Global Perspective—Global debt spike

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October 14, 2021

Global debt spike

In 2020, the global economy experienced a severe economic drop, triggering a massive fiscal stimulus response to mitigate the financial hardships. While fiscal authorities spent vast sums on pandemic-related spending, monetary authorities supported that fiscal spending with asset purchases (Slide 6).

According to International Institute of Finance (IIF) estimates, the global debt level increased by $24T last year, bringing the total closer to $300T, and moving countries a couple notches up on the debt-to-GDP ladder (Slide 3).

Lower rates improved affordability of debt

Record low interest rates, including negative rates in most of Europe and Japan, made debt servicing easier. Even though the world's total debt recorded in the Bloomberg Global Aggregate Index grew six fold since 2000, the servicing cost of that debt stayed flat over the years (Slide 5).

The tide has changed

Now we're hopefully nearer to the end of the Covid-19 crisis than the beginning; normalization of rates could strain public finances. It has already started in many emerging markets economies where inflation worries led to many policy rate hikes in 2021 (Slide 4). According to IIF estimates, each 1% change in average yields increases debt servicing cost by 2% of GDP in the U.S., complicating monetary policy decisions.

Now is the time for the denominator to work

Debt-to-GDP ratios in many countries have ballooned above 100%, including in the U.S. In 2021, the world economy is expected to grow a record 5.9%. Higher growth rates and inflation running higher than the servicing costs will eventually reverse the trend for debt-to-GDP ratios.

How much debt is too much?

If Japan, with a 256% estimated debt ratio, is the ultimate final destination for the developed economies, many countries have more room to rise. Not every country is in as fortunate position as Japan, which issues debt in its own currency (yen) and where more than half is owned by its central bank.

Top 10 indebted economies

Countries	Gross debt to GDP
Japan	256%
Greece	213%
Italy	155%
Portugal	131%
United States	127%
Canada	118%
Spain	117%
France	113%
United Kingdom	104%
Argentina	103%

Data Source: Truist IAG, International Monetary Fund, Gross Debt-to GDP ratio estimated for 2020 .

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Our take

With debt levels reaching above GDP in many countries, debt sustainability becomes a fundamental question. When analyzing sovereign debt structures, debt servicing is more important than the actual debt levels in many cases. Japan, the country with the highest debt levels in terms of GDP, has been servicing its debt at almost no cost, thanks to low interest rates enabled by the Bank of Japan. Even with the recent increases in fiscal spending, Germany borrows at negative interest rates, thanks to the European Central Bank's (ECB) ultra-loose monetary policy, which keeps the deposit rate at a negative half a percent. If the cost of borrowing is zero or negative, what is the amount a country can borrow? In theory, the answer should be "an infinite amount" as the cost of borrowing (servicing the debt) is negligible. Still, unfortunately, history is filled with international debt and banking crises or high inflation periods that result in currency crashes or debasements. Therefore, countries with arms-length control of the monetary authority and no external debt other than their currency will have an advantage going forward.

Highly indebted emerging economies are most vulnerable

In emerging markets, there are numerous countries with debt issued in currencies other than their own – such as in the U.S. dollar or euro. Argentina, Turkey, Brazil, South Africa, and Mexico are prime examples. Since these countries do not control the foreign currency, they're at a high risk of default if their local currencies decline in value. Therefore, inflation becomes a critical issue, and foreign currency fluctuations are keys to the debasement of the currency.

Highly indebted Eurozone countries are as vulnerable as emerging markets economies

In the Eurozone, no one country has full control over the decision-making of the monetary authority.

This feature improves the independence of the ECB; however, while this gives credibility in good times, it creates a bottleneck in bad times. During the European debt crisis of 2010-2013, with Greece at the epicenter, the common currency's future came into question with the ECB's hands tied by different factions within the organization. With relatively high amounts of debt, Greece, Italy, Portugal, Spain, and France are at the mercy of ECB's ultra-loose monetary policy, over which they have little to no control.

U.S. debt still manageable, debt ceiling could be an issue

During the pandemic, an unprecedented amount of fiscal stimulus was deployed, nearly 25% of GDP, pushing up the U.S.'s debt-to-GDP ratio. The Fed absorbed most of the additional deficit spending debt, increasing the size of its balance sheet. The U.S. only issues debt in U.S. dollars, and the federal government is the issuer of the U.S. dollar. In theory, assuming there is no debt ceiling, the government can issue new debt to pay old debt forever. There is one side effect of this theory—inflation. That is what happened in 2021, with inflation expected to reach its highest levels in three decades.

Bottom line

We expect global fiscal imbalances to persist for at least the next three years. Countries with debt issued in a foreign currency or countries with minimal control over their monetary policy, like those in the Eurozone, are the most vulnerable to debt-related crises. On the other hand, countries with complete control of their monetary policy and historically credible currencies such as the U.S., U.K., Japan, and Canada have much more room to maneuver. In fixed income, this is the key reason why we view hard and local currency emerging markets bonds as the least favorite asset class in our investable universe. Similarly, overseas developed markets bonds are less attractive than U.S. Treasuries or high yield corporate bonds.

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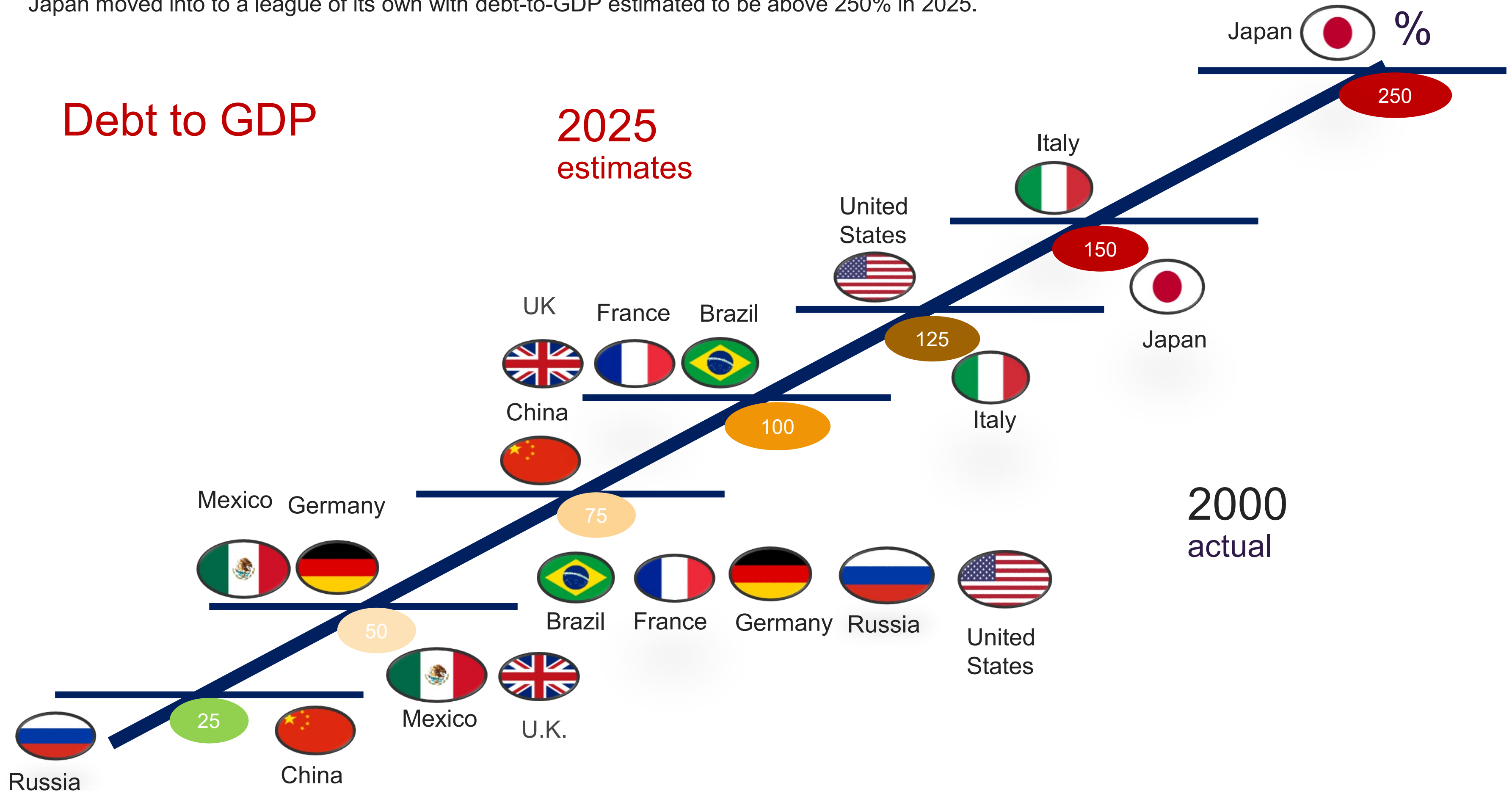
Climbing up debt-to-GDP ladder

Pandemic-related fiscal stimulus packages worsened public finance balances. Within the major developed economies, only Germany is estimated to stay around the same debt-to-GDP levels. Within major emerging market economies, only Russia's ratio improved. Japan moved into to a league of its own with debt-to-GDP estimated to be above 250% in 2025.



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Data Source: Truist IAG, International Monetary Fund, data not on scale.

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Inflation scare is hitting emerging markets' policy rates

Globally, fiscal balances are expected to take a hit when interest rates start to normalize. Emerging markets economies are much more vulnerable to interest rate hikes since it fuels inflation by increasing the cost of capital and also hurts fiscal balances via higher debt servicing.

To deal with the pandemic-related economic slump, we had a record 207 rate cuts and only nine rate hikes in 2020. In 2021, with inflation coming back and economies normalizing slowly, we had 65 rate hikes and nine rate cuts year to date.

Most of the rate hikes happened in the emerging markets economies, as they are more susceptible to inflation. Brazil, Turkey, and Russia experienced multiple rate hikes, and more are expected.

In the developed markets, policy rates mostly stayed stable. Norway and New Zealand were the only major economies raising policy rates this year. Within G7 economies, only the U.K. is a candidate to raise rates in 2021.

In the Eurozone, policy rates are expected to stay flat for a prolonged period as the ECB has not yet started tapering.

In the U.S., market pricing indicates one rate hike in 2022, and tapering is expected to be announced in December.

Noteworthy monetary policy rate changes in 2021

Emerging			Developed	
Brazil	4.25%		Norway	0.25%
Turkey	3.00%		New Zealand	0.25%
Russia	1.50%			
Czech Rep	1.25%			
Peru	1.25%			
Hungary	1.05%			
Chile	1.00%			
Mexico	0.75%			
Romania	0.25%			
Colombia	0.25%			
Pakistan	0.25%			
S Korea	0.25%			

Data Sources: Truist IAG, Bloomberg

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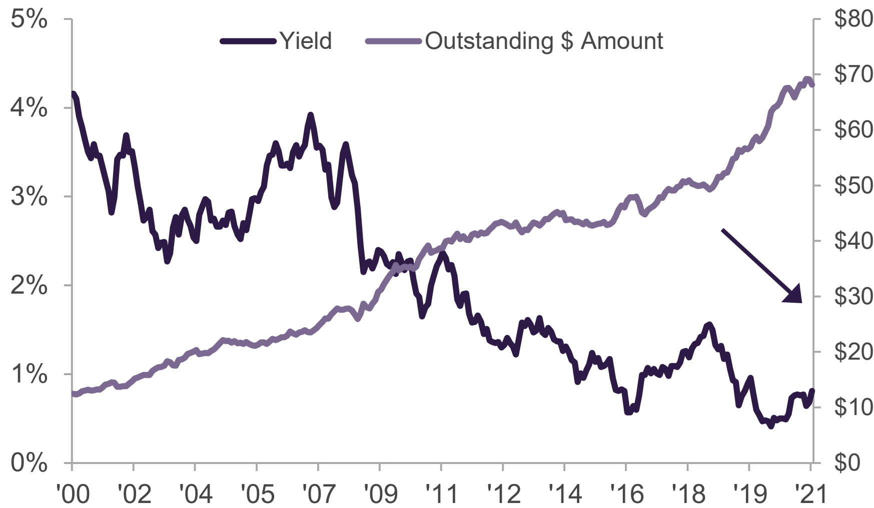
The amount of outstanding debt grew over six fold, but debt servicing stayed the same

The Bloomberg Global Aggregate Index measures investment grade debt from 24 local currency bond markets, including the U.S., Europe and Japan. The latest market value of index constituents is $68 trillion, and it has risen six fold since the new millennia. The index's average yield dropped from above 4% to below 1% over the last two decades. Lower rates kept the debt servicing at around similar levels over these years. In GDP terms, debt servicing dropped as the World's GDP grew since 2000 every year, other than 2020.

Bloomberg Global Aggregate Index yield % (l-axis) & market value (r-axis, trillions)

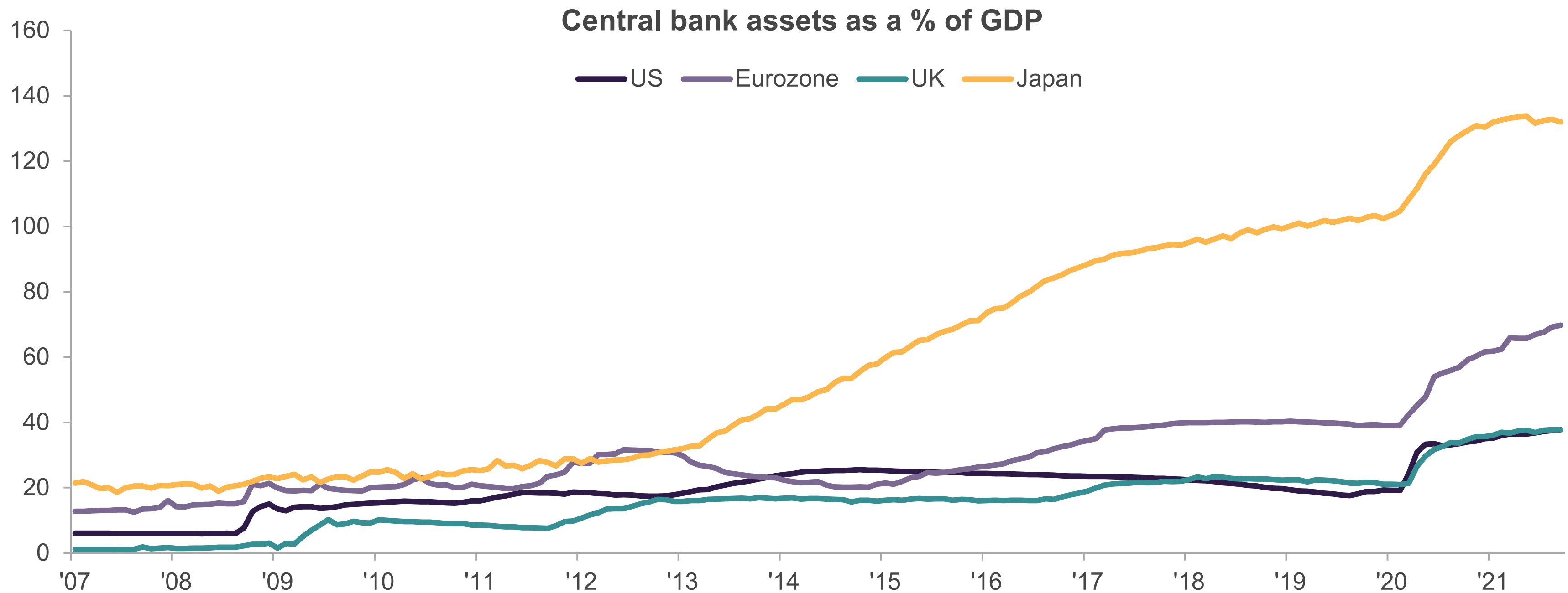


Annual debt servicing cost estimate (billions)

Data Sources: Truist IAG, Bloomberg; Debt Servicing Estimate: Bloomberg Global-Aggregate Yield to Worst * Outstanding market value of the index

Central banks come to the rescue

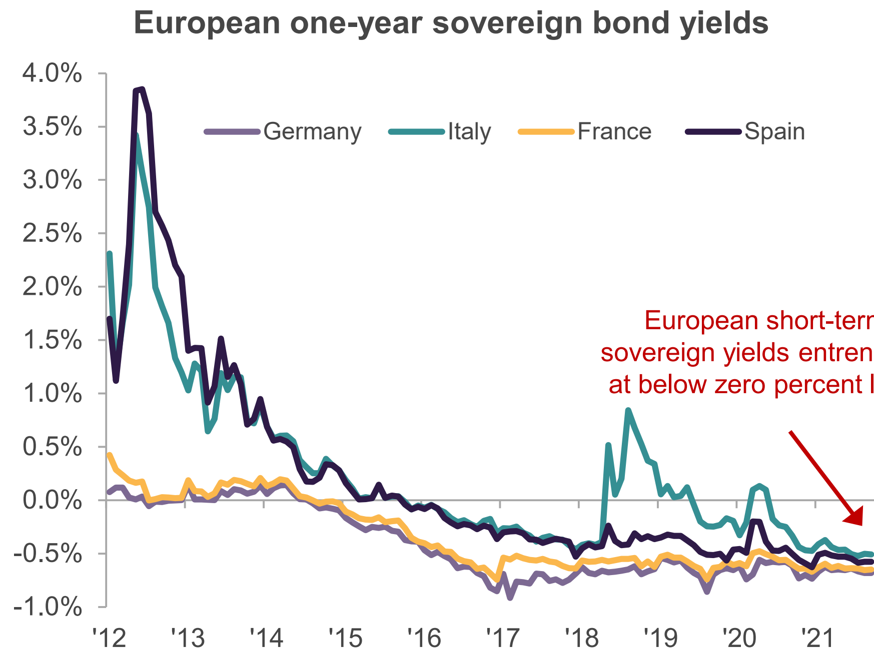
Global central banks had to increase their asset purchases to fund fiscal deficit spending and support local financial markets. Since the end of 2019, the Bank of England's assets increased 17%, the Fed's 19%, the Bank of Japan's 30%, and the ECB's 31%. As long as deficits grow above economic growth rates, central bank support is needed to suppress sovereign borrowing rates for cheaper debt servicing.

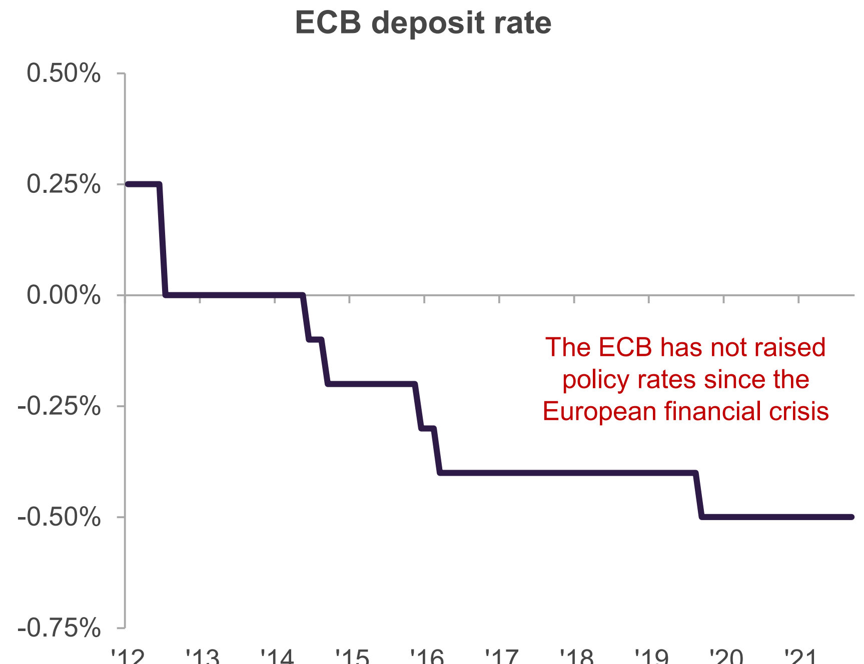


Data Sources: Truist IAG, Bloomberg;

European fiscal balances are more vulnerable to rising rates with short-term rates stuck at below zero percent level

An eventual rise in the policy rate could have a disastrous effect on fiscal balances for highly-indebted countries. The ECB's ultra-loose monetary policy, powered by a negative deposit rate since 2014, massive bond-buying programs, and cheap funding sources for the region's banking system led to suppressed interest rates in Europe. Major Eurozone countries, including fiscally-challenged Spain and Italy, are actually paid to borrow in the short term as yields are entrenched in negative territory.





Data Sources: Truist IAG, Bloomberg; Debt Servicing Estimate: Bloomberg Global Aggregate Yield to Worst * Outstanding Market value of the index

Where are the vulnerabilities

Economists and investors have been asking, "How much debt is too much?" for a while now. If there is a shoe to drop, highly-indebted emerging markets economies should be at the top of the list, where the highest foreign currency risk is in Argentina and Turkey. Europe is still not out of the woods yet with the currency controlled by a monetary authority that may not efficiently alleviate the funding issues of its highly-indebted economies.

IAG's current tactical recommendation

- Overweight
- Neutral
- Underweight
- Not Investable

Highly-Indebted emerging economies

There are many emerging markets economies with a high amount of debt issued in foreign currency. Argentina sits at the top of this list. The country defaulted nine times in the past, three times just in the last 18 years. There's still over $40B in debt needing to be renegotiated with the IMF. Year to date, the Turkish lira lost more value against the U.S. dollar than Argentinian peso or even Afghanistan's afghani. The Turkish banking system is particularly vulnerable to a full-scale currency crisis, and European banks, especially in Spain, have excessive exposure to the Turkish banking system.

Highly-indebted Eurozone economies

The Eurozone's highly-indebted countries, including Greece, Italy, Portugal, Spain, and France, all have higher debt than Argentina relative to their GDP even though their debt is denominated in the euro, which is the official currency. Their central bank, ECB, controls the euro, and these countries do not have the authority to govern the ECB. In short, these countries have debt as if it were issued in a foreign currency.

Stable Eurozone economies

Fiscally-austere countries of the Eurozone, like Germany, Austria, or the Netherlands, are vulnerable as they are in the same boat as the highly-indebted Eurozone economies.

Japan

The world's most indebted country in terms of GDP perplexes economists and market participants with the country's mountain of debt. In theory, Japan should be the canary in the coal mine for the "How much debt is too much?" question.

China

China's central government's debt ratio is relatively low at 66%, but total debt to GDP is well above 300%. Usually, market commentary highlights the debt dynamics of the Chinese economy but fails to highlight the assets the government owns or controls. In short, China has the means to deal with its debt.

U.K.

The U.K.'s debt-to-GDP is not as high as Italy's, Spain's, or France's. More importantly, the U.K. government has the ultimate authority on monetary policy. If needed, its central bank can essentially monetize its debt via quantitative purchases.

United States

Controlling the reserve currency of the world's financial system has unique benefits. Similar to U.K., the U.S. federal government has the ultimate authority on monetary policy. As in past crises and the recent pandemic-related crisis, the Federal Reserve can fund fiscal deficits via bond purchasing programs.

Data Source: Truist IAG

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CN2021-3574 EXP 10-2022

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