Lower Rates and Ever Higher Debt

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FINANCIAL STABILITY

At the Global Risk Institute we are often asked what is the most significant risk facing the global economy. While there are many emerging risks and opportunities that we are actively researching, including cybersecurity, geopolitics, regulatory change and climate change, we see the explosion of debt levels world-wide, fueled by extremely low interest rates, as the single biggest and most immediate risk.

We imagine Adam Smith's invisible hand has its fingers crossed. Since the financial crisis, unprecedented levels of central bank intervention and the resultant debt level build up have left the financial world in an ever more precarious position. As we all know, free economies run through cycles of growth and recession, with leverage generally exaggerating both sides of the cycle. With the current growth cycle getting a little long in the tooth (at approaching 84 months; average expansion phase is 58 months), it is appropriate to ask ourselves what the next recession will look like, in the context of this high leverage.

While it is a mugs game to hypothesise about the precise timing of the next recession (Robert Reich famously states that he predicted the 1991 recession so well because he had been predicting it every year for five years), it is appropriate to consider its nature and magnitude. One can characterize the state of the global economy since the financial crisis as slow growing and interrupted by periodic crises:

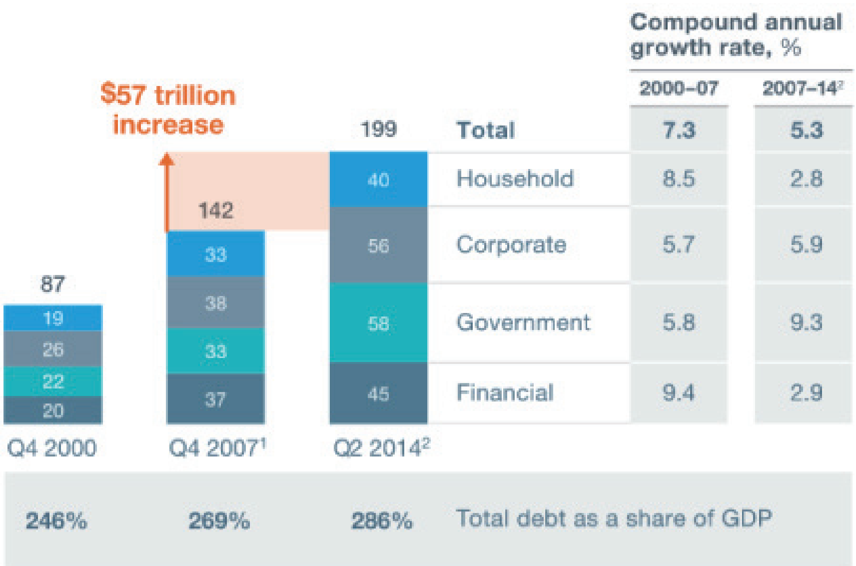
- *Global economic growth has struggled since 2010, making this one of the most tepid recoveries;*
- *Short term interest rates have been held close to zero (and for over $11 trillion of securities become negative) since the recession;*
- *And, for the first time in modern memory, central banks across the developed world have engaged in quantitative easing, buying trillions of dollars of marketable debt securities and forcing longer term (usually market determined) interest rates down across the curve.*

AND WHERE DOES THIS LEAVE US?

The largest monetary easing in the history of the world has left us with both a slow plodding economy combined with the largest expansion of debt in history. McKinsey consulting reports that global debt levels increased from $140 trillion in 2007 to almost $200 trillion in 2015, such that our collective answer to the worst credit crisis in 75 years has been to increase our debt load by 33%. And let's dig a little deeper into this exploding level of debt:

- *China alone has quadrupled its debt since 2007, increasing from $7 trillion to $28 trillion, and most of it in the private (primarily corporate) sector;*
- *Governments have nearly doubled their debt outstanding, increasing from $33 trillion in 2007 up to $58 trillion in 2015;*
- *Similarly corporate debt has increased dramatically, up another 50% from 2007 levels, to almost $60 trillion world-wide;*
- *And while the US consumer has been deleveraging since the crisis, households in much of the world have levered up such that total household debt is up almost 33%, to $40 trillion;*

Global stock of debt outstanding.
$ trillion, constant 2013 exchange rates



The following charts from McKinsey's paper "Debt and (Not Much) Deleveraging," illustrates global debt levels have grown to 286% of GDP (up from 246% in 2000).

It has been a general all-inclusive expansion of debt as the following chart illustrates by country. Debt to GDP levels have increased in all industrialized countries since 2007 and significantly increased in many cases.

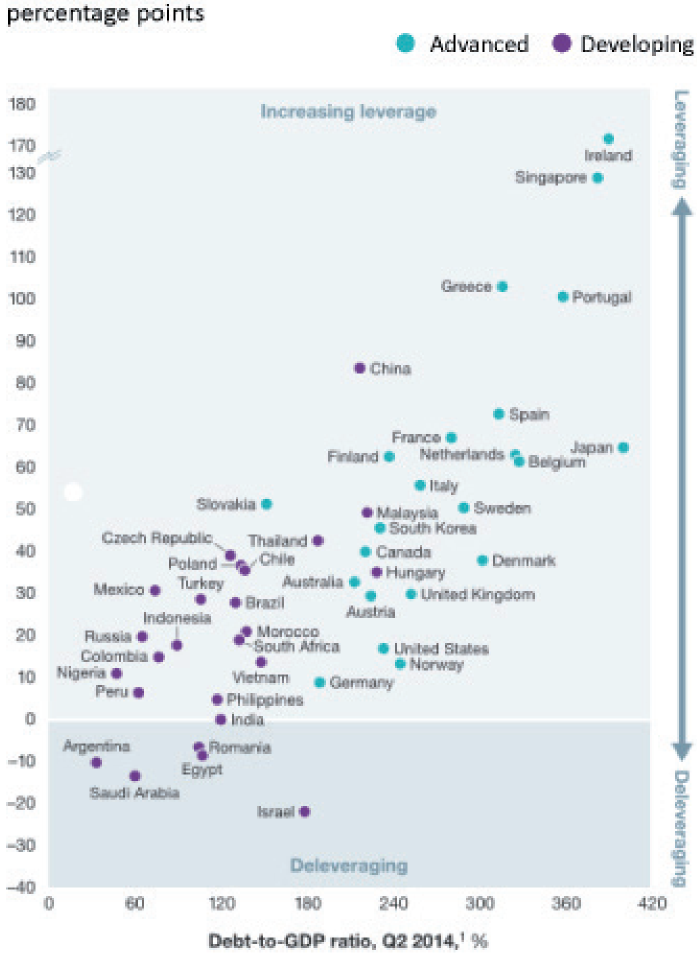
When considering stress scenarios it is often useful to think in terms of their general path characteristics:

- *All growth cycles come to a natural conclusion, so even barring a more dramatic driver (such as a geopolitical event, emerging market credit crisis, or a full scale currency / trade war) we should expect an economic slowdown / recession sometime in the near term;*

- *When the recession begins, we should expect business leaders to reduce investment spending swiftly and amplify their cost containment efforts (which have been ongoing since the financial crisis);*

- *Banks will presumably feel the pinch early and likely tighten their credit standards. We expect the Fed stress scenario will be ramped up to take into account the slowing economy. We also expect their review of bank stress test results will likely involve increased scrutiny of each bank's plan to mitigate the impacts of the coming recession;*

Change in debt-to-GDP ratio 2007-14,
percentage points



[1]Debt owed by households, nonfinancial corporations, and governments; Q2 2014 data for advanced economies and China; Q4 2013 data for other developing countries.

Source: Haver Analytics; national sources; McKinsey Global Institute analysis

- *Consumers, with the period of deep shock and spending curtailment during the financial crisis still fresh in their minds, and seeing the tightening of the credit and labour markets, are likely to curtail spending early and add to a self-fulfilling cycle of tightening and slowing (think in terms of the paradox of thrift, where increased saving by all means a shrinking economy where all are in fact worse off);*

- *Central banks, having exhausted most of their arsenal nursing along the slow recovery, are left with the prospect of negative interest rates and another massive round of quantitative easing;*

- *And finally governments around the world, despite recent political rhetoric, will likely be unable to come to the aid with fiscal stimulus, as budget hawks and in some cases balanced budget legislation and debt ceiling restrictions force further spending reductions to deal with massive declines in tax revenues.*

With the above largely being the first order impacts of the downturn, the second order effect is likely to be the felt through the credit cycle. As both businesses and consumers curtail their spending, and unemployment starts rising, the credit expansion of the last seven years comes to a halt. Credit portfolios that have seen massive growth, including Chinese corporate debt, US sub-prime auto loans (with terms extending out to eight years, loan to value ratios sometimes reaching 120%, and significant growth in credit scores below 680) and hot housing markets around the world will come under intense pressure, causing the banks to tighten credit standards even further; sovereign debt and credit portfolios that have never really recovered from the financial crises, particularly in Europe, would face their next round of crisis and could well include at least a local banking crisis. It is also important to remember that the tepid economic recovery of the past eight years has benefited from the massive build-up of credit, and the absence of ever expanding leverage will also be an economic headwind when the cycle turns. While it is easy to paint a dire picture, it is reasonable to conclude with the mountain of debt outstanding world-wide and the already depleted central bank policy tools, the next recession could be amplified and difficult to navigate.

SO, WHEN IS THIS SCENARIO LIKELY TO BE TRIGGERED?

As we mentioned above, it is difficult for economists to pin point both timing and particular triggers. Having said that, Richard Vague (Managing partner at Gabriel Investments), has developed an interesting framework for anticipating the onset of a recession. Mr. Vague studies the growth patterns of private debt in the economy as a strong indicator of a looming recession. When he analyzes the explosion of private debt over the past few years, it provides a strong indicator that the cycle is likely to turn in the near future. He notes that China alone is estimated to have $2-$3 trillion of problem loans, resulting from a massive build-up of corporate debt, which has resulted in excess capacity in everything from steel to housing and infrastructure.

Consider further the implications of negative interest rates. Throwing out the financial prudence we have all learned since childhood, negative rates penalize savers and encourage ever further leverage. On top of that negative rates inflate the price of financial and real assets, leading to concerns of bubbles and their aftermath.

It is ironic to think that the massive central bank efforts to nurse the economy along have resulted in both tepid economic growth and possibly the sowing of seeds for a more amplified recession when the economy turns. It would seem that the path forward requires a re-think:

- *To start with, God bless Janet Yellen, as she and the US Federal Reserve members are uniquely positioned to bring prudence to the issue and finally begin the process of increasing interest rates;*

- *Central Banks across at least the developed economies need to follow suit, and also end the experiment of quantitative easing and negative interest rates;*

- *In the end the capital markets need to resume their role in setting medium and long term interest rates, and the efficient allocation of capital;*

But maybe we are wrong in our assessment. Another scenario is that, faced with slow growth in spite of monetary stimulus and the desire for inflation, countries turn to fiscal expansion to spend their ways to growth. Instead of reducing debt we could see a period of rapid deficit increases. This is the scenario of "inflating" your way out of a debt crisis. By reducing the purchasing power of money, you essentially repay debt with paper worth less. We have seen this before and it never ends well. It is an unpredictable scenario that leads to currency devaluations, trade conflicts and real reductions in standards of living.

In any event, it is certainly time for financial institutions to recognize the fact that this increase in global leverage leaves them exposed to the next recession. Recall it was the firms (for example, large pension funds, some insurance companies, JP Morgan, and the Canadian banks more generally) who, back in late 2006 and early 2007, saw the coming crisis and prepared themselves and their balance sheets. They survived and thrived despite the global financial crisis. Firms need to solidify their balance sheets, maintain strong capital, bolster liquidity positions and maintain prudent leverage, so that they can turn the coming market pressures into opportunity.

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Brian is an Executive in Residence at the Global Risk Institute, after retiring from CIBC in 2015. Most recently Brian was CIBC's Executive Vice President and Chief Data Officer, where he developed their data strategy and governance framework. Prior to the CDO position Brian lead the Bank's Enterprise Risk Management group, including balance sheet and capital management.

Read Brian's full Bio on GRI Website **>**

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