Market Commentary

Debt Propelled

"After the 2008 financial crisis and the longest and deepest global recession since World War II, it was widely expected that the world's economies would deleverage. It has not happened. Instead, debt continues to grow in nearly all countries, in both absolute terms and relative to GDP. This creates fresh risks in some countries and limits growth prospects in many... Debt remains an essential tool for funding economic growth. But how debt is created, used, monitored, and when needed discharged, must be improved."

McKinsey Global Institute, *Debt and (Not Much) Deleveraging, February 2015*

One of the best post-mortem reports on the 2008 financial crisis came from the McKinsey Global Institute (MGI) in its January 2010 publication *Debt and Deleveraging: The global credit bubble and its economic consequences.* The document not only delved deeply into the causes of the crisis but also offered contextual insights by exploring historical parallels. Significantly, it laid out plausible roadmaps for recovery.

The key message was clear – although deleveraging would not be easy, quick or painless, it was essential. In MGI's view, which is supported by credible research, the massive debt burden created a serious headwind to economic growth, given that high levels of debt are associated with slower rates of GDP growth and a greater vulnerability to financial crisis.

MGI (an internationally respected business and economics research group) has just published an updated report on the world's progress in the last five years. The results are mixed at best.

Let's start with the good news: the financial sector got the message, reduced debt and became safer as a result. It's also noteworthy that the world's riskier forms of shadow banking, which directly contributed to the enormity of the crisis, are diminishing even as non-bank lending is rising in importance.

The flip side of the story is not so rosy. Rather than shrinking, global debt has increased by $57 trillion since 2007. Governments have added another $25 trillion to the wrong side of the ledger. Some of the countries swimming in red ink will need new solutions to get the deleveraging started. When nations are faced with severe debt, they typically try to "grow their way out," or cut back on spending. That's not likely to work this time since it would require an implausibly large growth in GDP and fiscal cuts would have to be extremely deep and painful.

The quadrupling of debt in China and the expansion of household debt worldwide were also singled out for special mention. Chinese debt is troubling for two reasons: first, approximately 50% of loans have either a direct or indirect link to real estate; second, China's murky shadow banking system is growing at more than 35% per year. In over 80% of the countries McKinsey studied, household debt has ballooned, largely due to mortgages. The report concluded that seven countries might have household debt levels that are unsustainable. Canada sits prominently within that group.

U.S. — The American Patient

The first quarter of 2015 looks a lot like the first quarter of 2014. Last year's slow start was blamed on the polar vortex, expired business tax breaks and uncertain healthcare coverage. This time around, fingers are pointing at severe winter weather, congestion in West Coast ports and the U.S. dollar's strong performance. Softer economic numbers from the first quarter are causing some analysts to lower their GDP growth estimates. Factory orders have been disappointing based on six consecutive declines in capital goods orders and flat shipments.

Analysts expect the second quarter to rebound nicely, with only the dollar continuing to drag on upward momentum. We can see some compelling evidence for believing in a rebound. Strength in new employment has been stellar, making it easy to infer that companies view the current economic softness as temporary. Consumers are in great shape and the recovery in housing seems to be picking up steam. Sales of new homes hit a seven-year high in February. Recently reduced mortgage rates on a median-priced house make it cheaper to own than rent in some cases. First-time buyers are showing up again.

Corporate earnings have been more volatile in the quarter and modestly softer. It's reasonable to expect lingering volatility for a while at least due to the current disruption in the energy sector and the strong U.S. dollar. Wage gains are not likely to threaten margins any time soon; lower commodity prices are also supportive. Earnings should firm up when economic growth reaccelerates in the back half of this year.

The U.S. Federal Reserve (the Fed) adjusted its guidance by removing the word "patient." Some Fed watchers found that confusing. Was the Fed planning to raise rates much sooner? Central bank chair Janet Yellen quipped in her post-meeting press conference that removing the word "patient" did not mean that "we are going to be impatient." She also said that a rate hike would be contingent on increasing strength in the labour markets and some assurance that inflation would not remain stubbornly below its 2.0% target.

Europe — Some Green Shoots?

Not surprisingly, the MGI report devotes considerable space to European debt, concluding that European economies "require significant fiscal adjustments to start public-sector deleveraging." The authors dismiss the notion that government debt ratios can be reduced by growth. History confirms that the rates of growth required to enable that path are well beyond current GDP forecasts. Instead of achieving debt retirement, the experiment with tight austerity measures galvanized political resistance. McKinsey's bottom line: "policy makers will need to consider a broader range of actions to stabilize or reduce government debt."

Evidence increasingly suggests that the European economy is growing. Recent manufacturing and consumer surveys all ticked up quite nicely. In March, the eurozone's measure of consumer confidence reached levels not seen since the summer of 2007. This is probably the result of falling unemployment, lower oil prices and perhaps a bit of "wealth effect" from rising equity prices. While the number of unemployed across the eurozone remains persistently high, it did drop by 900,000 in the year to January and likely dropped again in February. That's moved the unemployment rate down from 12.1% in May 2013 to 11.2% in January 2015. This all bodes well for consumer spending in the region.

China — Progress on Local Government Debt

The McKinsey report singled out three risks relating to China's debt that bear watching. First, approximately half the debt of households, non-financial corporations and government is tied either directly or indirectly to real estate. Second, runaway growth in local government financing vehicles (LGFVs) has left many of these entities struggling to repay loans created to service prior debt. Land sales are also funding debt repayments. Third, as much as one-third of the outstanding debt is in the form of loans from the rapidly expanding and unregulated shadow banking system.

These factors take on added importance right now for the following reason: until 2007, the Middle Kingdom's debt had grown only slightly faster than GDP. That year, it reached 158% of GDP, which was in line with other developing economies. Since then, however, China's debt has wildly outpaced growth, climbing to 282% of GDP at the mid-point of last year. Additional borrowing is not nearly as efficient a catalyst to growth now as it was in earlier years.

New growth targets announced early in March at the National People's Congress (NPC) received a lot of attention. One perhaps under-reported and under-estimated item coming out of the NPC was the plan for a massive debt-swap program to deal with the LGFV debt issue. The Ministry of Finance reportedly intends to put together a RMB 3-trillion debt-swap program that will allow local governments to directly raise debt in order to deal with existing budgetary shortfalls and repay debts borrowed from more expensive sources. (Local governments had borrowed vast sums of money to shore up growth through infrastructure construction in response to the global financial crisis. The legal status of those loans was “murky” and led to much higher borrowing costs.) This overhaul of local government debt achieves a couple of important things: it likely lowers borrowing costs for local governments by as much as 4.0% to 5.0%; and the swap program has the potential to remove one of the major concerns about China’s debt picture.

Premier Li and senior leadership are planning a bigger fiscal push for 2015, with a strong message to local authorities calling for adherence to the spending plan – after some unexpected shortfalls in spending in 2014. That plan is propelled by a 2.3% projected deficit. Top fiscal measures focus on infrastructure investment and social welfare programs.

Canada — House Poor?

The McKinsey report noted generally manageable levels of government and corporate debt in Canada, but it did highlight Canadian household debt – along with that of six other countries – as an area of vulnerability and concern. While Canada does not share the same overall debt-service ratios as the other six, we do have similarly high debt-to-income ratios for households. What’s worse, that debt has grown materially since 2007.

A crisis is not inevitable, however. According to the report, “the creditworthiness of borrowers, the ability of lenders to assess risk and the state of the macroeconomy will all influence the outcome.” That last bit certainly takes on more relevance given the recent oil shock to the Canadian economy. Bank of Canada Governor Stephen Poloz warned that the economic weakness in the first half of the year might be more front-loaded than anticipated. No doubt January’s data seized his attention. Exports slumped, manufacturing activity stalled and retail sales were off for a second month in a row. January showed a 0.1% decline in GDP; February may not be much better.

It’s too early to look for signs that a weakened loonie has contributed to better Canadian manufacturing results. We can expect to wait between one and three years before a lower currency produces improved results in that sector. Meanwhile, we will likely continue to see positive results in real net exports as manufacturers and consumers substitute the now-cheaper domestically produced goods for higher-priced imports.

Our Strategy

Our attention remains focused on the trends in corporate earnings, particularly in Canada and the United States. Ultimately, equity valuations come down to a couple of pretty simple questions: How much are corporations earning on the assets they own or control? What are we, as investors, prepared to pay for those earnings? The recent softness in U.S. earnings is concerning, but not overly so. The second quarter should tell us whether first-quarter results are an exception as they were last year, or a trend that requires action.

We continue to be constructive on the U.S. economy – and that is supportive of equities. Further expansion of the U.S. economy should help Canadian exporters. Consequently, our portfolio continues to favour stocks over bonds.

There's an adage in the investment world: "don't fight the Fed." It's a dicey gambit not to be invested when central banks globally continue to be highly supportive of economic activity, which tends to place a "floor" under many asset classes. All the same, high valuations merit caution.

The Last Word

The McKinsey report concluded its debt study with a chapter entitled "Learning to Live with Debt." In it, the authors catalogued a number of practical recommendations for dealing with high debt levels, including the development of better tools to monitor and manage debt, innovation in mortgage contracts, essential process improvements in private and public sector debt restructuring, opening public debate on the need to reduce tax incentives for debt (particularly mortgage debt) and ways to resolve bad debt with the least disruption to the economy.

The years since the Great Recession have borne witness to just how difficult it is to deleverage. Even so, the debt overhang continues to be a substantial and persistent obstacle to economic growth. Debt reduction will remain no small task for policy makers and central bankers everywhere.

BMO Wealth Management
BMO Private Banking