HOW THE ECONOMIC MACHINE WORKS

In lieu of a traditional quarterly investor letter I’ve decided instead to share a link to an animated video that I think everyone should watch, along with a summary of what I believe are the most important points. The animated video was produced and narrated by Ray Dalio, founder of the institutional investment management firm Bridgewater Associates, which manages more than $150 billion in client assets. The video, titled “How the Economic Machine Works” is available here:

www.economicprinciples.org

Ray Dalio presents the viewer with a host of important concepts in a surprisingly simple fashion. I believe that all investors (i.e., our clients) will benefit from watching the 30 minute video and contemplating the attendant investment implications. Dalio’s video uniquely summarizes consumer spending, credit, deficits, interest rates, inflation, economic growth, and recession and provides investors with a solid understanding for how a handful of key variables drive the economy and prices of assets, such as stocks and real estate.

I am somewhat reluctant to provide my own list of the most important lessons from the video because I don’t want our readers to assume that reading my summary is a sufficient substitute for watching the video. Please do not read the list below and assume that I have covered all of the critical points conveyed in the video because I haven’t. Dalio’s short video is extremely informative – and enjoyable! – and I am certain that anyone who spends the time to watch it will benefit from it.

My top 10 takeaways from the video are:

1. One person’s spending is another person’s income – it’s that simple. And, each time one of us spends we can do so by using one of two things: money or credit.

2. Credit cycles, both short and long-term cycles, are the single greatest driver of economic booms and busts.

3. In the absence of credit cycles the economy would grow in a remarkably predictable and stable fashion; we wouldn’t have asset bubbles, booms or busts. Therefore, understanding the credit cycle is the single most important thing for investors to master when trying to understand the economic cycle.

4. Credit isn’t inherently bad when it’s used to finance productive enterprise; credit is bad when it is used to finance unproductive enterprise and to enable the overconsumption of goods and services, which is exactly what happened in the recent housing bubble.

5. In addition to driving economic cycles, credit creation propels asset price bubbles and the inevitable endgame – asset collapses. History has demonstrated this phenomena over and over again in the stock markets and real estate markets.

6. When we have too much credit creation (i.e., too much debt or leverage) the unavoidable outcome is that we
7. There are only four ways to de-lever after a period of excess credit (i.e., get through our hangover): austerity, debt restructuring, wealth redistribution, or money printing.

8. Fiscal austerity (i.e., Europe’s response to its fiscal problems in the past few years) doesn’t work as well as people think it should. This is because each dollar of government spending is a dollar of income for someone else. So, any reduction in government spending leads to reduced income and reduced economic activity.

9. Historically, debt deleveraging has led to economic and social instability. Resentment between the “haves” and “have nots” leads to political upheaval and revolution. Think about Germany in the 1930’s, or better yet, think about the political division in the United States in the past 6 years.

10. There are three things that all individuals, corporations, and governments should do to manage the risks of credit cycle:
   a. Don’t allow debt to rise faster than income, otherwise your debt burdens will eventually crush you.
   b. Don’t allow income to rise faster than productivity, or you will eventually become uncompetitive.
   c. Do everything possible to raise productivity, because in the long run this is what matters most for economic growth and improved standards of living.

I’ve written about many of these concepts in the past, but the animated video simply does a fabulous job of summarizing the key variables in a way that anyone could understand. As investors, it is important to understand that we have been living through a global deleveraging for the past 6 years and it will continue for many years more. Within the U.S. economy itself we’ve had various measures of austerity, debt restructuring, wealth redistribution, and we’ve certainly had a tremendous amount of money printing as the Federal Reserve continues to purchase tens of billions of dollars worth of mortgage-backed securities and treasury bonds each month.

Whether or not the U.S. economy successfully navigates its way out of the current deleveraging cycle will largely depend upon the balance of all measures – austerity, restructuring, redistribution, and money printing – what the video refers to as a “beautiful deleveraging.” By most measures this appears to be where we are today, but it remains to be seen if the economy will ultimately reenter a benign inflationary phase, an unstable inflationary phase, or perhaps remain mired in a low-growth disinflationary phase for a very long time as has happened in Japan. Furthermore, as we’ve discussed in the past, future economic growth will be materially impacted by the demographics of our population and labor force – i.e. an aging population and shrinking percentage of people who work – both of which are proceeding in the wrong but unavoidable direction.

I hope that you all benefit from watching the video and, as always, clients of the firm are encouraged to call or write with any specific questions that they may have about this letter or the investments we manage on their behalf.

Sincerely,
Ian McAbeer, CFA