European Gazette

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# Implications of the global debt explosion

## Global debt was at an unprecedented level before Covid-19. With the subsequent policy response injecting liquidity into most parts of the world economy, the debt predicament is set for a worse path. We explore the implications for sovereigns, financials and corporates, particularly from the perspective of credit investors

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**At the start of this year, global debt was a staggering $255 trillion,[1] having grown persistently for decades and especially since the global financial crisis (GFC). The trend is set to accelerate following the onset of the Covid-19 pandemic and the subsequent policy responses.**


In the first half of this year alone, policymakers injected or pledged stimulus in excess of $14 trillion,[2] which equates to 18% of YE2019 GDP. The stimulus has come from a combination of fiscal measures ($9 trillion) and monetary measures ($5 trillion), albeit in some regions certain aspects of stimulus measures are in fact open-ended or unlimited!

Monetary measures, such as central bank stimulus, and indirect fiscal measures, such as state guarantees of lending, don't add to the debt burden. However, stimulus from direct fiscal and budgetary measures, such as grants, unemployment or furlough benefits do. These measures currently exceed $4.4 trillion. When the growth in private sector indebtedness, from both bank lending or net corporate bond issuance, is considered, global debt will increase by at least $9 trillion, or 12% of YE19 GDP, from actions in the first six months of this year alone.[3]

Looking ahead, stimulus will likely continue, even if it is in varied pace or form. We're mindful that policymakers especially fear a deflationary trap. It is a difficult and dangerous cycle to exit if consumers and businesses cease spending in the belief that prices will fall. We need little reminder that Japan spent more than two decades fighting deflation, where persistent use of fiscal stimulus saw the government debt-to-GDP ratio rise to nearly 2.4x.

With more stimulus, increased public and private sector debt and falling GDP, global debt-to-GDP ratios are set for a deteriorating path. This ratio rose 40 points, from 2.8x to 3.2x, between the onset of the GFC in 2007 to the end of 2019.[4] We are now on target to reach 3.5x this year, and if we were to face another severe demand shock, such as from a second global Covid-19 wave, the ratio could approach 4.0x over the next decade unless dramatic action is taken to reduce the global debt burden.

### The implication for sovereigns

We have not seen government deficits or the stock of government debt-to-GDP rise like this since the second world war. Market focus is currently on the policy response, and while central banks are buying large amounts of sovereign debt via Quantitative Easing (QE) programs, debt sustainability will not be doubted. Over time, however, this will be an increasingly dangerous assumption.

When the dust settles, country risk will become increasingly important to credit investors, as corporate bond spreads will further reflect sovereign debt sustainability. It may be hard to say at what point a sovereign could hit its "fiscal" wall, whereby markets are no longer willing to finance a deficit.

When we think about country risk in investment grade, we favour nations with the fiscal room and political will to continue to stimulate and borrow, such as Germany, the Netherlands and the Nordics. Within countries with high debt stocks, ie greater than 100% of GDP, we prefer those with their own central banks and currencies which can implement policies of yield curve control if necessary. In this category we favour the US and UK over, for example, France and Spain, which do not have that ability.

We are also cautious on eurozone political risk. A significant amount of political will within Europe will be required to manage Italy's debt stock, and questions over the use of the EU Recovery Fund, burden-sharing and debt forgiveness are increasingly possible in the future. We have concerns that the market is too ready to accept that those major political changes will be made in a sensible and timely fashion.

## The implication for banks

Following the GFC the banking sector went through a decade of re-regulation and deleveraging. The Core Tier 1 capital-to-risk-weighted assets ratio, a key measure of a bank's financial strength, increased from 7% to 12.5%. As such, the banking sector went into this crisis in a position of strength and is seen as part of the solution.

Policy measures taken by governments and regulators are designed to ensure the financial sector does not amplify the shock of the pandemic. These include government guarantees of lending, fiscal transfers, payment moratoria, capital relief and (near) unlimited liquidity. These measures so far appear to be working. Lending guarantees and fiscal packages shape the distribution of losses between sovereign and banking sector balance sheets.

For example, furlough schemes allow households and small and medium-sized enterprises (SMEs) to continue to service their bank debt. This protects not only households, but also the corporate sector and indirectly the banking sector, but it adds to the sovereign debt stock as the funds come from the government. With state backed loans, the bank makes the loan, the central bank provides the funding and the taxpayer takes the credit risk.

This way, unlike in the 2008/09 crisis, both the banking sector and the corporate sector have liquidity. There is no credit crunch. However, the corporate sector has taken on more debt, and the sovereign will ultimately foot the bill for losses.

When we run the numbers for the banks we cover globally, we forecast peak bad debt charges for European banks similar to those experienced during the GFC, and about half of GFC levels in the US, despite GDP growth being much weaker. We expect core capital ratios to fall by around 100bps across the sector globally over the next year or two, but to remain well above regulatory requirements in aggregate.

Although banks came into the Covid-19 crisis with less leverage and better placed to endure the pandemic, particularly with strong policy support which has sustained lending and buffered losses recognised, credit spreads for the banking sector will be tied even more to the sovereign.

## The implication for corporates

Since the GFC, the amount of outstanding corporate debt has nearly doubled in size, exceeding $74 trillion,[5] and exceeding government debt. A key driver of this growth has come from investment grade (IG) corporate bonds, particularly from companies rated BBB, and including those who pursued extensive debt-financed M&A.

Taking the US as an example, the non-financial corporate debt-to-GDP ratio moved to an all-time high of 75% at the end of 2019.[6] We expect this to continue to increase by around 10 percentage points this year. US index-eligible BBB bonds were equivalent to 4% of US GDP in 2008 growing to 11% of GDP by 2019. We expect this to move to around 14% by the end of the year as corporates shore up liquidity in response to falling top lines.

This increased indebtedness impacts the creditworthiness of the companies in which we invest. Looking at IG, for the non-financial companies we cover globally we expect net debt/EBITDA in the US to exceed 2x by year end, having steadily increased from 1.16x in 2009. For Europe we forecast it to be 3.1x by the end of the year, up from 2.5x in 2009.[7]

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Companies in sectors hardest hit by the pandemic, such as hospitality, transport and energy, have rushed to raise funding. Across sectors more broadly, lower earnings – due to a multi-year recovery which brings structural and behavioural shifts – will keep the risk of ratings downgrades elevated. It is possible that the average rating for IG corporates could migrate from low-A to high-BBB.

However, IG companies are not typically hostages to fortune. Management teams can choose to reposition balance sheets to run with lower leverage. If anything, the pace of leveraging seen during the past decade is simply not sustainable. If a low growth outlook becomes entrenched, management teams faced with large piles of debt will be increasingly motivated to deleverage. We expect this process to begin next year. We can select deleveraging credits to capture balance sheet improvement stories. However, a consequence of any deleveraging would likely perpetuate low growth as companies scale back investing in employees and the business.

## Implications for the asset class: Investment Grade corporates

Historically, spread compression has correlated with accommodative policy given increased liquidity in the system, and vice versa. As discussed, policy support is likely to stay accommodative and provide a positive technical backdrop for corporate bond demand.

To illustrate this, the European Central Bank (ECB) has used a negative interest rate policy for the past five years, and one repercussion is that more than half of bonds in the Barclays European Aggregate bond index are now negative yielding.[8] Additionally, in recent months (notably during the second quarter) it is estimated that the ECB bought 40% of net primary market bond issuance as part of QE.[9]

While easy policy should benefit credit investors in the near term, we strongly caution that the longer-term efficacy of easy policy should not be extrapolated and without question. We challenge the sustainability of sovereign indebtedness and acknowledge that corporate deleveraging has yet to occur.

Lastly, we see that global IG bond spreads have normalised to a great extent. Having started the year at +100bps, spreads peaked at 340bps and have now settled at +130bps.[10] At these levels, bondholders are still compensated for their exposure to liquidity risk and default risk. With the stimulus and liquidity support from policymakers, liquidity premia is still elevated, particularly when we look at the difference between corporate bond spreads and credit default spreads. In addition, the default rates implied by IG spreads are also well in excess of historical average. The historical five-year cumulative default is approximately 0.9% for IG (or around 0.2% per annum).[11] Note, however, that IG defaults are much lower than high yield, given IG issuers will not typically jump to default, but transition first to HY.

We recognise that downgrade risks are more elevated than ever. Defaults in speculative grade corporates will also persist, with smaller companies in the most exposed industries most vulnerable. Value from IG will therefore come more significantly from issuer and issue selection. Value can be extracted by avoiding downgrade candidates and seeking out corporate deleveraging candidates.

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[1] Institute of International Finance, Global Debt Monitor, April 2020.
[2] IMF, May 2020, https://blogs.imf.org/2020/05/20/tracking-the-9-trillion-global-fiscal-support-to-fight-covid-19 / Columbia Threadneedle analysis, June 2020.
[3] Columbia Threadneedle analysis, July 2020.
[4] Institute of International Finance global debt data, January 2020.
[5] JPMorgan, 'Flows and Liquidity – More Debt, more liquidity, more asset reflation, July 2020.
[6] Institute of International Finance, Global Debt Monitor, January 2020.
[7] Columbia Threadneedle analysis, June 2020.
[8] Bloomberg, July 2020.
[9] Deutsche Bank, Macro Credit Brief, July 2020.
[10] Bloomberg, June 2020.
[11] Deutsche Bank, Default seems to be the hardest word, May 2020.

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Issued 09.20 | Valid to 03.21 | J30888 | 3235525