

Bridgewater®

Daily Observations

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Great Moves!

The Treasury, Fed, and Congress finally agreed to agree to build the safety net!!!!

Overnight central banks added \$180 billion in liquidity!

Regulators moved against short sellers.

Morgan Stanley was frozen and is about to be dealt with, and Goldman isn't far behind, but moves are in the works to deal with them.

The Near Term:

The Safety Net: The most fundamental question we have had and, in our opinion, the Fed should have, is whether financial institutions will be kept intact (via sale, refinancing, or being taken over by the government) – as Bear, the GSEs, Merrill, and AIG were – or if they will be allowed to fail (as Lehman was). That is because, if they are allowed to fail, their assets will have to be dumped, large losses on their paper will occur in places that would be bad (e.g., in money market funds), and failed counterparty/derivatives exposures will probably cause huge problems – so the effects will be catastrophic. We have only seen a small fraction of what that catastrophe will be like as a result of them letting Lehman fail, and what we have is borderline catastrophic. If instead these firms are kept intact, these things won't happen, or they will happen in a much slower, more manageable way. So, there really is no choice. I presume that the folks at the Fed, Treasury, and Congress now see this and that they are going to do what needs to be done. But, it is not yet certain that this will be enough.

The mergers and private market refinancings of these financial institutions are of course the best ways to keep them intact because they will be kept off the government's books. But if these don't happen, failing institutions must go into a safety net so that they continue to function until they are restructured. As the Fed is the only safety net in place at this time, either a) the Fed will take financial responsibility for those institutions that are both in trouble and can't be sold or refinanced, or b) we will have a meltdown. As mentioned, I believe that the Fed knows this and will operate consistent with this "keep them intact" approach. I think there's better than an 80% chance of them playing the role of the safety net for important U.S. financial institutions that would otherwise go into bankruptcy and less than a 20% chance of them not doing this and the worst case scenario happening until some other safety net gets built. As prospects for this new safety net have been announced (though none of its particulars), it's very likely that the Fed will operate consistent with this compelling necessity until the new organization is operative.

Not only will following this path keep the deleveraging related to these institutions much more orderly, but it will significantly reduce the risks of the credit contractions elsewhere in the economy becoming disastrous. There is a lot of debt that is coming due and that needs to be rolled over. If the meltdown of financial firms happens at the same time as these debts have to be rolled, there is a good chance that the liquidity problem will extend broadly to other debtors. We are watching the rollovers in order to understand this impact and to stay away from those institutions that could have problems via the following tables.

The first table shows US financial firms. We highlighted those companies that are not backed by the US government or already bankrupt and that have short term debt that exceeds their cash on hand.

At end of 2Q 08. All financial firms with over \$10bn in debt due within one year.				
Company	Debt due within 1Yr, \$bn	Cash & Cash Equivalents, \$bn	Ratio of ST Debt / Cash	Total Assets
JPMORGAN CHASE & CO	\$434	\$288	1.5	\$2,175
CITIGROUP INC	\$434	\$333	1.3	\$2,100
BANK OF AMERICA CORP	\$416	\$154	2.7	\$1,717
MERRILL LYNCH & CO INC	\$402	\$282	1.4	\$966
GOLDMAN SACHS GROUP INC	\$397	\$230	1.7	\$1,088
MORGAN STANLEY	\$358	\$243	1.5	\$1,031
LEHMAN BROTHERS HOLDINGS INC	\$329	\$189	1.7	\$600
FEDERAL HOME LOAN MORTG CORP	\$326	\$218	1.5	\$879
FANNIE MAE	\$241	\$49	4.9	\$886
WELLS FARGO & CO	\$86	\$18	4.9	\$609
WACHOVIA CORP	\$55	\$47	1.2	\$812
AMERICAN INTERNATIONAL GROUP	\$52	\$120	0.4	\$1,050
ANNALY CAPITAL MANAGMENT INC	\$52	\$2	33.8	\$61
U S BANCORP	\$41	\$8	5.2	\$247
SLM CORP	\$37	\$9	4.2	\$164
PRUDENTIAL FINANCIAL INC	\$22	\$35	0.6	\$475
STATE STREET CORP	\$21	\$41	0.5	\$146
COUNTRYWIDE FINANCIAL CORP	\$20	\$35	0.6	\$199
REGIONS FINANCIAL CORP	\$18	\$4	4.2	\$144
AMERICAN EXPRESS CO	\$18	\$20	0.9	\$137
NATIONAL CITY CORP	\$14	\$9	1.5	\$154
STUDENT LOAN CORP	\$12	\$0	17,990.2	\$25
JEFFERIES GROUP INC	\$12	\$7	1.7	\$25
HUDSON CITY BANCORP INC	\$12	\$0	62.6	\$49
SUNTRUST BANKS INC	\$11	\$6	2.0	\$177
BB&T CORP	\$11	\$3	3.8	\$136
Total	\$3,829	\$2,349	1.6	\$16,054
Total Financial Firms	\$3,983	\$2,796	1.4	\$21,808

The next table shows US non-financial corporations' short-term debts. Note GE's numbers.

At end of 2Q 08. All nonfinancial firms with over \$5bn in debt due within one year.					
Company	Debt due within 1Yr, \$bn	Cash & Cash Equivalents, \$bn	Ratio of Short Term Debt / Cash	Total Assets	
GENERAL ELECTRIC CO	\$205	\$65	3.16	\$847	
AT&T INC	\$16	\$2	10.10	\$285	
CATERPILLAR INC	\$13	\$1	15.38	\$60	
PROCTER & GAMBLE CO	\$13	\$4	3.70	\$144	
INTL BUSINESS MACHINES CORP	\$13	\$10	1.29	\$121	
DEERE & CO	\$10	\$3	3.58	\$42	
PFIZER INC	\$9	\$26	0.36	\$117	
VERIZON COMMUNICATIONS INC	\$9	\$2	4.50	\$201	
COCA-COLA CO	\$8	\$7	1.21	\$48	
GENERAL MOTORS CORP	\$8	\$21	0.39	\$136	
WAL-MART STORES INC	\$7	\$7	0.99	\$167	
ABBOTT LABORATORIES	\$5	\$5	1.05	\$44	
JOHNSON & JOHNSON	\$5	\$13	0.39	\$88	
FIRSTENERGY CORP	\$5	\$0	73.09	\$34	
INGERSOLL-RAND CO LTD	\$5	\$1	6.06	\$26	
Total	\$333	\$165	2.01	\$2,358	
Total Non-Financial Firms	\$586	\$993	0.59	\$11,532	

The following table shows what the next few weeks look like in aggregate in terms of the amount of debt that is coming due and will need to be rolled over. Financial firms will need to roll \$5.5bn of debt on Monday and nonfinancial firms will need to roll over \$1.5bn of debt on Tuesday. Larger amounts of debt will come due on October 1st and October 15th, including bonds issued by major US retailers, manufacturers, energy companies, car companies, etc.

\$bn of US debt maturing				
		Non-Financial	Financial	Total
Thursday	9/18/2008	\$0.0	\$0.0	\$0.0
Friday	9/19/2008	\$0.1	\$0.2	\$0.3
Monday	9/22/2008	\$0.0	\$5.5	\$5.5
Tuesday	9/23/2008	\$1.5	\$1.4	\$2.9
Wednesday	9/24/2008	\$0.1	\$0.0	\$0.1
Thursday	9/25/2008	\$3.1	\$1.8	\$4.9
Friday	9/26/2008	\$0.1	\$0.5	\$0.6
Monday	9/29/2008	\$0.2	\$2.2	\$2.4
Tuesday	9/30/2008	\$1.2	\$2.2	\$3.4
Wednesday	10/1/2008	\$13.9	\$2.5	\$16.4
Thursday	10/2/2008	\$0.1	\$3.0	\$3.1
Friday	10/3/2008	\$0.0	\$5.6	\$5.6
Monday	10/6/2008	\$0.3	\$2.3	\$2.6
Tuesday	10/7/2008	\$0.1	\$0.0	\$0.1
Wednesday	10/8/2008	\$0.0	\$0.0	\$0.0
Thursday	10/9/2008	\$0.2	\$1.2	\$1.4
Friday	10/10/2008	\$0.2	\$0.4	\$0.6
Monday	10/13/2008	\$0.0	\$0.0	\$0.0
Tuesday	10/14/2008	\$0.0	\$0.9	\$0.9
Wednesday	10/15/2008	\$6.5	\$12.6	\$19.1

And the next table shows the short-term external debt burden for several emerging market countries, as well as the reserves available for these countries to pay off the debt if they cannot roll it over. There are 12 emerging countries that have more short-term debt than external reserves.

Short Term External Debt of Emerging Countries (\$Blns)							
Country	Total Debt	of which Public Debt	Total ST Debt	Total Debt Service	Total ST Debt + Debt Service	External Reserves	ST Debt + Debt Service % Reserves
Turkey	\$298.8	\$97.1	\$53.4	\$66.7	\$120.0	\$75.5	159%
Hungary	\$164.7	\$60.2	\$24.0	\$18.7	\$42.7	\$27.1	158%
Israel	\$93.2	\$36.5	\$37.0	\$8.6	\$45.6	\$32.5	140%
Slovakia	\$51.7	\$11.1	\$23.2	\$3.2	\$26.4	\$18.9	140%
Lebanon	\$30.8	\$17.5	\$13.8	\$5.5	\$19.3	\$13.8	140%
Jordan	\$14.0	\$6.9	\$8.5	\$0.5	\$9.0	\$6.7	133%
Romania	\$95.8	\$25.3	\$35.8	\$9.2	\$45.0	\$39.3	114%
Bulgaria	\$48.0	\$9.3	\$14.4	\$6.4	\$20.8	\$19.6	106%
Uruguay	\$15.4	\$11.6	\$4.6	\$1.8	\$6.4	\$6.1	105%
South Africa	\$81.5	\$53.9	\$24.0	\$7.4	\$31.3	\$30.7	102%
Ukraine	\$84.2	\$30.5	\$29.2	\$5.8	\$35.0	\$34.7	101%
Czech Republic	\$83.4	\$17.0	\$28.9	\$9.0	\$37.9	\$37.6	101%
Croatia	\$38.2	\$12.2	\$10.5	\$4.6	\$15.0	\$15.3	99%
Indonesia	\$139.1	\$85.8	\$33.0	\$19.2	\$52.1	\$55.1	95%
Mexico	\$163.8	\$101.8	\$34.5	\$35.2	\$69.7	\$94.5	74%
Ecuador	\$18.0	\$10.9	\$1.5	\$2.3	\$3.8	\$5.3	72%
Chile	\$48.8	\$11.0	\$8.5	\$5.8	\$14.3	\$20.0	72%
Argentina	\$160.7	\$104.2	\$20.2	\$9.9	\$30.1	\$45.4	66%
Venezuela	\$56.8	\$37.7	\$9.6	\$4.8	\$14.4	\$22.7	63%
Colombia	\$47.3	\$30.5	\$5.8	\$6.4	\$12.2	\$21.9	56%
Brazil	\$277.1	\$79.6	\$66.9	\$41.7	\$108.6	\$199.8	54%
Poland	\$260.9	\$101.2	\$20.9	\$22.5	\$43.4	\$81.7	53%
Korea	\$240.6	\$20.0	\$97.2	\$27.6	\$124.8	\$242.7	51%
Philippines	\$62.4	\$35.3	\$7.8	\$8.2	\$16.0	\$32.6	49%
Peru	\$31.4	\$20.2	\$7.4	\$5.4	\$12.8	\$34.1	38%
Russia	\$555.4	\$68.7	\$142.4	\$58.2	\$200.7	\$581.6	34%
Thailand	\$63.6	\$12.0	\$24.8	\$8.0	\$32.8	\$103.0	32%
Malaysia	\$47.3	\$18.1	\$9.2	\$11.8	\$21.0	\$124.4	17%
China	\$413.1	\$38.6	\$248.7	\$29.5	\$278.2	\$1,756.7	16%

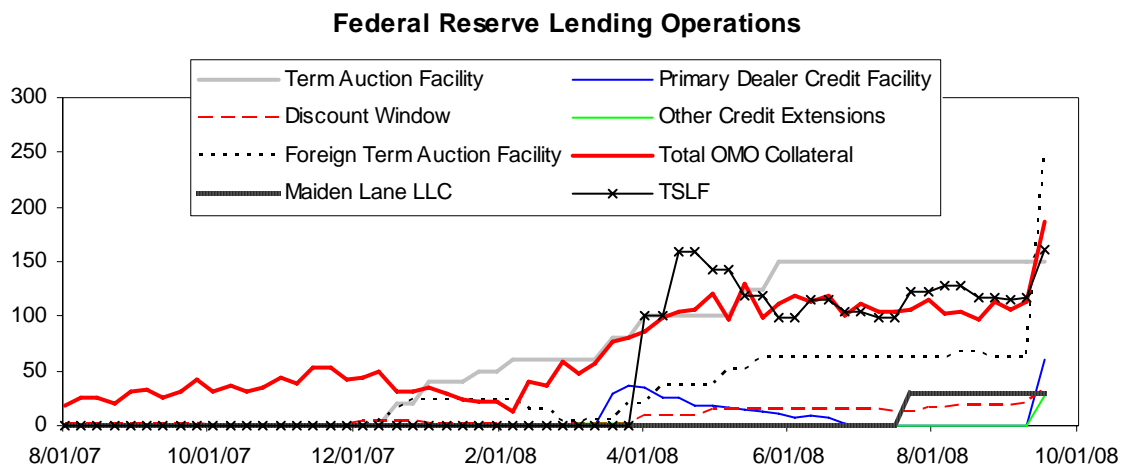
To be clear, if the Fed and Treasury do what they need to do (which we expect they will), it will reduce the risks of these rollovers going disastrously, but it won't eliminate it.

Adding Lots of Liquidity:

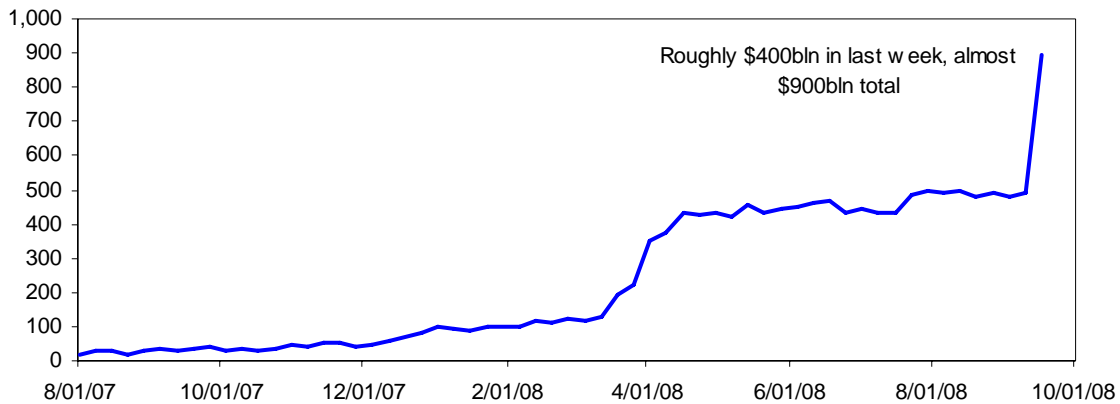
The Fed (and other central banks) is also responding strongly to the crisis by aggressively adding liquidity in exchange for a broad range of assets. The following table shows how the Fed's balance sheet has changed over the last year and over the last week.

Federal Reserve Balance Sheet Assets (\$blns)			
	1yr ago	Last week	Current
1) Treasury & Agencies Held Outright	779	480	480
1a) Note: Treasury Securities Lent to Dealers (including TSLF program)	0	118	126
1b) Treasuries currently held by Federal reserve (1 - 1a)	779	362	354
2) Repurchase Agreements (updated with Thursday's net OMO operations, \$92bln)	45	127	190
3) Term Auction Facility Loans	0	150	150
3a) Note: Non-Treasury / Agencies pledged as collateral for repos (lines 2 & 3) (also updated with Thursday's net OMO operations, \$73bln)	0	220	322
4) Discount Window Borrowing	7	23	34
5) Primary Dealer Credit Facility	0	0	60
6) Other Credit Extensions (includes AIG loan)	0	0	28
7) Net Portfolio Holdings of Maiden Lane LLC (Bear Stearns)	0	29	29
8) Other Federal Reserve Assets	40	99	101
9) Gold + SDRs + Currency	52	52	52
10) Total Assets	923	960	1,032
11) Other Central Bank TAF Auctions	0	67	247
Total Fed Lending Operations (1a + 3a + 4 + 5 + 6 + 7 + Other Central Bank TAF Auctions)	7	458	873

The following charts show each of the Fed lending operations over the past year and the total liquidity injections by the Fed over the past year.

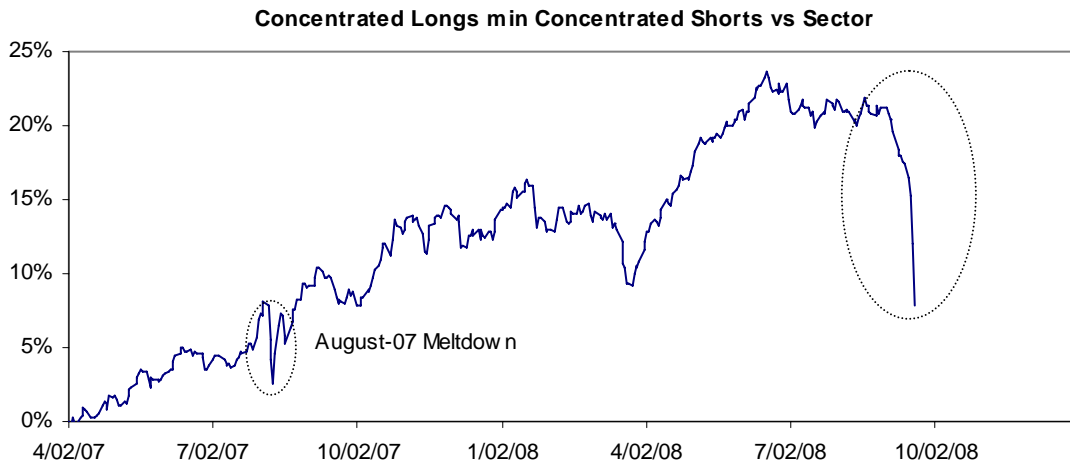


Federal Reserve Lending Operations (\$Blns)

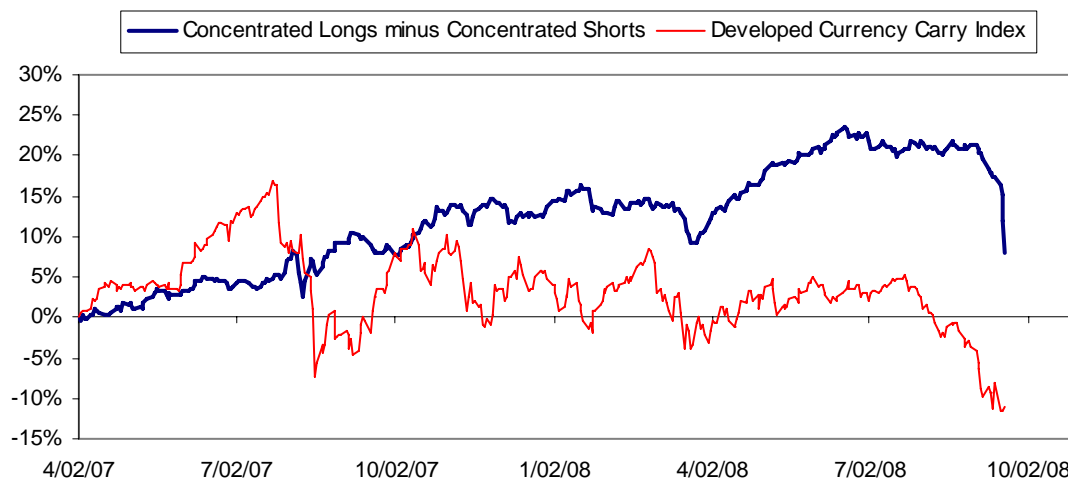


Regulators Moved Against Short Sellers: The deleveraging of hedge funds and rules against shorting isn't good for these hedge funds. Hedge funds have already been very squeezed in this environment.

One clear place that you can see the results of the deleveraging and the squeeze on hedge funds is in the price action of stocks that are heavily traded by them. The following chart shows the cumulative return of stocks that are substantially held by hedge funds relative to the return of stocks that are substantially shorted by hedge funds. Since the beginning of September, stocks with concentrated hedge fund longs have fallen by 14% relative to stocks with concentrated hedge fund shorts, with the bulk of that move happening since last Friday. The magnitude of this squeeze swamps the August 2007 squeeze in stat-arb.



You can also see the squeeze in the high correlation between carry trade currencies and concentrated hedge fund positions in the equity market. From a fundamental standpoint, carry trade currencies are completely unrelated to these equities. But the same players are being squeezed out of both positions. The correlation has clearly risen since Bear Stearns failed. Since that time we have seen tighter financing standards by prime brokers and tightening credit standards by banks that have squeezed hedge funds out of their positions.



The Longer Term:

Government policies can determine how much the deleveraging will 1) come in an orderly way or a chaotic way, and 2) be manifest via a credit crisis (when defaults are allowed to occur) or via a dollar decline (which occurs when the government prints the money to pay for the losses). But, government policies can't change the fact that the deleveraging will occur.

The exponential growth of U.S. debt (i.e., the dollar debt bubble) ended because the debt burdens became too large for the bubble to continue. There are limits to debt growth and with it limits to excess consumption. The size of one's debts is limited by one's collateral (i.e., one's equity) and one's ability to service one's debts (i.e., one's debt service payments relative to free cash flow).

Debts and debt service payments grew to be too big in relation to equity and free cash flows, so asset sales, defaults, reduced real borrowing, and reduced real spending had/have to occur, so real net worths and real incomes had/have to fall. So, though credit growth has slowed, individuals and financial institutions have become more leveraged and will be unable to increase their debts and their consumption relative to their incomes, and real income growth will fall.

As foreign investors recognize that investment into U.S. debt has unacceptable credit and currency risks, it is likely that their lending to U.S. borrowers will shrink at the same time as debt monetization picks up, which will be further bearish for the dollar, especially relative to the yen and stronger balance of payments countries' currencies (especially China and other surplus currencies). These adjustments in debt/equity, debt service/free cash flow, real exchange rates, interest rate differentials, and balance of payments toward more sustainable levels will be long and painful. But now risk premiums are enormous.

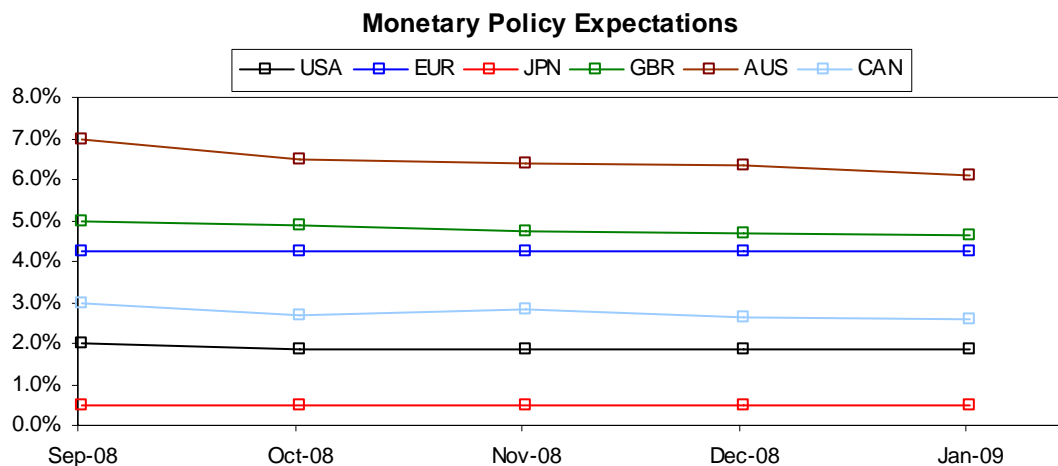
Other Industrialized Countries

Short Rate Pricing

The latest news that the US government will further manage the crisis by creating a mechanism to take bad assets off of financial company balance sheets, in a way similar to the RTC mechanism, and the announcement by UK regulators to ban short sales of financials, caused a broad-based rally in global stock markets overnight. European stocks surged more than 6% in many markets, and US stock index futures are up 3.7% as we write this (which would put stocks back to their level from last Friday).

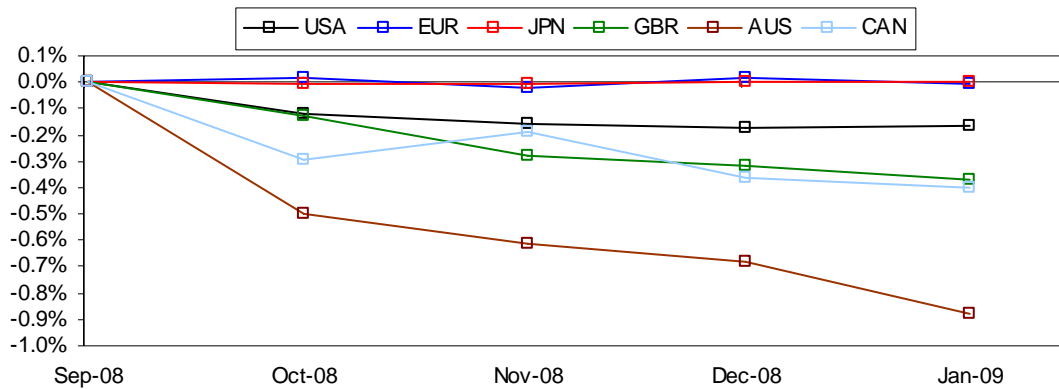
For the developed world, the real economic impact caused by the global credit crisis has now spread well beyond the US, and while developed world central banks have actively addressed strain in the money markets, changes in interest rate policy have remained unnecessarily limited, given the sharp slowdown in domestic demand and easing of inflationary pressures. Today, most developed world central banks are priced to ease modestly through the start of next year, ranging from roughly 0 – 40bps (except for Australia). In recent weeks, concerns over the interbank market have elevated Libor spreads significantly across the developed world, creating an implicit tightening for all borrowers (as stimulation from easing is only supportive if the ultimate borrowing cost falls as a result). Responding to the strained money market by flooding banks with hundreds of billions of dollars is clearly a highly targeted way to bring down spreads, and, combined with other targeted measures to restore confidence in lending to financial institutions is required to ease financing costs that are coming as a result of tighter money markets. But these targeted actions, if successful, will only help return conditions to be more in line with current interest rate policy. Continued slowing growth, along with easing inflation pressures, give central banks space to ease interest rates as a way to further stimulate in the face of deteriorating economic conditions (beyond the other policies that they are enacting to deal with the crisis). With relatively little easing priced in, we are long short rates in most of the developed world.

The following chart shows the current implied path of the level of central bank rates across the developed world. Rates in the US are predicted to remain significantly below that of Europe and the UK, which are just now starting to feel the impact of the global slowdown, and have yet to ease substantially.



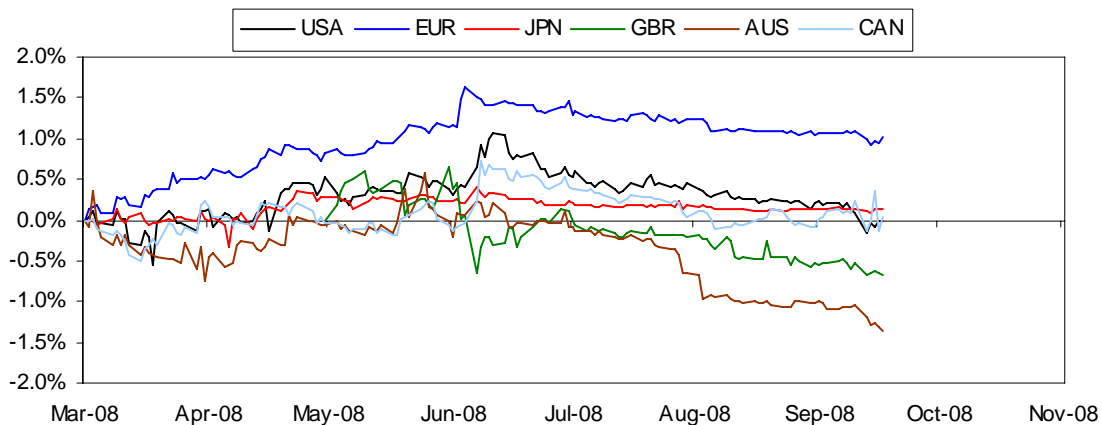
In general, across the developed world, expectations are for monetary policy to ease modestly over the next couple of months. The priced in easing in Australia implies a couple of additional cuts over the period, but with interest rates at such a high level, monetary policy will remain relatively tight until at least the start of next year.

Expected Change in Monetary Policy



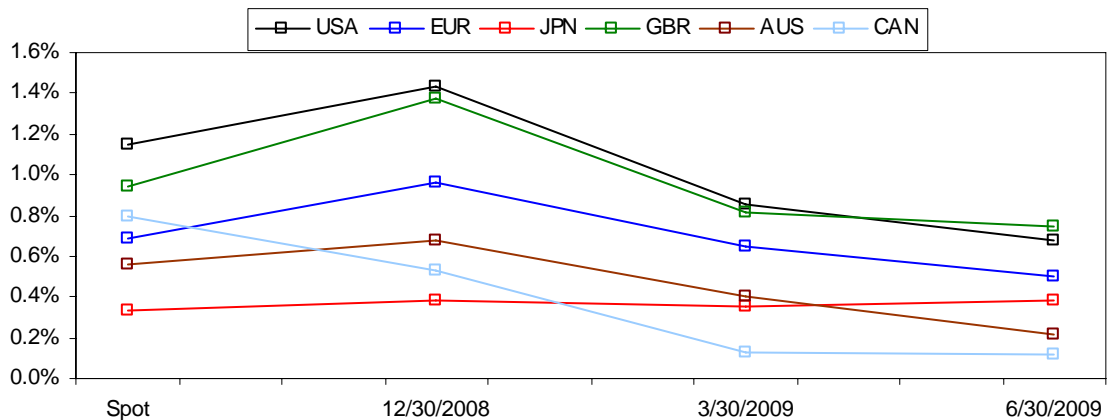
Expectations of tightening have come down significantly from the summer peaks, when inflationary pressures due to the sharp rise in commodity prices become a serious concern for central banks.

Change in Expected Monetary Policy for Dec 2008

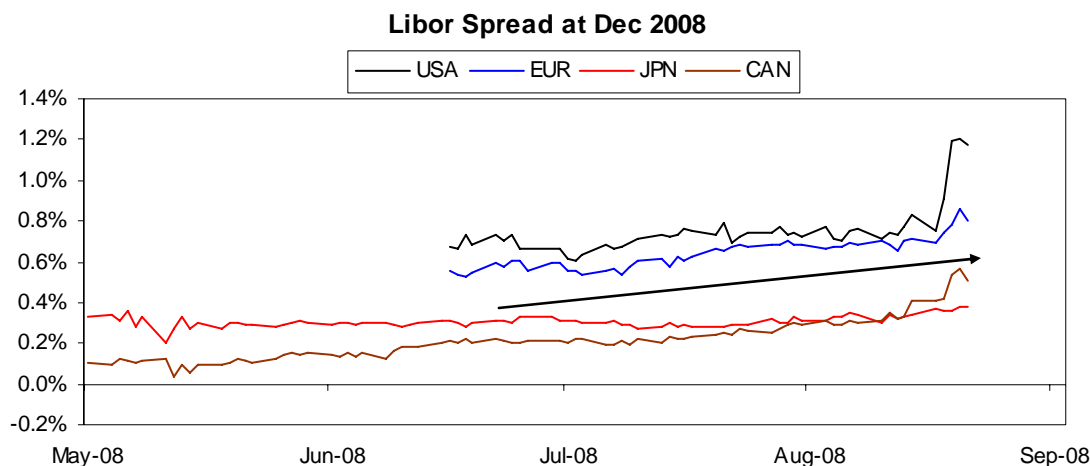


The increase in expected easing by developed world central banks has been partially offset by rising concerns about the banking system. Even with today's global equity rally, spreads on banks quoted in the Libor market remain elevated on the short end, adding from 1%-1.5% to funding costs in the US. We're clearly starting to see the impact of global central bank efforts to ease these short-term conditions, which should help provide some implicit easing in the coming months.

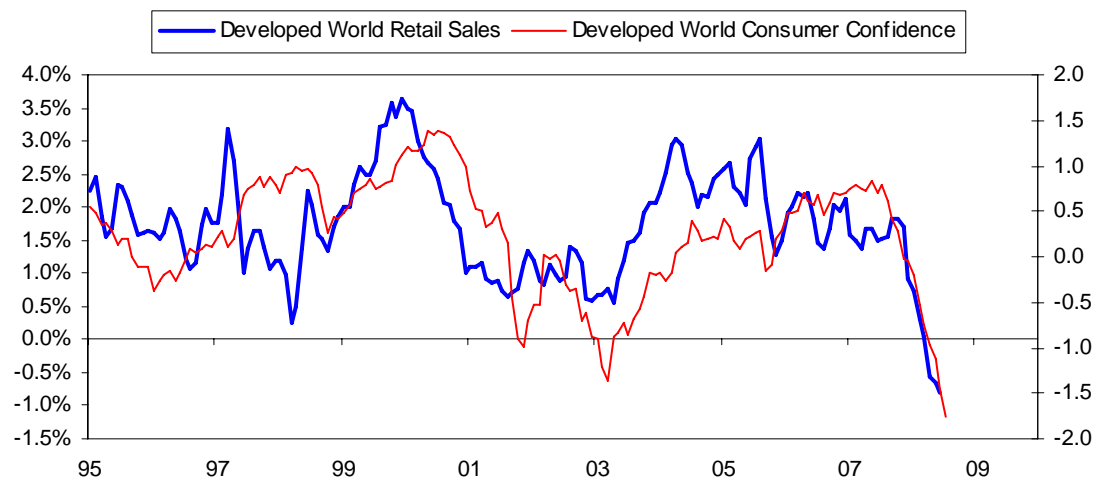
LIBOR Spread Curve



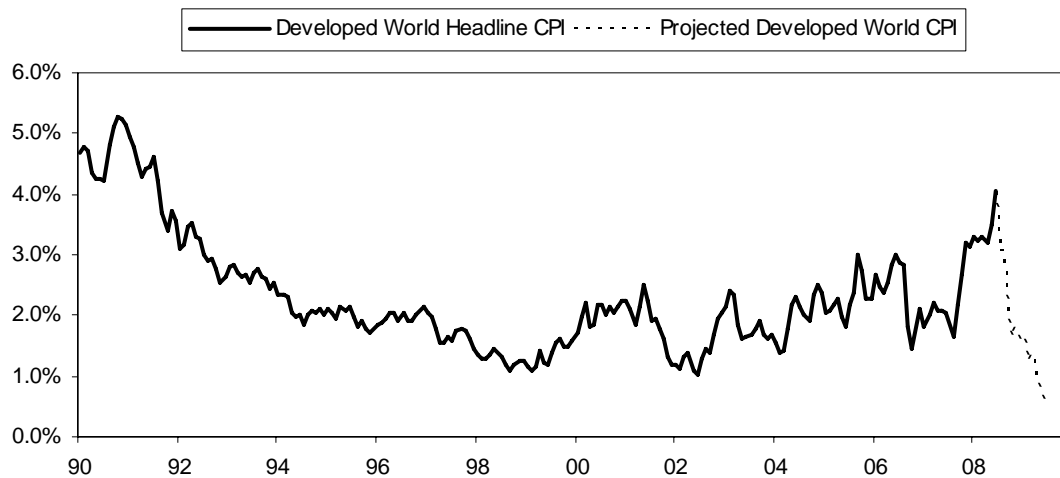
This widening of spreads has offset increased expectations of central bank easing in the coming months, particularly in the US. The chart below gives a picture of the Libor spread impact on expected December 2008 interbank rates.



While the active engagement in the money markets will help ease pricing, there is room for central banks to extend their actions to additional cuts in interest rates. Domestic demand across the developed world has fallen sharply in recent months and is now well below that of the recession in the early part of the decade. With labor markets deteriorating, credit markets inaccessible, and asset prices tumbling, it's no surprise that consumer confidence has also deteriorated sharply as well, which will weigh on consumption in the next few months.



During the summer, concerns about the sharp rise in inflationary pressures kept central bankers on the sidelines, but with a nearly 30% fall in commodity prices, inflationary pressures are likely to ease significantly in the coming months. The following chart gives a picture of the expected path of developed world inflation given current commodity prices and an expectation of flat core inflation (though with easing growth conditions and falling asset prices it's not unreasonable to see a fall in core as well).



While steps to address the strain in short-term funding and provide a broader net through a RTC-style mechanism will help ease monetary conditions and stimulate growth across the developed world, continued weakness in growth and easing inflationary pressures will likely allow developed world central bankers to ease more than currently expected.

Conclusions

Credit Markets

N. America

<i>US Bonds</i>	<i>US Euro\$</i>	<i>Canadian Short rates</i>
Strongly Bullish	Strongly Bullish	Strongly Bullish

Europe

<i>UK Gilts</i>	<i>Euroland Bonds</i>	<i>UK Euro£</i>	<i>Euroland Short rates</i>
Neutral	Moderately Bullish	Strongly Bullish	Strongly Bullish

Asia

<i>Japanese Bonds</i>	<i>Australian Bonds</i>	<i>Japanese Euro¥</i>	<i>Australian Bank Bills</i>
Strongly Bearish	Strongly Bearish	Strongly Bullish	Neutral

Currency Markets

<i>CAD v USD</i>	<i>EUR v USD</i>	<i>GBP v USD</i>	<i>JPY v USD</i>	<i>AUD v USD</i>
Neutral	Neutral	Neutral	Neutral	Moderately Bearish

Equity Markets

<i>US Equities</i>	<i>Japanese Equities</i>	<i>German Equities</i>	<i>UK Equities</i>	<i>French Equities</i>	<i>Canadian Equities</i>	<i>Australian Equities</i>
Moderately Bullish	Neutral	Neutral	Neutral	Neutral	Moderately Bullish	Moderately Bullish

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