

Global Macro Commentary

Debt, Debt, Debt

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- Debt undermines growth and the world has never been more **indebted**.
- Reinhart and Rogoff's 2010 research on the topic concluded that growth is about 1 percentage point lower in the long run when sovereign debt is 90% or more of GDP. They found that these **episodes** of 'high debt' were long and costly and that the average period (of 'high debt') lasted 23 years. [Such long duration advocates that 'high debt' is not merely a function of a downturn in the business cycle.]
- Debt levels of many countries have reached levels far higher than 90%. Those levels do not include the trillions of dollars in corporate debt (which has grown rapidly in the last 5 years). In many countries, debt has been **growing at a rate** far faster than economic growth. Such a trend is clearly unsustainable. Historically, rapid increases in debt levels typically result in a financial crisis or a prolonged slowdown in GDP growth.
- The government debt-to GDP level of 104% in the US does not even include gargantuan **unfunded** entitlement liabilities which many argue will reach levels greater than \$100 trillion in the next 10 years. It could be argued that a US growth rate of 2% might be the best case scenario for many years.
- Loose monetary policy is supposed to provide cheap(er) funding for investment into **capital projects** that ultimately create jobs and spurs economic growth throughout the broader economy. However, when there is limited visibility, projects will not be undertaken. Highly indebted corporations will be reluctant to take out more debt for capital projects without some sense of the value of those future cash flows as well as the cost of operating that future business.
- Currently, it is too difficult to **handicap** future costs, and changes to the tax code, employee health care costs, regulations, or the fiscal policies (of whomever our elected leaders will be). Low and negative interest rates have not led to borrowing for capital projects because of this uncertainty. Without these fiscal reforms, the effectiveness of monetary policy is muffled.
- Yet, a massive amount of borrowing has taken place. Unfortunately, the proceeds of the huge corporate debt issuance have been used for share buybacks and dividend increases. To make things look 'less bad', corporate executives have made efforts to increase **earnings per share** (EPS) ratios by making sure that the "S" falls faster than the "E". The net result is higher asset prices that increasingly diverge from underlying economic fundamentals.
- Low interest rates attempt to **buy time**. The idea is to bring consumption forward until the economy heals on its own as capital projects are completed. But those projects never began for the reasons I mentioned. The end result is ever-higher debt that borrows more and more from the future. Unfortunately, it borrows from the future without making the future any brighter through solutions to root causes of economic ailments.
- At some point, **the "future" becomes "today"**.
- A former central banker used a good analogy to describe the current condition in which central banks have placed themselves. He said it is like cycling **up a hill** that is getting increasingly steeper and steeper and you need to pedal faster and faster to maintain the same position.
- The hill is steepening as low and negative interest rates are no longer bringing spending forward. The BoJ cut in January to negative rates caused consumers to **retrench**. This was likely due to worries about what such extraordinary measure must mean for the future. Expectations matter. This market reaction has rightly acted as a warning sign to central banks about the limits of their policies.
- There are trillions of dollars of **debt maturing** in the next 24 months. In this light, some random facts follow. China has around \$86 billion of debt maturing in May alone. The largest in their history. US CMBS has over \$125 billion in loans maturing both this year and next. Italy has around €360 Billion of impaired assets and non-performing loans (NPLs), which equals almost 25% of GDP. Since Greece had missed budget targets due to weaker than expected tax receipts, creditors may have to give them more money in order for Greece to be able to pay the €3.5 billion interest payment due in July. The Malaysian state fund 1MDB defaulted this month on the interest on a \$1.75 billion bond which in turn led to a few cross defaults.
- The bottom line is that high debt typically inflicts future financial stress. The **burden magnifies** if interest rates rise, or if the debt burden either cannot be rolled over or can only be refinanced at wider spreads.



- High yield bonds spread have come roaring back from wide levels, but credit will face headwinds and challenges going forward. Emerging markets (EM) corporations and countries that have borrowed in US dollars face similar **challenges**, particularly due to the relative strength of the USD in recent years (which is likely to persist). According to the BIS EM borrowing in USD has soared above \$9 trillion.
- My view of **US Treasuries** has not changed. The compelling technical story, which I have outlined in several notes, remains firmly intact. The global shortage of (and increasing demand for) high-quality, risk-free, and positive-yielding collateral can be added to the list of factors. I still expect long-maturity Treasury yields to fall to all-time low levels in 2016. Other financial assets will not perform so well.
- “Know what you own, and know why you own it” – Peter Lynch

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