Global Debt Explodes: Enjoy Today's Cyclical Bounce, Prepare for Tomorrow's Structural Risk

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Executive Summary: 2021 Market Themes

- **Virus:** Distribution of vaccines protecting the vulnerable and a relaxation of restrictions will spur more rapid than expected consumer re-engagement, broadening the recovery thereby limiting scarring. Consumers, supported by excess savings, robust net worth and additional fiscal aid, will return to discretionary spending, leading to further recovery in the service sector.
- **Global Growth:** The recovery in services spending coupled with resilience in goods demand will usher in an extended period of above trend global growth, easing pressure on the income divide. China will be a key driver of global growth near term but its cyclical influence will wane over time as it evolves from a global goods producer and exporter of disinflation to a service driven economy.
- **EM:** While lagging the initial rebound, EM's higher potential growth rate will be a key incremental source of global growth as longer-term demographic and debt headwinds increasingly weigh on more advanced economies. Global monetary and fiscal accommodation combined with less uncertainty and a more multilateral trade environment will benefit EM, attracting abundant capital which will further stimulate growth.
- **Inflation:** Resurging global growth will produce an inflationary pulse that will prove muted in magnitude and duration as lingering excess supply and productivity growth allow capacity to exceed the increasing level of demand. The return of service demand will create localized but less globally transmissible pockets of inflation.
- **Central Banks:** Central banks still fear deflation and will prioritize support for growth and broad labor market dynamics over the containment of cyclical inflationary pressures. Competing QE purchase activity between the Fed and the ECB will control the direction of the dollar with the ECB seeking to limit significant appreciation of the euro.
- **Global Debt:** The ongoing savings glut will allow governments to continue funding large deficits, fueling global growth in the short term while delaying the structural growth suppressing effects of their burgeoning debt. Despite elevated debt levels, corporate health will improve as revenue growth outpaces interest costs and competitive forces drive innovation.
- **Markets:** A rebounding economic environment, fostered by a duality of fiscal and central bank support, will push spreads uncomfortably tight. Already heavy use of economic stabilizers creates fragility to shocks and will leave investors exposed to increasingly asymmetric risk profiles. Diversification, tail risk hedging and careful analysis of cyclical vs. structural factors are necessary to mitigate downside risks.

No Really, This Time Is Different (Sort Of)

In a typical business cycle, overexuberance creates a bubble that inflates asset prices beyond their intrinsic value. Market forces eventually catch up, the bubble pops and regulators introduce new (but backward-looking) rules to help ensure a similar type of "boom and bust" never happens again. In response, excess and overexuberance are expressed in ways that are different than in the last cycle. In other words, a new business cycle usually introduces new risks.

"The 2020 recession is unusual because it was not caused by a risk or excess that had been building up in the market over a long period of time. Instead, COVID-19 was a sudden, unexpected shock that forced policymakers to respond with extraordinary measures to prop up an economy that was intentionally put on pause."

The 2008 crisis, which was driven primarily by excessive consumer leverage, is a perfect example of the traditional "boom and bust" cycle. Subprime mortgage debt exploded and home prices soared, creating a bubble that became systemic because of heavily leveraged bets tied to subprime mortgages in financial markets.

"The COVID-19 dislocation did not wipe away leverage from the corporate credit arena—in fact corporate leverage has increased further relative to its long-term average on the heels of record 2020 issuance."

The implementation of stricter mortgage lending standards following the financial crisis, by and large, had its intended effect. Mortgage debt after the 2008 crisis charted a steadier, healthier trajectory on a historical basis as a percentage of GDP. On the other hand, corporate borrowing in the decade after the 2008 crisis reached all-time highs as a percentage of GDP, outpacing growth in the economy and displaying characteristics normally associated with a market later in its cycle.

Unlike previous recessions that ended in forced de-leveraging, the COVID-19 dislocation did not wipe away leverage from the corporate credit arena. In fact, corporate leverage has actually *increased* relative to its long-term average on the heels of record 2020 issuance.

The Fed stepped in and backstopped corporate credit markets. This action by the Fed prevented the wave of defaults that normally accompanies the end of a credit cycle and in fact triggered demand as some investors chose to "Follow the Fed".

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How corporations use the proceeds of newly issued debt will be a critical risk factor to monitor going forward. The good news is that so far, corporations, in aggregate, seem to be using new debt to strengthen their liquidity and defend their competitive position in the marketplace. These are uses that the debt market does not view as threatening. Despite elevated debt levels, our view is that corporate health will improve as revenue growth outpaces interest costs and competitive forces drive innovation and profitability. While not our central case, the risk that must be monitored closely, is the potential for low cost debt to entice a more aggressive wave of leveraged buyouts or other balance sheet destructive activities that usher in an era of asymmetric downside risk for credit investors.

When Will Deficits Matter Again?

In many cases, measures taken by policymakers to help combat COVID-19, while necessary and appropriate, exacerbated structural problems that were in place prior to the pandemic. Like other central banks, the Fed was still in the process of unwinding the "extraordinary and unprecedented" measures it used to fight the 2008 crisis. The fear was that the lack of rate hikes since 2008 would make dealing with the next downturn that much harder.

However, the response to the pandemic forced the Fed to slash (already low) rates to zero, a Zero Interest Rate Policy stance (or ZIRP) that the Fed announced would stay in place for the foreseeable future. Europe and Japan had made even less headway in terms of unwinding their accommodative policy since 2008. Prior to the pandemic, real yields in Europe and Japan lingered within or near negative territory. Following the pandemic, negative yielding debt now accounts for almost 40% of all global government debt outstanding.

Government debt has increased dramatically and will continue to do so. In the near term, this explosion of debt provides a boost to growth and is advisable and easily supported due to low interest rates. However, in the long run this massive increase in debt could be a suppressant to growth as any eventual increase in interest rates will increase debt servicing costs and either crowd out other initiatives or require higher taxes. While we believe higher growth and inflation could allow countries to grow into their debt levels, catalysts for inflation will not be found in monetary policy driven by central bankers, but instead in sound fiscal policy and global economic policies targeted towards sustainable global growth.

Don't Take the Bait: Inflation is Cyclical, Not Structural

Given rapid money growth and expectations for above trend growth in 2021, many investors are becoming increasingly concerned about inflation. Don't take the bait. Like every other data point, monitoring inflation risk requires context for the uniqueness of the economic environment created by the measures to contain the spread of COVID-19.

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For example, the recent strength in some areas like airfare is related to a recovery of demand from very depressed levels. In other areas like household and recreation items, the higher pricing is likely more permanent, as recent strength is due less to a recovery of demand and more from increased demand relative to pre-COVID levels. Furthermore, global demographic trends and the continued influence of a global savings glut will also lean against persistent inflationary trends beyond the coming period of cyclical rejuvenation.

While inflation is a risk we always monitor, we ultimately believe that these scenarios will prove to be temporary and/or limited to certain areas of the economy.

What It All Means for 2021: Cyclical Alignment, Structural Questions–And Don't Forget About the Tail

Heading into 2021, the market backdrop for cyclical sectors is extraordinarily positive. Consumers, supported by excess savings, robust net worth and additional fiscal aid, will drive a recovery in discretionary spending, leading to a full re-engagement of the service sector. The recovery in services spending coupled with resilience in goods demand will usher in an extended period of synchronized above trend global growth easing pressure on the income divide. Global synchronized expansion is here.

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In the near term, cyclical sectors across securitized credit, corporate credit and emerging market debt are relatively attractive. We believe that a rebound in economic growth, fostered by a duality of fiscal and central bank support, will push spreads uncomfortably tight in 2021.

However, we also recognize the market seems to be very aligned on the near-term positive direction of risk assets. This one-way sentiment opens the door for unexpected volatility. The vaccine news is overwhelmingly positive and we ultimately believe the vaccine will succeed. However, the potential for episodic market stresses, whether connected to the vaccine or other global factors, should not be overlooked.

"Diversification, tail risk hedging and careful analysis of cyclical versus structural factors are necessary to mitigate downside risks and prepare portfolios for the income-starved world we face ahead."

The heavy use of economic stabilizers creates fragility to shocks and will leave investors exposed to increasingly asymmetric risk profiles. Security selection, which is always important, has become absolutely critical as the dispersion between "winning" and "losing" investments within sectors will remain extremely wide. Diversification, tail risk hedging and careful analysis of cyclical versus structural factors are necessary to mitigate downside risks and prepare portfolios for the income-starved world we face ahead.

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