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Growing debt

A potential obstacle in the global recovery?

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After nearly a decade of extreme monetary policies, barely visible inflation, and meager economic growth, some signs of economic improvement going into 2018 have finally given investors something to cheer about. Gross domestic product (GDP) growth in 2017 improved in many economies. Equity markets have been strong, albeit with some volatility in early 2018, and the effects of US tax reform and other fiscal policy appear stimulative.

Yet below the surface of this burgeoning economic recovery lies one important factor: global debt. The size of global debt — which hit a high of $233 trillion in the third quarter of 2017, according to the Institute of International Finance (IIF) — is largely the result of years of accommodative central bank measures pumping liquidity into the markets.

Could this growing debt potentially trip up the global recovery? Is it unlikely to be tackled in the short term, and thus less threatening? Or is it a warning sign for the longer term, a headwind that risk-aware investors should account for? After writing extensively about the debt supercycle in 2016, we believe the potential momentum of global growth provides a backdrop to revisit the debt issue, including the current state of the overhang, what it can portend, and practical portfolio considerations in a debt-laden market.

Signs of improvement, but looming debt

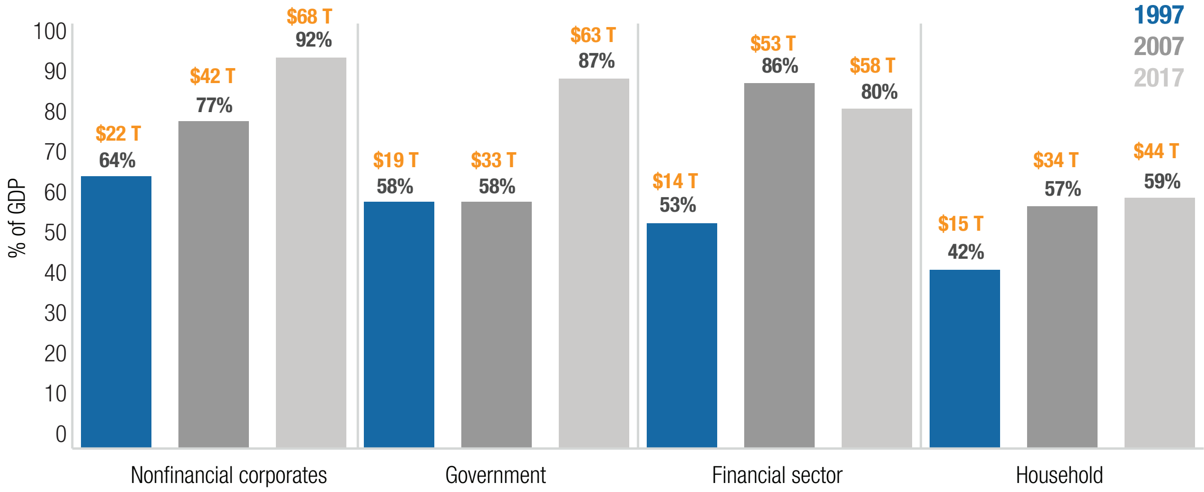
In an important sign of improvement, the global economy grew 3.7% in 2017, its fastest pace since 2010 (source: International Monetary Fund (IMF), 2018). Every major country or region grew, including Europe, China, Latin America, and Japan, in an emerging global synchronization. Fiscal stimulus, through deregulation or potentially through US tax reform, may be playing a part, or the economic progress may be a result of wage growth showing indications of at last breaking through inflation pressures. Nearly a decade since the global financial crisis, perhaps it is simply long-overdue optimism.

However, while the general consensus might conclude that the overriding themes for fixed income investors in 2018 are growth, a wage-led pickup in inflation, and a return to normalized monetary policy, we see things a little differently. Our view is indeed for solid-to-stronger growth, particularly in the United States in the first half of the year due to tax cuts and deregulation. As for inflation, our analysis of multiple measures makes it difficult to make a case that inflation is trending higher. For example, we found that inflation in 2017 surprised consensus thinking by remaining subdued and, in many cases, we saw core inflation actually falling. Inflation currently appears locked below the target levels of many central banks.

The two most significant factors that we see as continuing to drive fixed income markets — factors not generally a focus of consensus thinking — are central banks' extraordinary monetary policies and high levels of debt. We are still very far from "normal."

Debt piling up

Global sector indebtedness comparison: 1997, 2007, and 2017



Source: IIF, IMF, Bank of International Settlements, Haver Analytics.
Data shown are $US trillion, % of GDP, and at end of the third quarter of each year.

The tyranny of debt continues

Global debt levels are large and growing. By the end of 2017, the global debt had increased by $16 trillion, or nearly 7%, from levels at year-end 2016. That represents an astonishing 300% of debt-to-GDP, or more than three times global growth. (Source: IIF)

The source of debt has also changed since the global financial crisis, when a large part came from overleveraged, high-risk consumers. Since then, corporations have slowly started to re-engage in leveraging. But the real debtors today are governments, which are pumping liquidity into the financial markets and global economy by taking down large amounts of debt — debt that is nonproductive, tending not to generate sufficient return for debt servicing. That means the debt overhang is not only huge, but most of it is not creating growth. These significant debt increases may be pulling forward demand (the aggregate demand in the economy), but it is important to remember that this debt will have to be serviced with tax receipts in the future.

After eight years of monetary easing, interest rates near zero or at negative levels in many parts of the world, and debt levels rising precipitously — and with most of that debt steered into nonproductive ends — central banks have started to shift. In recent months, they have begun to move in the opposite direction, tilting toward tighter policies and potentially driving up rates.

That's the tyranny of debt — what looks easy to service when rates are low becomes increasingly difficult if rates rise. When do we cross the Rubicon with sovereign debt levels? There's no simple answer, partly because there can of course be different tipping points for different countries and regions or types of debtors. But with growing levels of debt, at some point it will become an issue to grapple with.

Amid the growth, some warning signs?

With improved economic growth in many parts of the world emerging in 2017, and markets performing strongly, many investors appear hopeful we've turned an economic corner. On the other hand, it can also be said that it has taken years and dramatic monetary policy for there to emerge even a spark in growth, which has been paltry since the financial crisis. The shift, however, appears to us to be genuine for the near term — as long as aspects such as the trading environment remain stable and tax reform, which has helped unleash some level of business optimism in the US, can propel widely positive effects. However, it remains to be seen how sustainable this growth is.

Amid this improvement, some signs of potential debt concerns are worth watching. One has been the market volatility in early 2018. The choppy markets appear to have been triggered partially by inflation fears, which seem to us unfounded. While equity markets may be on solid fundamental ground that will allow further advance as 2018 continues, volatility is always a reminder of how the current global economy is abnormally dependent on high asset valuations and low interest rates.

Central banks finally tilt away from easing

The shift of interest rates — as the yield on 10-year Treasurys increased significantly from 2.11% on Aug. 31, 2017, to 2.86% on Feb. 28, 2018 — speaks to another potential signal as well as near-term risk: Will central banks' exit from accommodative policies help fuel the ratcheting up of rates, and thus help make debt more expensive?

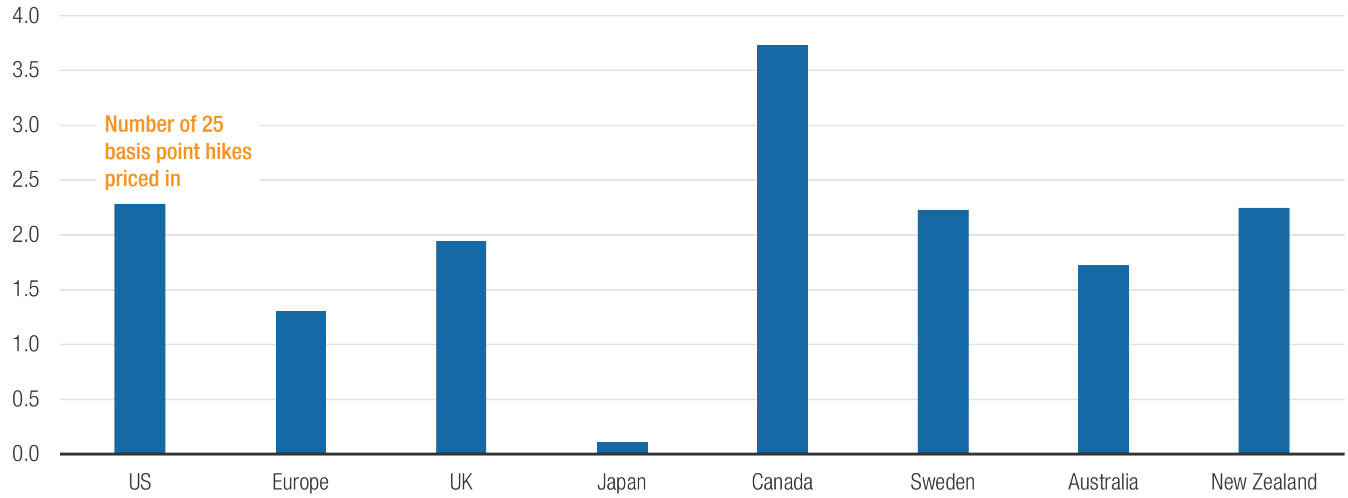
The US Federal Reserve has been slowly raising interest rates since December 2015, and signaled several increases for 2018. In an apparent indicator of continuation of the gradual tightening tilt, Fed Chairman Jerome Powell made note of the US fiscal stimulus and strengthening economy in recent remarks — as well as offering a reminder of the unsustainability of the nation's debt. The Fed is also continuing with its quantitative tightening process started last fall to reverse its Treasury-buying program. That process is also very measured. If the Fed were to unwind its $4.5 trillion balance sheet at its current rate of $120 billion a year, it would take more than 35 years to run off. But the Fed's balance sheet expands with the size of the economy, so the effect may be less dramatic — the balance sheet may pull back by only $1.5 trillion to $2.0 trillion.

Despite the restrained pace, there is a definite tilt in monetary policy among many of the central banks globally. The Bank of England and the Bank of Canada have raised rates, the European Central Bank has begun to pull back on its aggressive bond buying (although it is still a net buyer), and others are suggesting a shift toward tightening as well.

Quantitative tightening does not directly raise rates as a central bank rate hike does. But it serves to create additional pressure on rates in general. Even a subsequent marginal increase in rates can put pressure on the economic system. However, we see the measured approach used by central banks as a mechanism to control monetary policies, as well as the effects of natural market reactions, as forces that can lead to continued relatively low rates for the longer term.

Central bank policy: More pronounced tilt expected in 2018

Rate hikes priced in over the next two years



Source: Citi research, September 2017.

A self-correcting mechanism

This self-correcting mechanism for rates is important. Higher rates are not only bad for hyper-interest-rate-sensitive bonds. They can also have negative effects on stocks and risk assets and act as a stressor on economies. As a result, our view is that there is a natural ceiling on how high rates can go before economic stresses and other forces compel rates to decelerate, or even reverse.

One example of this phenomenon was in 2015 when China reversed course on its quantitative easing (QE) and began withdrawing liquidity from the economic system in dramatic fashion. This action offset the positive QE from other central banks and put pressure on certain sectors, and commodities and oil prices collapsed. However, once China began pumping money back into the system, prices stabilized and a crisis was averted.

Indebtedness is one of the key structural challenges facing the global economy, and high debt levels and high yields cannot coexist. If the current trend toward higher yields continues, it is our conviction that natural forces will take over and result in this same self-corrective mode. Nonetheless, prudent investors should watch how the rate environment develops — this is not necessarily the same kind of rising rate environment we have had in the past.

Tackling the debt

Even marginally higher interest rates could make the debt more difficult to service and force attention on this underlying problem. However, if rates generally remain at lower levels, it will continue to be easy to put off tackling the debt, however large and looming it is — at least in the near term.

The 2008-2009 global financial crisis is telling — it was a debt-driven crisis. The resolution for such a crisis can be to deleverage, which occurred in the US at the household level, as overleveraged mortgages were foreclosed. But this kind of deleveraging was painful and not as successful a few years later in other countries facing debt crises such as Greece, Portugal, and Cyprus. Indeed, except for a few European countries, central banks around the world have rejected the notion of deleveraging with their moves to zero and negative interest rate levels.

In the US today, there also is not much appetite to address the debt. One huge factor facing the US and many developed countries — which also may be thwarting any efforts to tame debt levels — can be found in demographics. Aging populations usually mean fewer people in the workforce, and more healthcare and government-sponsored entitlement programs. Each is a drag on economies and adds to debt levels. In our view, the US, for example, is unlikely to challenge its debt in the short term, and likely not in any significant way until the debt and its service levels begin to displace programs such as defense, education, and especially entitlements as budgetary priorities.

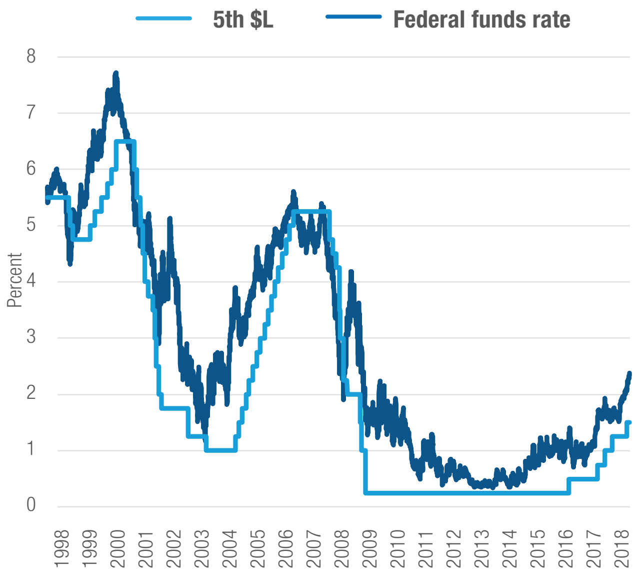
Flattening yield curve: No sign of imminent threat

When observing US spreads, the yield curve has steadily flattened through 2017, but the theme is global. What does a flattening yield curve signify?

A sustained inverted yield curve has been a warning of recession, but flattened curves are not necessarily good indicators of pending economic conditions.

US yield curve: 10-year less 2-year spread

US federal funds rate and 5th Libor future



Source: Bloomberg. Data in the left-hand chart are as of Dec. 29, 2017; right-hand chart as of Jan. 5, 2018.

Investment implications: Don’t fear duration

While global central bank dynamics are unlikely to change fundamentally in the short term and the markets’ addiction to debt continues, it seems clear that the increasing global debt must be dealt with eventually. While it is unlikely that a tipping point will occur in the short term, we take the view that a chase for yield by global investors will persist, and that this can call for accumulating duration as a sensible strategy in a multisector portfolio.

In an environment where investors, even as they are driven to fill their portfolios with risk assets in their search for yield, are nonetheless concerned about a slight uptick in inflation or an incremental increase in interest rates in the short term, we say don’t fear duration. Duration or interest rate risk aren’t the enemy. For example, adding a small piece of high-quality, long duration assets could create a hedging mechanism and diversification tool against the risk assets in a portfolio.

With those portfolios today full of risk assets, investors tend to be apprehensive about rising rates. Rates going up can generally be beneficial for lower-quality bonds, but not necessarily for stocks. However, if a portion of a portfolio is dedicated to higher-quality, longer duration assets, then this can act as a diversifier — rather than a solely “stocks rise you win, stocks drop you lose” scenario — and buffer the portfolio overall.

We don’t see forces like global debt beginning to produce cracks in the market environment in the near future, but at the same time, investors and global markets could pay the price down the road. We believe that the only way for investors to protect themselves is to build prudent buffers in their portfolios.

Steps investors can take

Global debt may not be at a tipping point yet, but underlying concerns can call for a practical approach by investors — primarily diversifying their portfolios, such as with high-quality, long duration assets.

Investing involves risk, including the possible loss of principal.

Past performance is no guarantee of future results.

Diversification may not protect against market risk.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower’s failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation.

Duration measures a bond’s sensitivity to interest rates, by indicating the approximate percentage of change in a bond or bond fund’s price given a 1% change in interest rates.

All charts shown are for comparison purposes only.

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