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CIO Viewpoint

An indebted recovery and the seeds of instability?

Investment Solutions

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Low interest rates, record levels of personal savings and historic fiscal and monetary stimulus are all combining to reshape the global economic and financial environment. Government and corporate debt has never been higher. Investors are questioning whether this debt, from financial or economic leverage, contains the seeds of market instability.

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Key takeaways

- Record levels of debt in the economy, including financial leverage, raise questions over a potential for future instability. A recent case highlights the dangers of poor risk management
- The IMF and UN have warned about emerging market debts. We believe most of these economies have the macro-economic strength to withstand volatility
- As economies normalise, debt will become a more important metric to assess financial health as cheap credit has masked some inefficiencies
- While these historic levels of debt remain affordable, investors must focus on its objectives, favouring quality investments over short-term spending.

Two weeks ago Archegos Capital Management LLC, a New York-based family office, offered an example of excessive financial leverage. Its investment portfolio depended on high levels of leverage, which, when it failed to cover margin calls from its prime brokers, triggered an equity-selling spree. In the scramble to unwind an estimated USD 30 billion in trades, Credit Suisse, Nomura, as well as UBS, all lost money. Credit Suisse was the most affected, and is now writing down CHF 4.4 billion of assets linked to the case and will post a CHF 900 million loss in the first quarter, cut its dividend and reduce its share buybacks, Bloomberg reported.

The banks' losses and equity market volatility led to questions about whether there is too much financial leverage. Yet the notable thing is that while the impact fell especially on some banks' shareholders, the Archegos incident did not pose a broad systemic threat to the financial sector.

Too much leverage?

Markets shrugged off the incident and continued to price in a rapid economic recovery. US Treasury bill yields reflect this optimistic outlook for economic debt, reaching their highest levels in 15 months last week. The US benchmark bonds rose as high as 1.74% as the Biden administration unveiled a USD 2.25 trillion infrastructure spending plan on 31 March, adding to the USD 1.9 trillion pandemic relief approved two weeks earlier.

While the current macro data and trends point to a strong economic recovery, debt held by economic actors such as governments, companies and households also needs monitoring. More than a decade of low-to-negative interest rates worldwide and colossal government spending boosted borrowing to never-before-seen levels. At the end of 2020, global debt stood at USD 281 trillion, the equivalent of 355% of the world's gross domestic product.

Still, in this environment of accommodative financial conditions, we believe that the issue is how governments spend this money, rather than whether the debt remains affordable. The Federal Reserve continues to reassure markets that its plans to raise rates will not kick in for another couple of years. In the eurozone the European Central Bank has spent 1.85 trillion euros on its Pandemic Emergency Purchase Programme, and says it wants to increase its bond buying.

All this intervention is propping up large sections of the economy. At the corporate level, many sectors are experiencing possibly permanent changes to their business models. The shifts in demand for travel and tourism, real estate, healthcare and remote communication technologies are creating both 'zombie' firms, surviving on cheap credit, as well as winners.

For now, corporate default rates worldwide are running at around 6.6%, according to Moody's Investors Services, a little higher than their 4.3% four-decade average and half their peak of 2009 during the Great Financial Crisis.

Credit default swaps, which illustrate the cost of insuring debt, tell a similar story. They are trading at less than one-third of their 20 March 2020 high, according to the Markit CDX North America Investment Grade Index, and five times lower than their peak of November 2008.

The risks to emerging markets

Emerging markets are another potential concern. Last week the United Nations reported that in the past year, 42 economies have had their sovereign debt downgraded, including 27 emerging markets and 9 least developed countries. Six nations, Argentina, Belize, Ecuador, Lebanon, Suriname and Zambia, defaulted on their foreign debt in 2020. On 24 March, Argentine Vice President Cristina Fernandez de Kirchner said that her government cannot repay a USD 45 billion loan to the International Monetary Fund (IMF), and is renegotiating terms. The country restructured USD 65 billion of its debt with creditors in 2020.

Total downgrades and defaults may underestimate the threat of these levels of debt, according to UN Secretary General António Guterres. Many governments, including Brazil and South Africa avoided deeper problems by borrowing from domestic lenders at high interest rates, he said.

The pandemic's eventual aftermath will be difficult for many emerging economies to navigate. The "prospects for recovery are diverging dangerously" between emerging and developed economies, the IMF's Managing Director Kristalina Georgieva told a meeting last week.

One tool, debt relief, will be addressed at the Group of 20 meeting of finance ministers and central bank governors, scheduled for 7 April. There, the World Bank's Debt Suspension Initiative (DSSI) worth USD 5.7 billion through June this year, should be extended by the G20 until the end of 2021, said Ms Georgieva.

Nevertheless, by some measures, emerging economies have rarely looked healthier and appear strong enough to withstand some macro volatility, thanks to little external dependency. Many nations hold enough foreign exchange reserves and the current accounts of most of the largest emerging economies were in surplus in late 2020, including South Africa and India, two of 2013's 'fragile five', while Brazil and Indonesia are close to balance. Turkey is the only exception, where we believe the story is largely idiosyncratic.

Thanks to contained inflation pressures in most countries for the near future, we expect interest rate rises to be gradual enough to keep financial conditions favourable, at least through this year. These countries will of course also benefit from the improving global trade flows. In the eventual wake of the pandemic, investors will need to pay attention to the differing fiscal discipline demonstrated by these governments, given their varying abilities to finance their debt levels.

Increasing debt scrutiny

As the world's economies normalise, we believe that debt will become an even more important metric for investors to assess the financial health of states, industrial sectors and corporations. This will inevitably shape the investment opportunities as we recover fully from the pandemic. For now, the US's ambitious infrastructure spending plans signal that the purpose of this new debt is investment in a sustainable economic future. This should have a positive effect of up to +0.5% per annum on potential growth and increase the country's ability to repay debt.

Central banks' asset-buying programmes coupled with cheap credit have masked the inefficiencies of some sectors. Financial leverage may continue to throw up further examples of poor risk practices, loose credit standards among investment banks keen to build market share, or excessive risk taking. Longer-term questions therefore remain, and investors will increasingly look at debt costs, and their implications for the global financial system.

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