Global Investment Insights

Mounting debt and the many paths to recovery

Pyrford International Ltd. is a specialized global investment team of BMO Global Asset Management

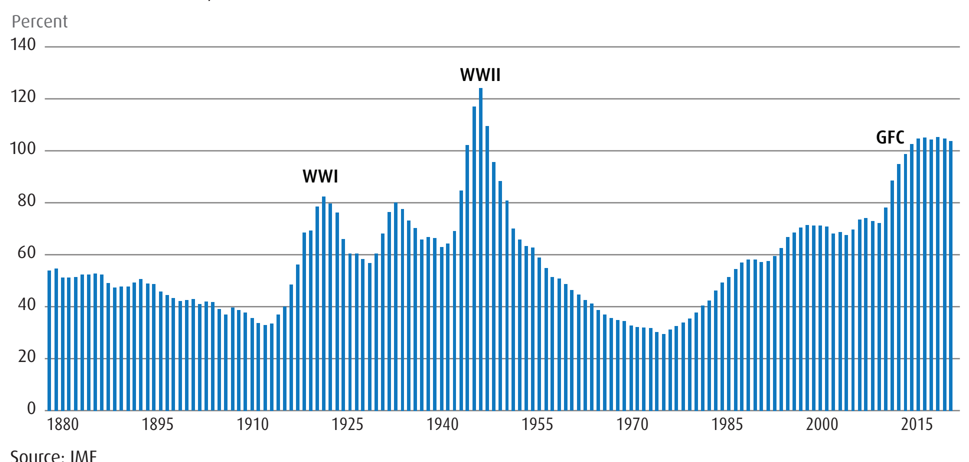
The extraordinary events of 2008 remain fresh in the minds of all those who were involved in the markets at that time, while the causes and ramifications should remain fresh in the minds of everyone—but they don't. After all, 10 years feels just like yesterday but selective amnesia is employed by all humans. The follies of the past are soon forgotten in pursuit of the next buck—or vote.

To be sure, it won't be U.S. housing that sends the world into the next downward lurch as we are at least creative enough to find another way of digging an enormous hole into which the world economy can plunge but it will inevitably involve debt, in one guise or another. Debt is something that we are expert at creating and very bad at shedding. According to the International Monetary Fund (IMF), global gross debt (non-financial) has increased by more than 30 percentage points of global GDP since 2007.

Debt in the hands of governments is at particularly worrying levels. If we focus on the advanced economies the debt load relative to GDP was only higher than currently during World War II – and it then rapidly fell as post-war reconstruction massively boosted output (see below). There is no similar catalyst for a significant output spurt this time around. Governments find that expanding their debt levels is very seductive – after all, it's not their money and spending enhances their popularity which suggests the voters haven't figured out where the money is coming from.

General government debt as a % of GDP

Advanced economies, 1880-2018



Source: IMF

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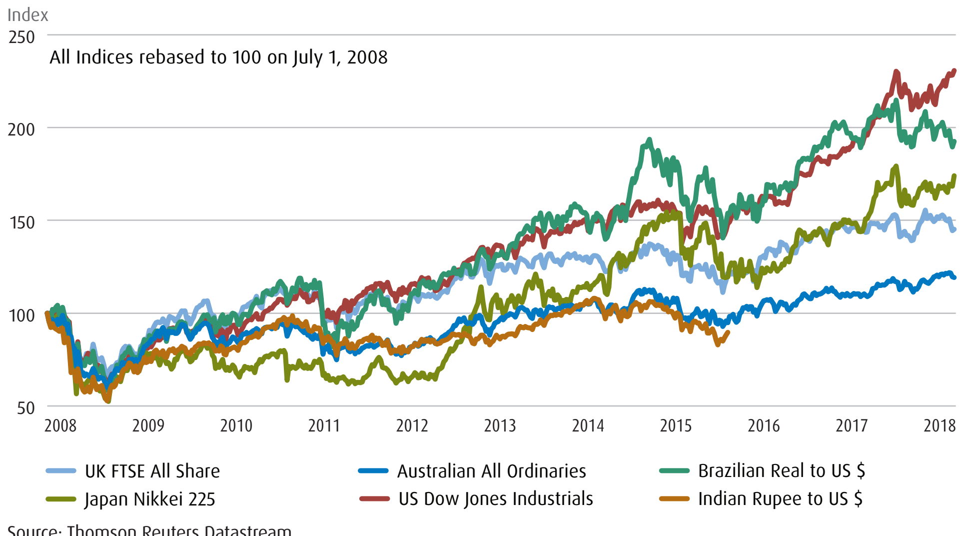
But back to the financial crisis. The demise of Lehman was just one stepping stone in the gory path towards financial meltdown, but it was probably the most visible sign that events were spiraling out of control. Share markets had been falling since late 2007, but the decisive downward move after Lehman that culminated in the final trough in March 2009 resulted in most markets falling 50% or more from their peak.

In any downward plunge market correlations are very tight. There is nowhere to hide. Recoveries, however, produce many different paths. The graph below plots the movements of six major share markets from July 2008 (indexed to 100 at that date) to the present time. The 'bunching' of markets on the way down is clear. In the subsequent ten years, however, the outcomes have been very different.

> The U.S. stock market has raced away from all others.

Stock market performance since July 1, 2008

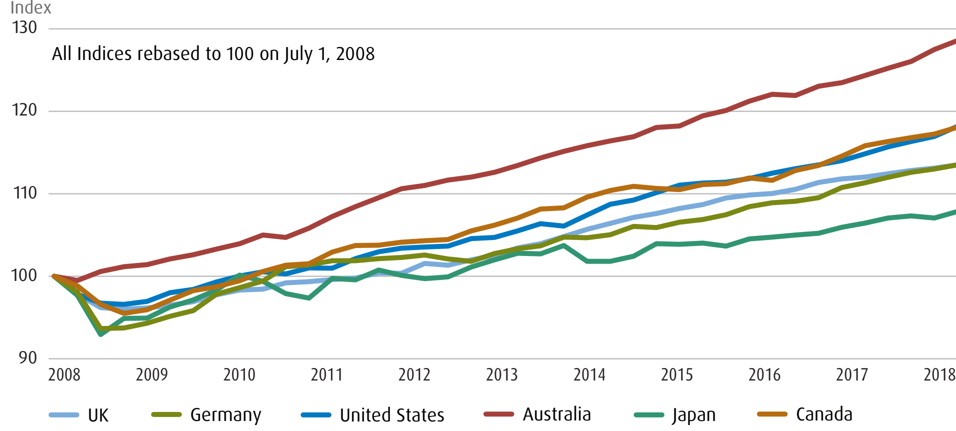


Source: Thomson Reuters Datastream

The U.S. stock market has raced away from all others. On the other hand, Australia and Canada have turned in dismal performances—only decisively passing their 2008 index levels in 2016. Now you may say that these relative movements are easily explained by underlying economic growth. Not so.

If we index real GDP growth in the same six countries from an identical start-point, we find that it is Australia that has raced away, while Canada has matched the performance of the U.S. and surpassed that of the others.

Real GDP since July 1, 2008



Source: Thomson Reuters Datastream

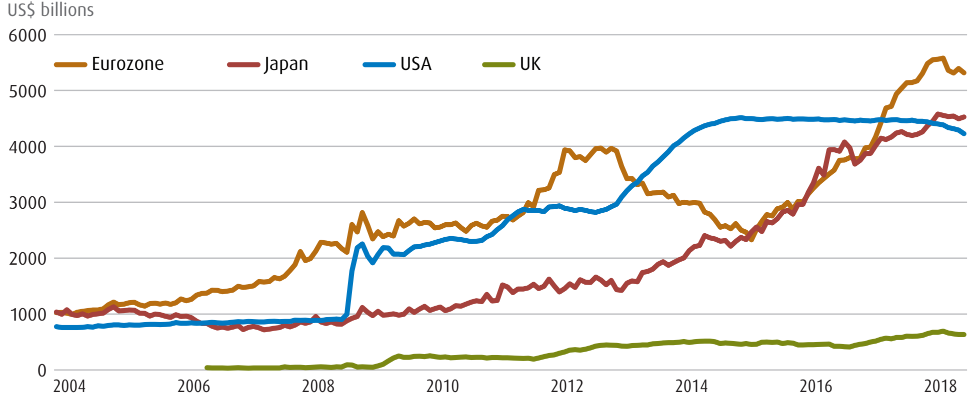
In simple terms what this means is that share markets in the U.S., Japan, Germany and the U.K. have all outstripped growth in the underlying economies. The U.S. is the most extreme example with share market performance almost double that of real output growth.

Is this a surprise? Not really, as the countries that have engaged in extraordinary financial intervention and manipulation (Quantitative Easing and its many derivatives) have been the very countries to have produced significant share market outperformance. Funny thing though. If you pump trillions into the markets they go up. In Japan, they (the central bank) took the gloves right off and openly purchased equities as well as bonds—in fact, through the purchase of exchange traded funds, the Bank of Japan is now a major shareholder in around 40% of listed companies as well as owning close to half of the government bond market. They also pushed short-term interest rates below zero (they are still there). Canada and Australia performed some minor financial gymnastics but did not indulge in the dark art of QE.

The trillions pumped into the various markets by the 'majors' are evident in the following graph.

Change in central banks' balance sheet assets

Billions of U.S. dollars (Federal Reserve, BOJ, BOE, ECB)



Source: Thomson Reuters Datastream

Japan is only second on the list, but the liabilities of the Bank of Japan are now equivalent to 90% of GDP. The European Central Bank is at 40%, U.S. Federal Reserve at 21% and the Bank of England 27%. We keep hearing murmurs from Japan about unwinding or at least slowing some of the stimulus but it never gets past the murmur stage. At least the Fed, BOE and ECB are belatedly taking some action, but with trillions needing to be extracted, we won't hold our breath awaiting speedy movement.

So 10 years down the track, we have a situation where it is clear that the unprecedented interventions by (mainly) central banks have benefited equities, bonds and various other "investables" but the poor old economy and many of its citizens have been left far behind. Each extra dollar of stimulation has produced relatively paltry economic growth.

According to OECD calculations its member countries have experienced the weakest economic recovery in the last 45 years (following a recession)—whether measured by real GDP growth, productivity, trade, employment, investment or consumption. Little wonder that "populist" political parties have emerged from the ruck.

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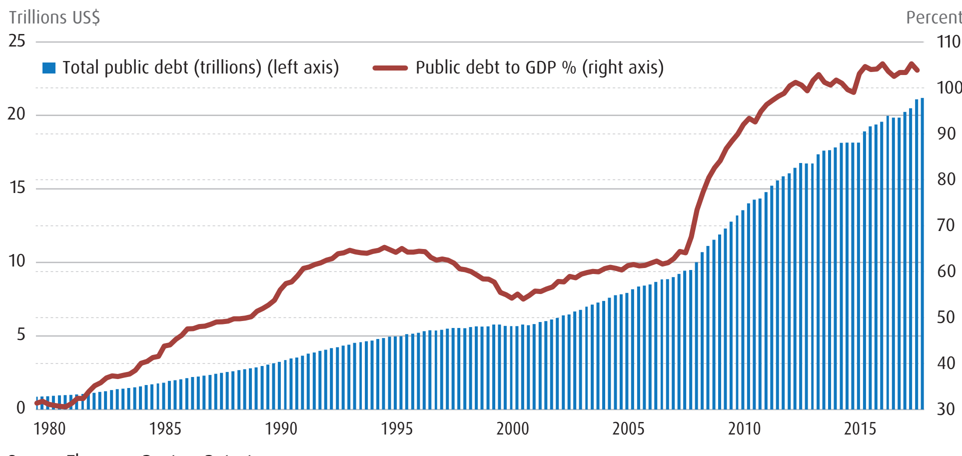
The U.S. provides a classic example of the debt/growth conundrum. Immediately pre-crisis (end of 2007) public debt amounted to $9.2 trillion, equivalent to 62% of GDP. Today, public debt is around $21 trillion, equivalent to 104% of GDP. Nominal GDP has expanded by $5.7 trillion but public debt by $11.8 trillion. If this is what immense stimulation amounts to, we suggest it is not working very well. Is there any firepower left to battle the next crisis? There is always some, but it will resemble a popgun more than a canon.

Over 500 private banks have gone bust in the U.S. since the beginning of 2008. In 2009, 140 banks failed and, in 2010, 157.

United States public debt

Treasury securities outstanding



Source: Thomson Reuters Datastream

Over 500 private banks have gone bust in the U.S. since the beginning of 2008. In 2009, 140 banks failed and, in 2010, 157. The assets involved in the failures of these two years alone amounted to $544 billion (Federal Deposit Insurance Corporation data). Almost all were acquired under the auspices of the FDIC. Have you heard of the Vantus Bank of Sioux City, or the Flagship National Bank of Brandento, or perhaps the Mirae Bank of Los Angeles? Probably not. These "minor" disasters slip under the radar and at best induce a stifled yawn because few depositors lost money. Can bailouts of this magnitude plus bailouts of the "big boys" who make the headlines be repeated next time around? Not with a popgun.

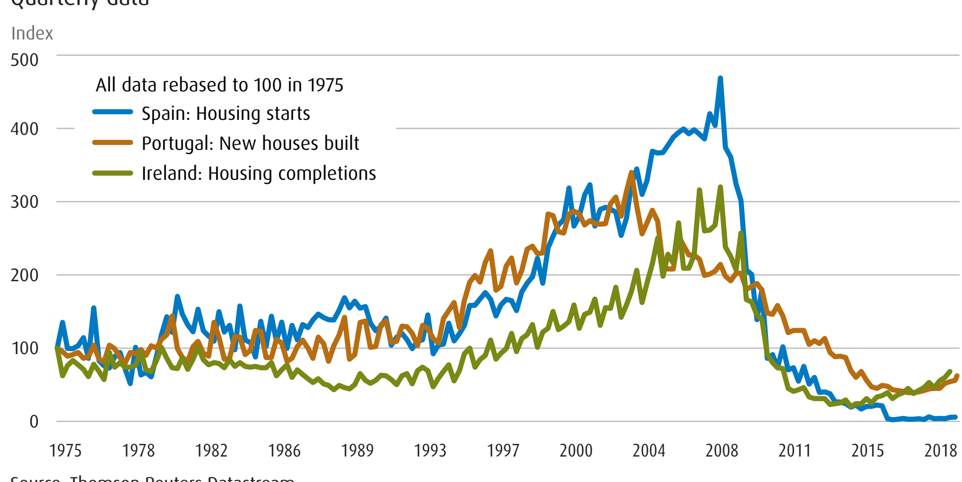
Ireland

In the financial crisis, Ireland effectively went to the wall. It was one of the financial crisis poster-boys. Now it has bounced back in extraordinary fashion. The IMF calculates that real GDP growth in 2017 was 7.8%, and is forecasted at 5.0% in the current year and 4.1% next year. The public debt burden has fallen to below 100% of GDP, there is modest expansion in the housing market and employment has recovered to its pre-crisis level. Loans from the IMF, Sweden and Denmark have been repaid ahead of schedule. None of these outcomes seemed possible just a few years ago.

As in the U.S. and a number of other countries housing and associated leverage was at the core of Ireland's crisis and demise. The Irish banks were up to their eyeballs in property-related debt. The Irish property bubble was indeed something to behold. The fact that it came just a few short years after Ireland joined the eurozone with its associated cheap and plentiful financing was not a coincidence. The banks failed and the subsequent government bailout cost close to the equivalent of 50% of GDP. OECD data indicates that general government gross financial liabilities in 2007 were a modest 28% of GDP. They then catapulted to an alarming 133% of GDP in 2013.

A portrait of three housing busts

Quarterly data



Source: Thomson Reuters Datastream

In Spain housing is still flat-lining, while Ireland has clearly picked-up and Portugal is showing modest signs of recovery. Ironically, housing supply in Ireland is now rapidly approaching the "tight" level, causing rents and prices to rise—although they remain well below their pre-crisis peak. It is important to avoid another boom/bust cycle, so it is to be hoped that appropriate initiatives are taken to encourage supply.

The movement in employment in the eurozone "disaster" economies is evident in the following chart. Ireland is back to its "start" point (along with Italy). Greece remains dire.

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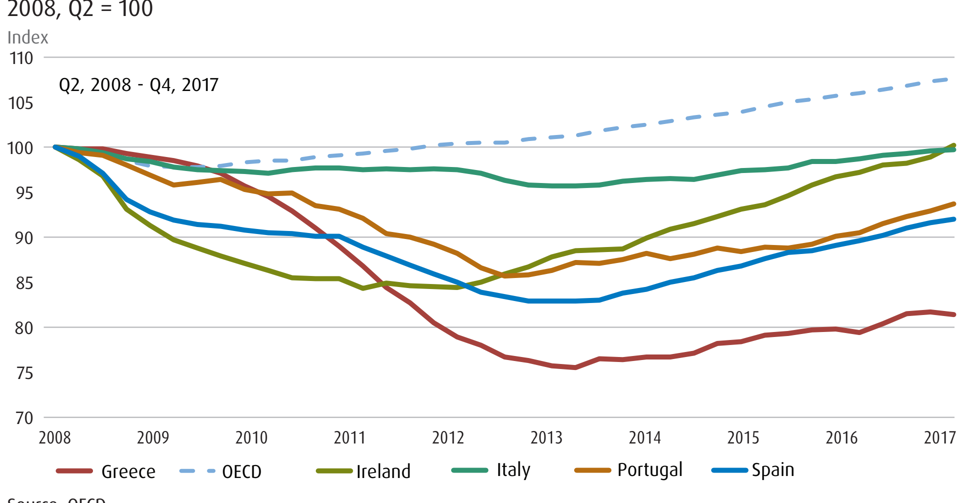
Employment since the 'crisis'

2008, Q2 = 100

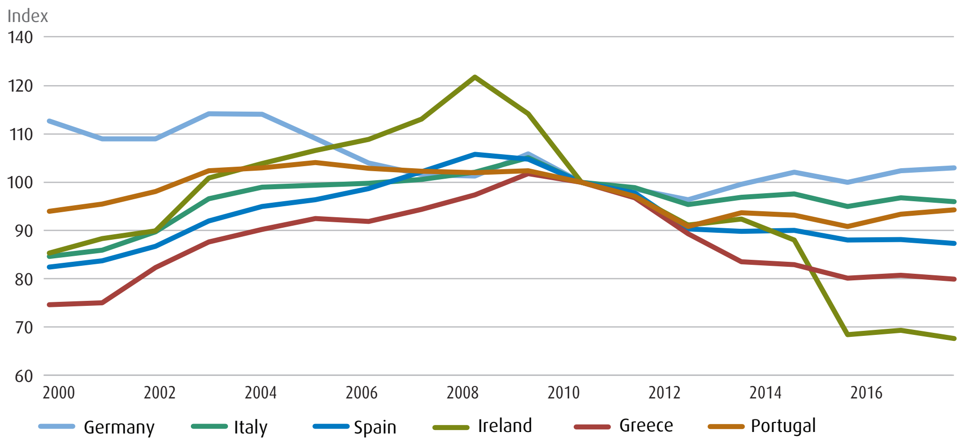


Source: OECD

But perhaps the key data relates to unit labor costs—Ireland has taken a big hit in both the public and private sectors in order to regain international competitiveness, while the other troubled economies have experienced smaller adjustments. Since 2008 Ireland's unit labor costs have tumbled by an astonishing 45%. Absent the possibility of an exchange rate adjustment, Ireland had no option but to attack relative wage costs—with gusto. The consequence was that exports were the initial driver lifting Ireland from recession.

Relative unit labor costs

Index: 2010 = 100 proved oil reserves at end 2017



Source: OECD

There is still much work to be done. Government debt relative to GDP continues to fall, but remains above the eurozone average, while household debt, also falling (relative to incomes), remains significantly above the eurozone average. At its peak in 2009, household debt to disposable income in Ireland reached an eye-watering 230%.

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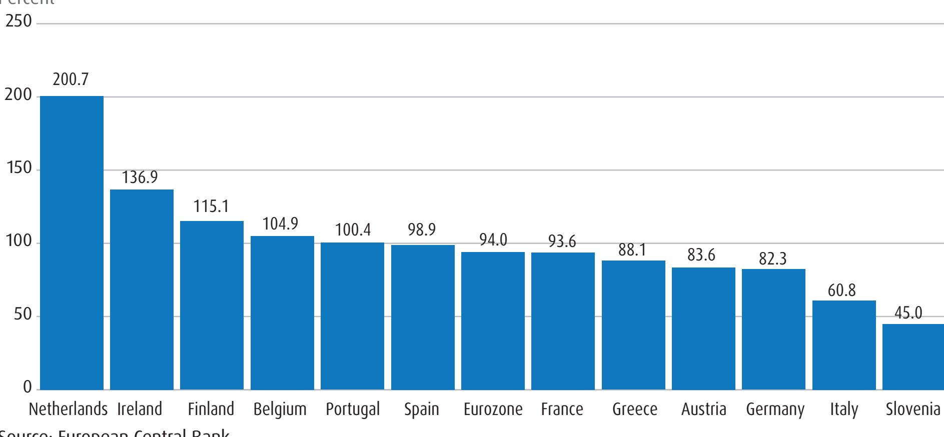
Household debt to gross disposable income (%) as of 1Q18



Source: European Central Bank

The Irish banking sector has undergone massive restructuring since the government bailout with improved capital ratios and asset quality. Nevertheless, non-performing loan ratios remained high at 10.7% in 2017 (IMF data), although representing an impressive improvement on ratios above 20% as recently as 2014. This, however, remains an area of vulnerability as significant sections of the private economy remain financially stressed.

Foreign direct investment (FDI) played a major role in Ireland's boom pre-crisis and has again been vital in the recovery—substantially aided by the fall in labour costs. Ireland's open economy and its famous (infamous) corporate tax rate of 12.5% is a huge attraction to offshore multinationals. Many major U.S. names have significant operations in Ireland and contribute a large share of Irish tax revenue.

The role of major multinationals complicates the measurement of economic output and growth as a share of their activity carried out in other countries is recorded in Ireland's national accounts. The Irish Central Statistics Office has calculated an alternative measure of economic activity—Modified Gross National Income—which excludes the profits of re-domiciled companies, the depreciation of intellectual property products and aircraft leasing.

Adoption of this measure shrinks the size of the economy (relative to the GDP measurement) by around 30%, but does little to deflect from the impressive trend in the last few years in employment, demand and output.

In its recent overview, the IMF concluded: "The outlook remains positive, but the economy is rapidly approaching full capacity. External risks are on the downside, most notably from a resurgence of protectionism and a hard Brexit. Changes in the international taxation landscape may affect the operations of the multinationals in Ireland, with repercussions for the economy and public finances."

Around two-thirds of Irish exports are shipped via the U.K. so Brexit and the hard/soft border issue is a vital variable impacting the country's near-term outlook. We remain optimistic that it will be resolved satisfactorily but it would be foolish to totally dismiss a poor outcome. In the longer-term, however, we are confident that common-sense will prevail.

It never pays to underestimate the Irish.

Protectionism

It is distressing that since we last commented on the Trump initiatives they have been ramped up even further. As we write, a further US$200 billion of Chinese goods will be subject to tariffs on top of an existing US$50 billion. This is equivalent to approximately half the value of goods imported by the U.S. from China in 2017. Mr. Trump is employing his infamous "doubling down" tactic. He has threatened to add another US$260 billion to the list, taking coverage to virtually all Chinese exports to the U.S. The Chinese have retaliated by slapping tariffs on US$110 billion of U.S. goods. Mr. Trump is backing up his election promises and his support base duly engages in enthusiastic cheering.

We do not. Protectionism never works for the greater good. In today's interconnected world with global supply chains, it has even less chance of working than in the past. Costs will rise, growth will slow. In its latest interim economic outlook, the OECD reports that the U.S. initiatives have "...already resulted in marked changes in trade flows...policy announcements have also adversely affected business sentiment and investment plans, reflecting uncertainty about the possible disruption to supply chains and the risk that restrictions may intensify."

Our view has been that thiS disagreement fundamentally relates to Intellectual Property, which the U.S. claims the Chinese have been stealing for years (with justification), but it has now morphed into a far broader fight. Perhaps the Trump tactic will work and a meaningful set of negotiations will soon commence and cool heads will prevail. Or perhaps not.

China re-invented the word "long" in the expression "long-term" view and will wait Mr. Trump out if necessary. Xi Jinping has no elections to worry about—ever. China's aggressive expansion in the South China Sea, Africa and elsewhere should be weighing more heavily on Mr. Trump's plate than these trade issues.

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Emerging markets

Rising U.S. interest rates and the trade war are destabilizing many emerging markets. The most vulnerable are those with substantial external debt denominated in foreign currencies (mainly the U.S. dollar) together with current account deficits. Countries that feature prominently in both categories are Turkey, Argentina, Columbia, South Africa, Chile and Indonesia while slightly less prominently, but nevertheless with a foot in both categories, are Mexico and Brazil. Hungary, Poland and Malaysia (in that order) have very sizeable external debt relative to GDP but are running current account surpluses (OECD data as of the end of 2017).

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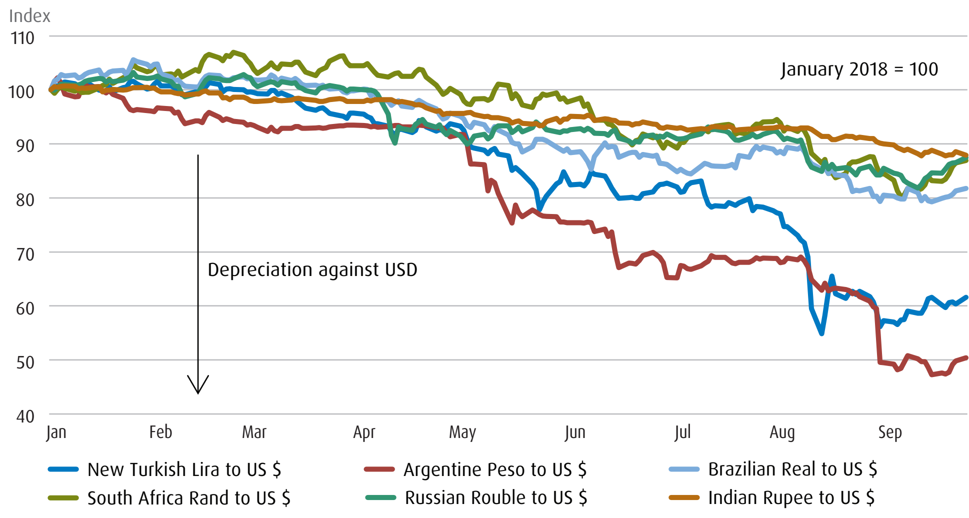
The two countries that have experienced the most dramatic depreciation of their currencies this year are Argentina and Turkey (excluding the Venezuelan horror story). The Argentinian peso has depreciated by 50% relative to the U.S. dollar and the Turkish lira by 40%.

Selected emerging currencies to U.S. dollar



Source: Thomson Reuters Datastream

Mr. Trump has hit Turkey with tariffs of 50% on steel and 20% on aluminium. The U.S. is Turkey's leading export destination for steel, so the impost is painful. The genesis of this skirmish is a diplomatic row with the U.S. over a detained U.S. Pastor, but inevitably it has broadened to include all sorts of unrelated issues. Domestic inflation has passed the mid-teens and the Turkish central bank has now raised its key interest rate to 24%.

Turkey's foreign debt includes at least US$150 billion owed to European banks—mainly Spanish, French, German and Italian (Bank for International Settlements data), so there are many vested interests watching this situation closely.

Argentina has been battling extremely high inflation (over 30%) and the key central bank interest rate is now at 60% (raised from 45% in August). Most of the country's debt is denominated in U.S. dollars. The President of the central bank has now resigned for "personal" reasons after just three months in the job—in the midst of critical discussions with the IMF. This is the sort of situation the word "disaster" was coined for.

The fragility of emerging markets is often underestimated. They generally experience faster average growth than the advanced countries but they depend heavily on foreign direct investment and credit, trade growth and political and currency stability (perhaps a better term is "certainty")—none of which can even be remotely guaranteed. In the meantime the intricate web of global connectivity is all too easily upset by economic initiatives in the advanced world, which have a disproportionate impact on the emerging economies.

We have always been enthusiasts for the emerging world—provided a long-term view is taken. Volatility must be expected and accepted, along with the occasional disaster. The lesson is to avoid those heavily reliant on offshore borrowings while running current account deficits but that does reduce the size of the audience somewhat. We suppose the pragmatist would point out that one of the lessons from the recent financial crisis is that even the advanced world can get it horribly wrong (and often does), so perhaps it is best to avoid preaching altogether.

> Deregulation, the reduced corporate tax rate and repatriation of foreign profits have boosted economic activity, while record share buy-backs have propelled the stock market despite constant net selling of equity mutual funds by domestic investors.

The final word

The U.S. is booming. It must be, as Mr. Trump boasts of it on a daily basis. Deregulation, the reduced corporate tax rate and repatriation of foreign profits have boosted economic activity, while record share buy-backs have propelled the stock market despite constant net selling of equity mutual funds by domestic investors.

Let's just check Mr. Trump's numbers. Since the beginning of 2017 through to the June quarter of 2018, real GDP in the U.S. grew at an average annualised compound rate of 2.7%. If we ex-out the financial crisis and measure the pace of the U.S. economy in the 20 years to the December quarter of 2007 we find that it grew at an annual average compound rate of 2.9%. So the numbers are not dissimilar, but it doesn't suggest that recent U.S. growth is exactly something out of the box (Bureau of Economic Analysis Data).

The reduction in the corporate tax rate is a one-off, as is the repatriation of foreign-sourced profits. They will have an ongoing multiplier impact but this will diminish over time.

The U.S. economy will ultimately fall back on productivity growth and employment growth to keep things moving along. The former is currently running around its long-term average of 1.6%, while United Nations projections indicate workforce growth will average around 0.3% over the next 20-30 years. All-up the rate of future real GDP growth should average around the 2% level.

This is not a criticism. It is just reality and not dissimilar to the prospects for many other advanced economies, while substantially better than some (Japan and several European Union economies spring to mind).

Our concern is that the legacy of the financial crisis remains, with elevated debt levels and extremely low interest rates. This, of course, applies to much of the world. QE is yet to unwind. The world economy relies on the "game" being played for quite a bit longer to ensure the legacies are substantially vanquished.

But now the great "disrupter" is at work with his attack on world trade. This unneeded intervention introduces a wild card that could very easily throw all the cogs out of gear. And into the mix we throw the Brexit "circus."

Predicting the economic path over the next few years is impossible. We'll leave that to the brave folks in the OECD and IMF. Our view remains, however, that equity and bond markets are expensive and risks remain elevated. For as long as the world's third largest economy (Japan) targets a 10-year bond yield of zero and short-term interest rates below zero, we'll continue to say that things are crazy and investment caution is not only advisable but imperative. We'll stick to that old-fashioned view!

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