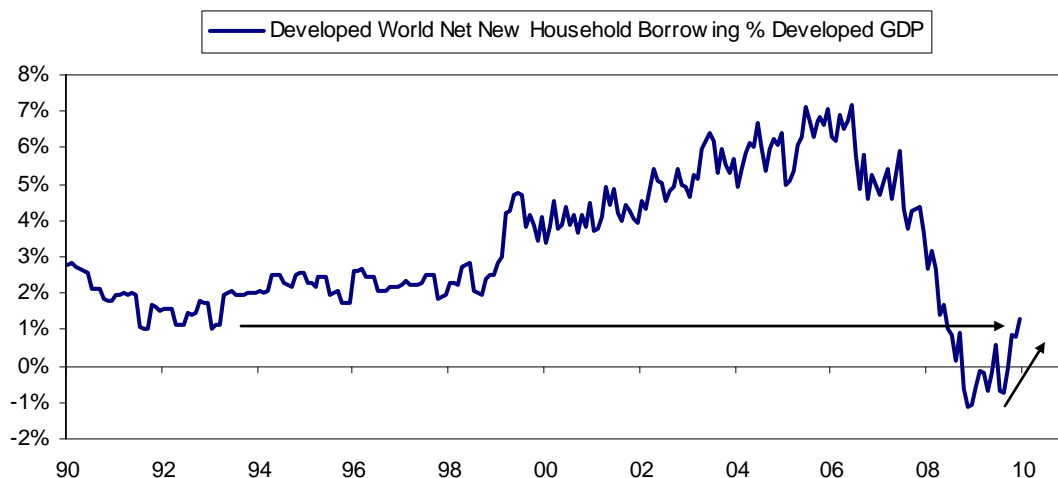


Other Industrialized Countries

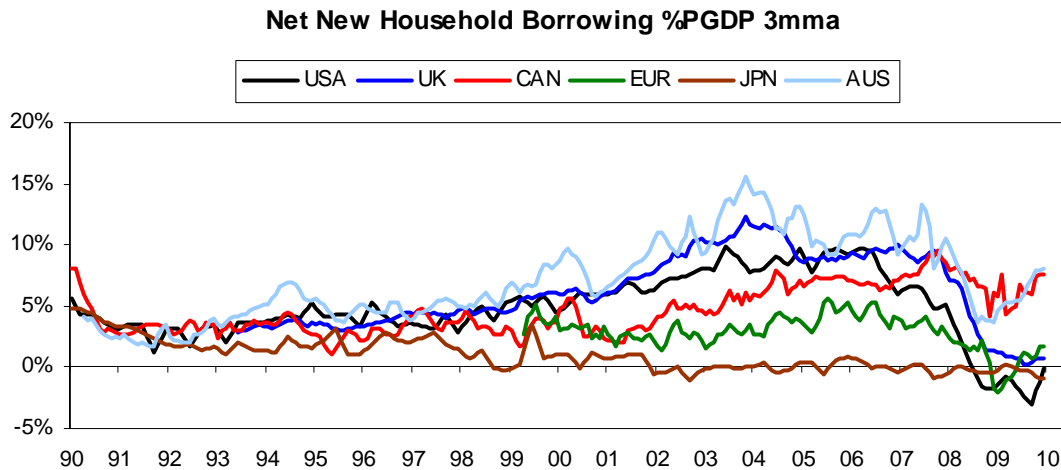
Update on Developed World Household Borrowing

In recent months, net new household borrowing has increased a bit, though the level of borrowing remains significantly lower than it was during the last expansion, and is as low as it has been at any other point in the last 20 years. Normally households respond to significant stimulation by increasing borrowing or decreasing savings. But for reasons we have described previously, including the significant debt overhang, their responsiveness has been low this time around. Going forward, the question is whether this rate of improvement will continue, sparking a self-reinforcing credit expansion. Borrowing conditions are clearly better for households as asset prices have improved off lows, employment conditions are gradually stabilizing and credit standards are easier. On the other hand, the massive government monetary and fiscal support around the globe is waning. If private sector credit growth does not continue to increase, there will not be enough economic activity to fill the void left by the government.

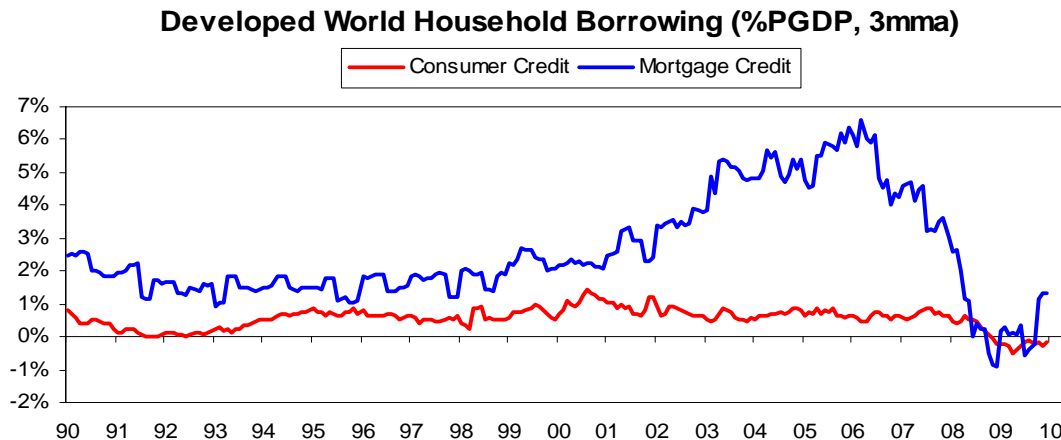
Below we start by showing aggregate household borrowing in the developed world.



When we go country by country, the picture is mixed. The US (the country with the largest debt overhang) has recently stopped contracting and is now at roughly 0% credit growth. The UK, which had similar debt dynamics as the US, is also floundering at about 0% growth. Euroland has shown a bit of a better improvement of late and is now growing at about 2%, which is still as low as at any other point in the last decade. By contrast, Canada and Australia never saw the same slowing of borrowing during the crisis and both continue to strengthen to near peak levels over the last several months.

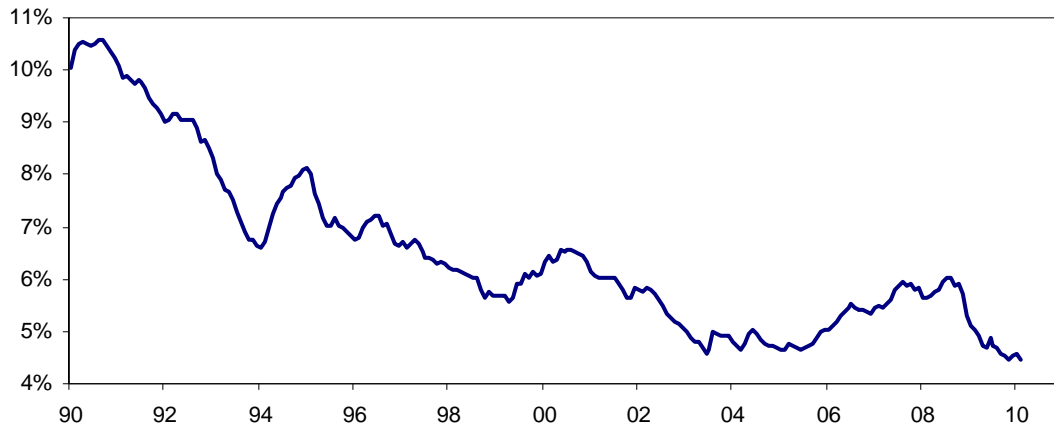


Going into the components of household borrowing, the majority of the improvement in net credit flows has come from mortgage credit (which is the lion's share of household borrowing). Consumer credit is still contracting on a developed-world basis.



In terms of conditions for future credit growth, conditions are increasingly accommodative. First, mortgage rates have fallen significantly and are at their historical lows. Rates are now down 150 bps across the developed world.

Developed World Mortgage Rate

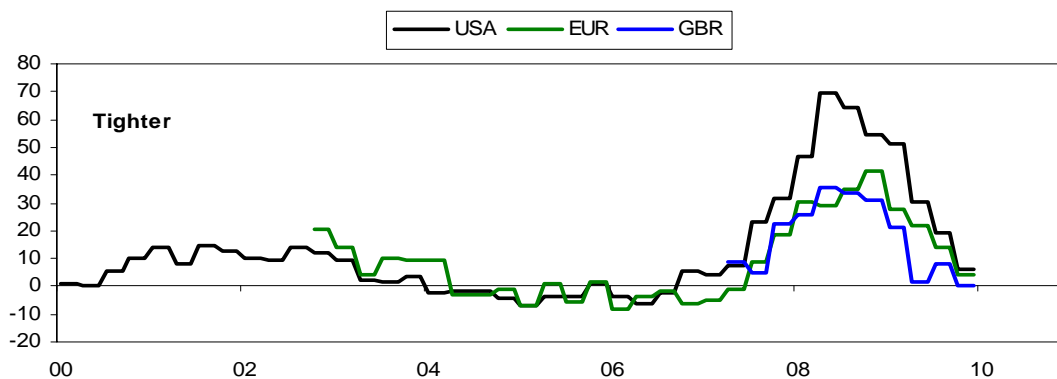


Further, every country in the developed world is still far below its peak level of rates. Also, every country is at or near its low in mortgage rates, except for Australia where the RBA has already begun to tighten.

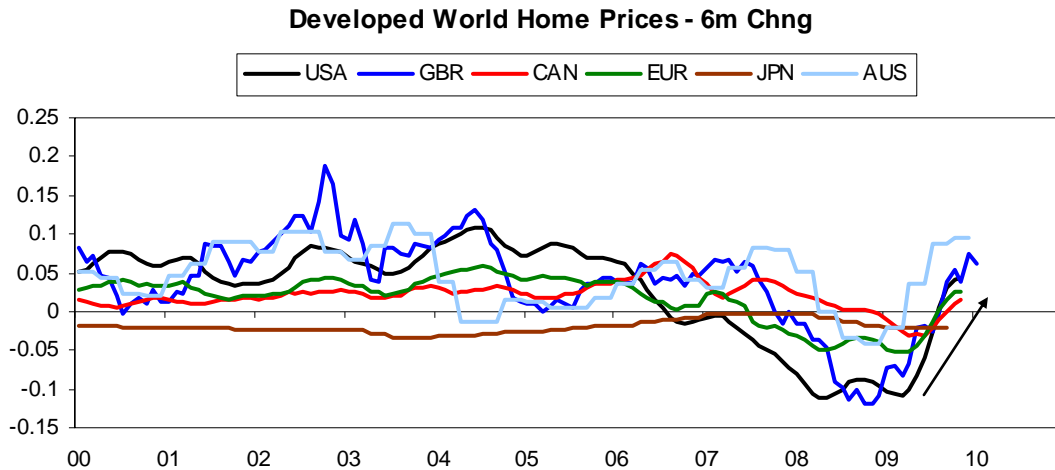
Developed World Mortgage Rates			
	Current	Peak (6/30/2007)	Change From Peak
USA	5.1%	6.6%	-1.4%
GBR	4.3%	6.6%	-2.3%
CAN	5.5%	7.2%	-1.8%
EUR	4.0%	5.2%	-1.2%
JPN	3.1%	3.5%	-0.5%
AUS	6.6%	8.0%	-1.4%

Meanwhile, banks have nearly stopped tightening standards, but are still not net easing them. After the significant tightening of standards in the last two years, banks' standards are a lot tighter than they were before the crisis. In many cases the amount of net borrowing that is taking place is only possible with significant government support.

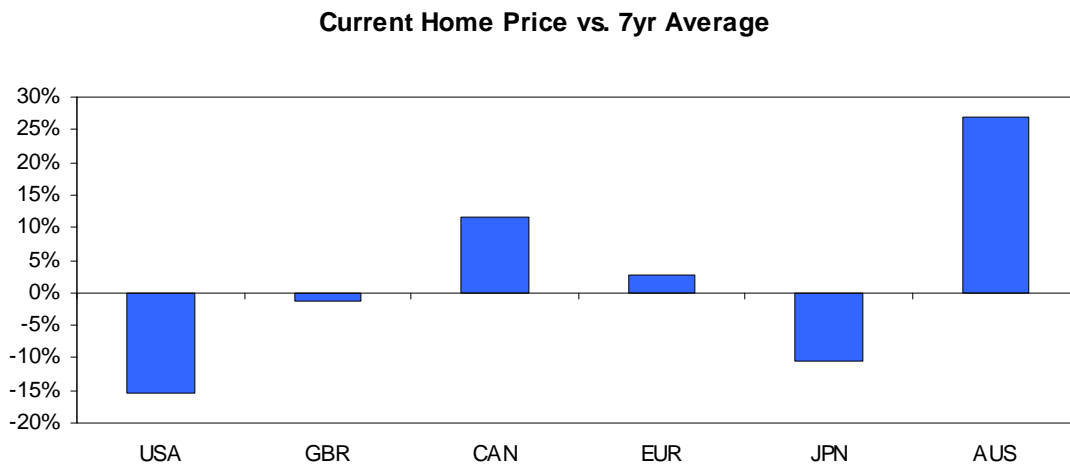
Credit Standards - Lending to Households



This easing of rates, printing of money, and various forms of fiscal support have created a stabilization of home prices globally. Every country in the developed world except Japan now has increasing home prices. Australia and the UK have seen prices increase in the last six months as fast as they did in the boom. This trend will be supportive for borrowing in the near term. Home prices are still down a lot from peak in some countries (such as the US and Japan), while they are making new highs in Canada and Australia.



In the US, prices are still down 30% from peak, leaving a significant portion of borrowers underwater with no equity to leverage in their homes. Likewise, Japan continues its secular decline in asset prices with no sign of a turn. The UK is in a similar but slightly better situation, with prices down 10% from peak. Canada and Euroland are both back to peak levels of prices, but have not seen any material appreciation. Australia has seen prices rise rapidly of late, further supporting their mortgage boom.



Improving asset prices, low rates, and stabilizing employment are all significant positive changes to the household borrowing picture. So far the response to these changes, while noticeable, has been fairly muted relative to the normal cycle. Going forward, the question is whether household borrowing will continue its rate of improvement and will do enough to offset the intended reduction in government fiscal and monetary support to growth.

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