Economic Perspectives

Leverage: taking the axe to the tree

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November 2022

Summary

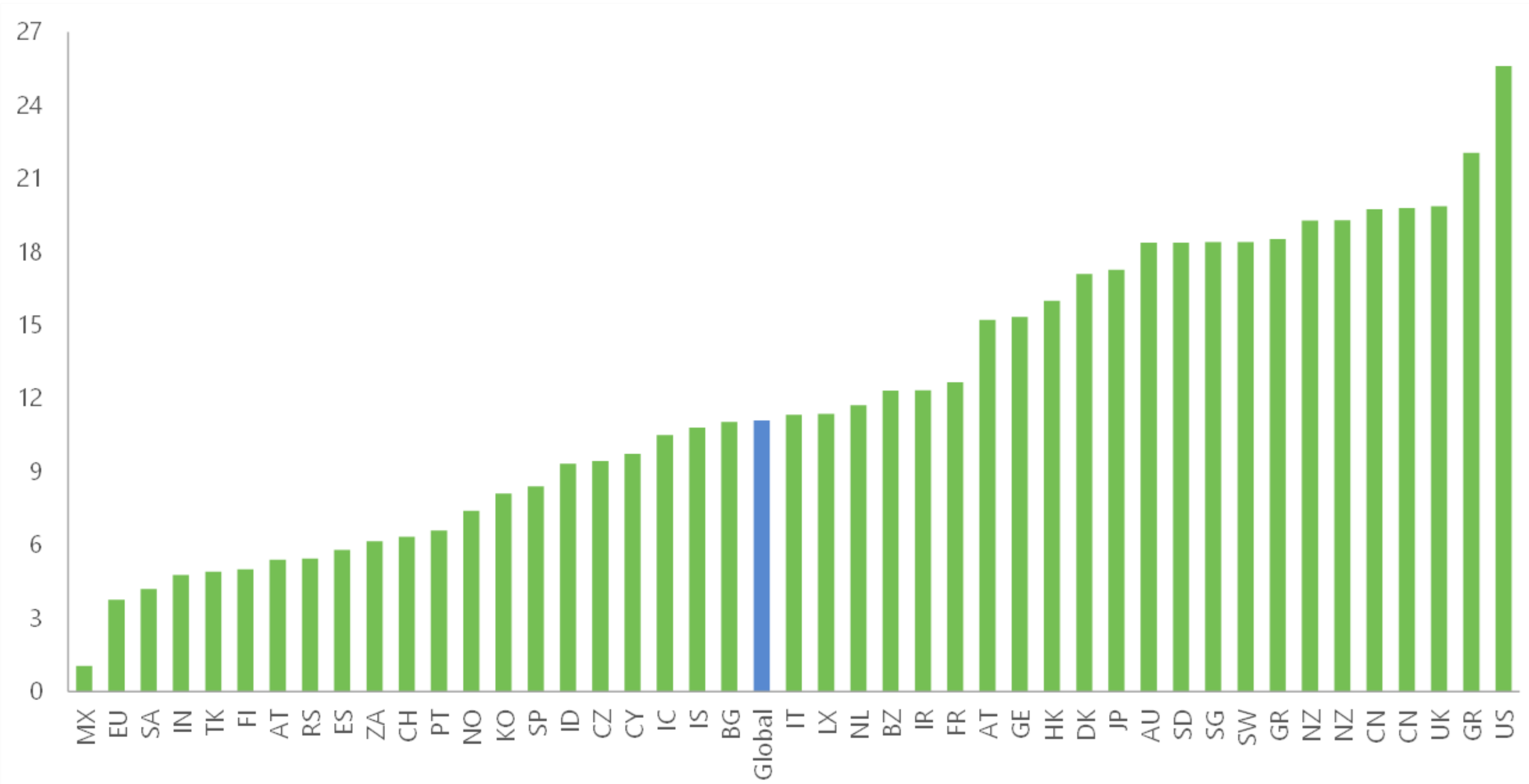
- In multiple contexts, we have pushed towards the limits of debt absorption
- Debt service costs are soaring and budgets are stretched, but our higher debt burdens mean we can’t tolerate a deflationary contraction
- Public policy is directed towards rapid nominal GDP growth, regardless of its composition
- Public and private leverage ratios must be reduced as quickly as possible using the time honoured route of financial repression
- Inflation protection is still the name of the game

What Covid did next!

- The challenge of Covid triggered a war-like response from governments
- Escalation of public spending and debt
- Public guarantees of bank loans to corporates
- Splurge of public and private debt taking leverage ratios to all-time peaks
- Monetisation of the incremental debt interacted with supply constraints to usher in inflation
- Debt service burdens have soared, dampening final demand for goods and loans

Astonishing global fiscal relaxation

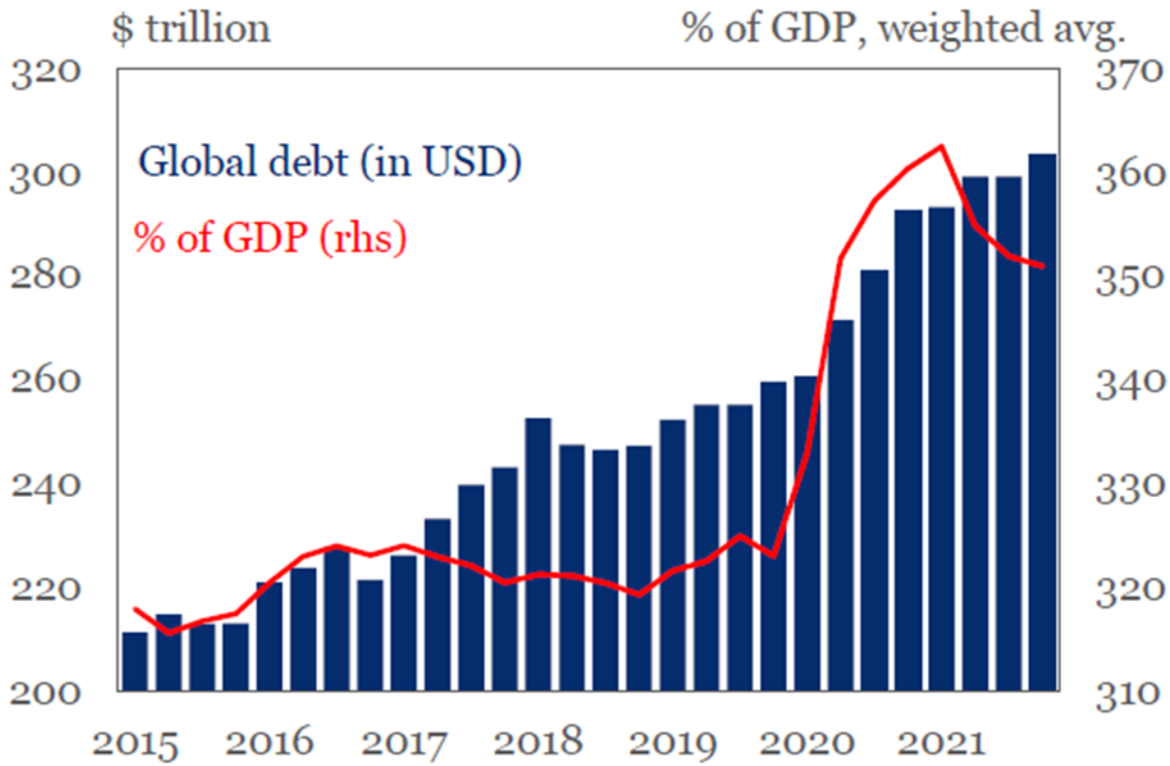
- Announced discretionary fiscal support as % of GDP, 20-21



Covid-related debt expansion was a bridge too far

- Central banks forced into monetisation

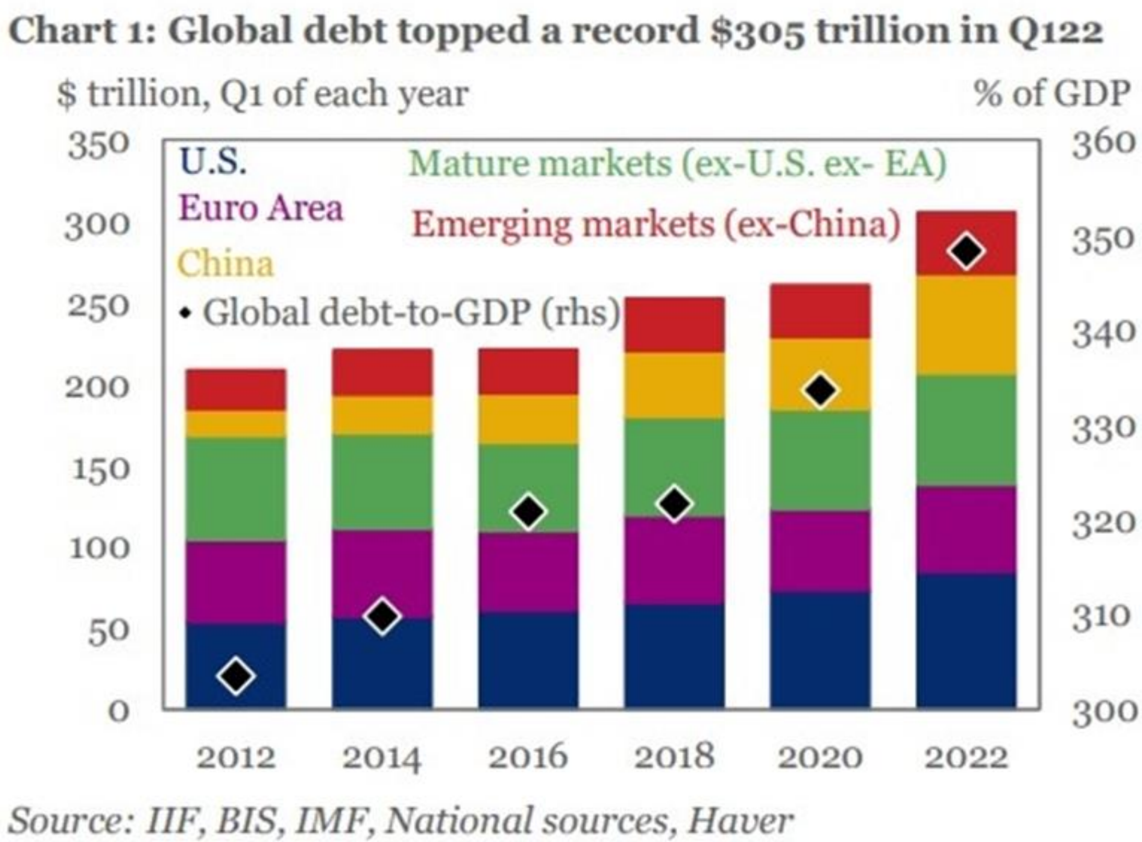
Chart 1: Total global debt surpassed $300 trillion in 2021



Source: IIF, BIS, IMF, National sources, Haver

US and China contributed the most to surging debt

- But global leverage ratio fell 15pp in past year



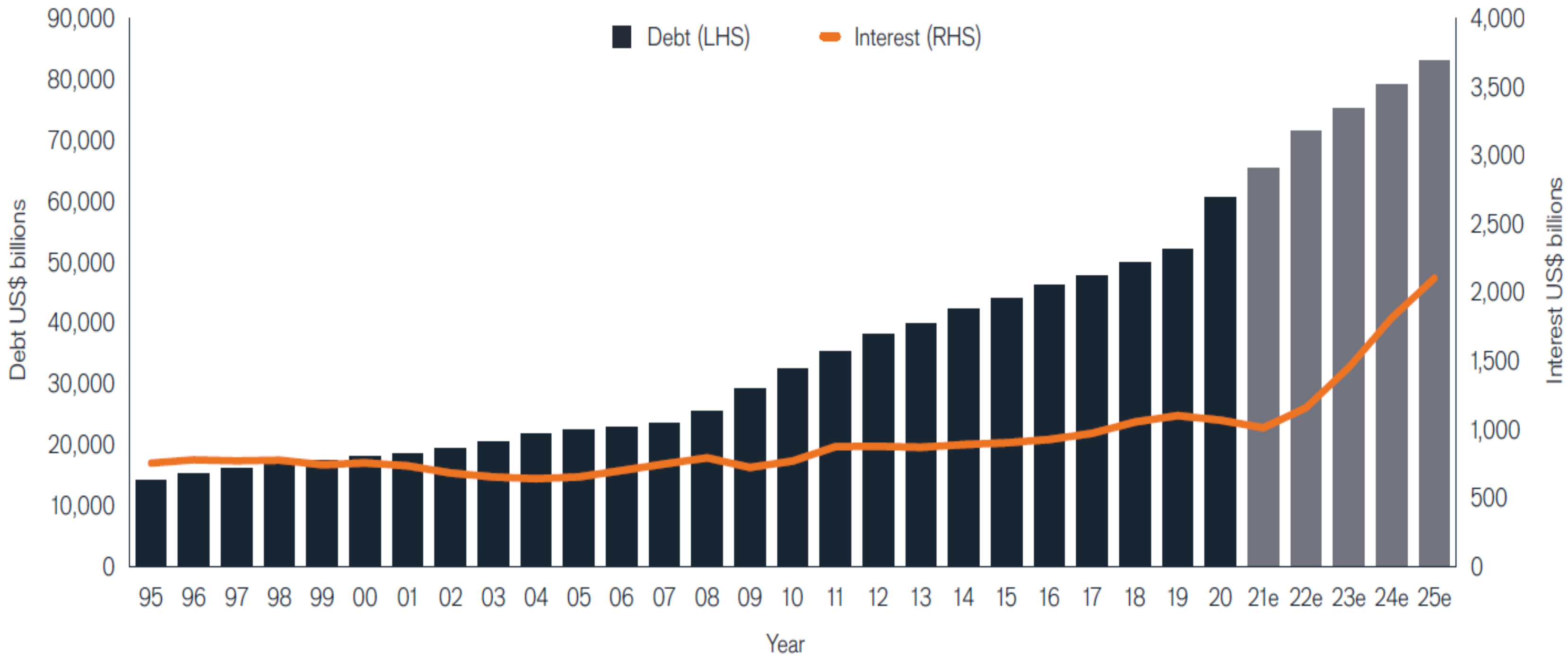
Dramatic escalation in debt service burdens

- Loss of financial discipline during Covid has opened up a can of worms
- Catch-22: governments can’t stand aside and allow central banks to wrestle with the inflationary challenge because of the painful consequences for the economy and financial system; but if they curtail CB tightening and spend more on social protection then inflation takes hold
- Rise in public debt service costs is a lose-lose proposition: it obstructs attempts to tame the budget deficit and it reduces the scope for programme spending

Ending the fantasy of limitless public borrowing

- Servicing costs expected to double in 4 years

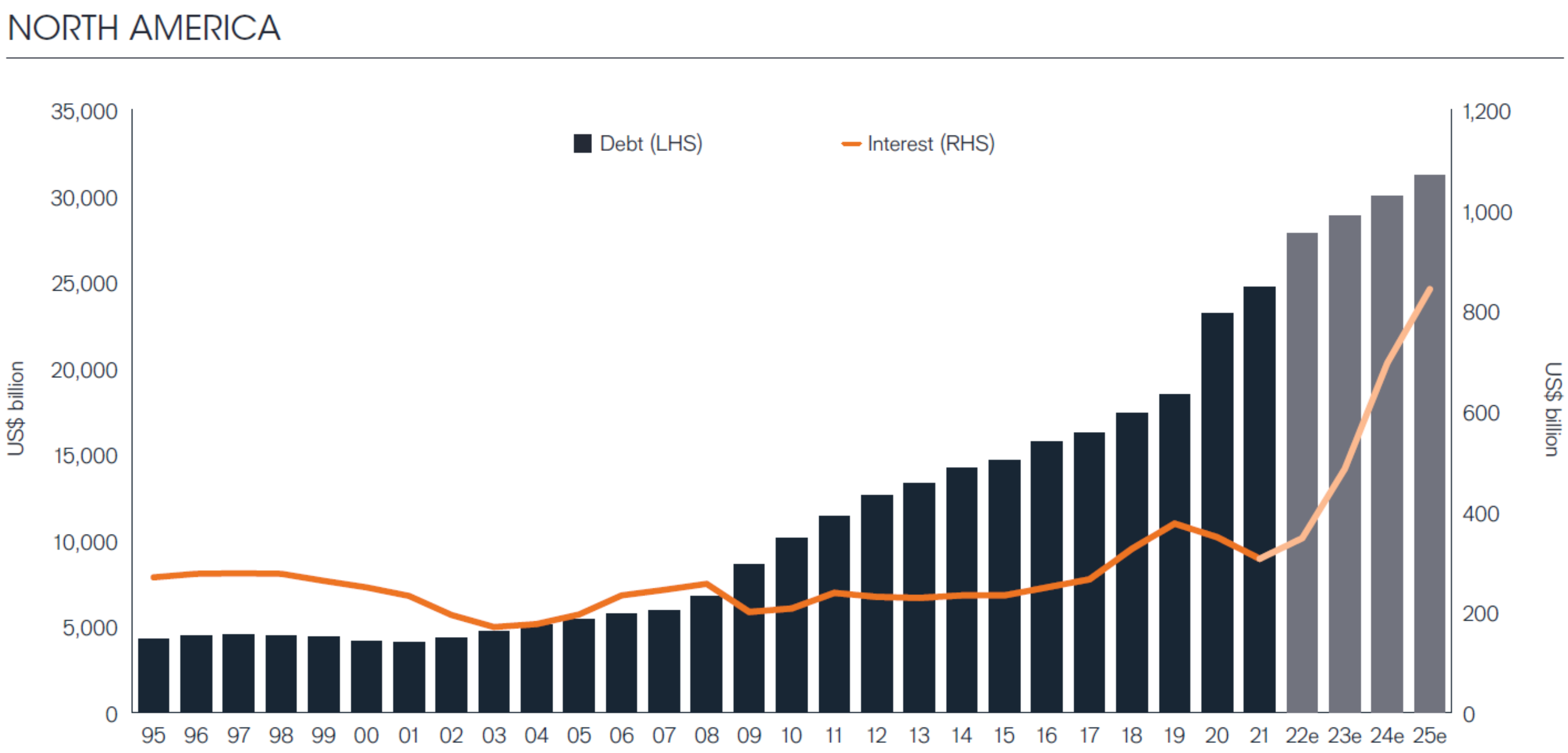
GLOBAL GOVERNMENT DEBTS V INTEREST PAYMENTS



Source: Janus Henderson

US budget deficit reduction is coming undone …

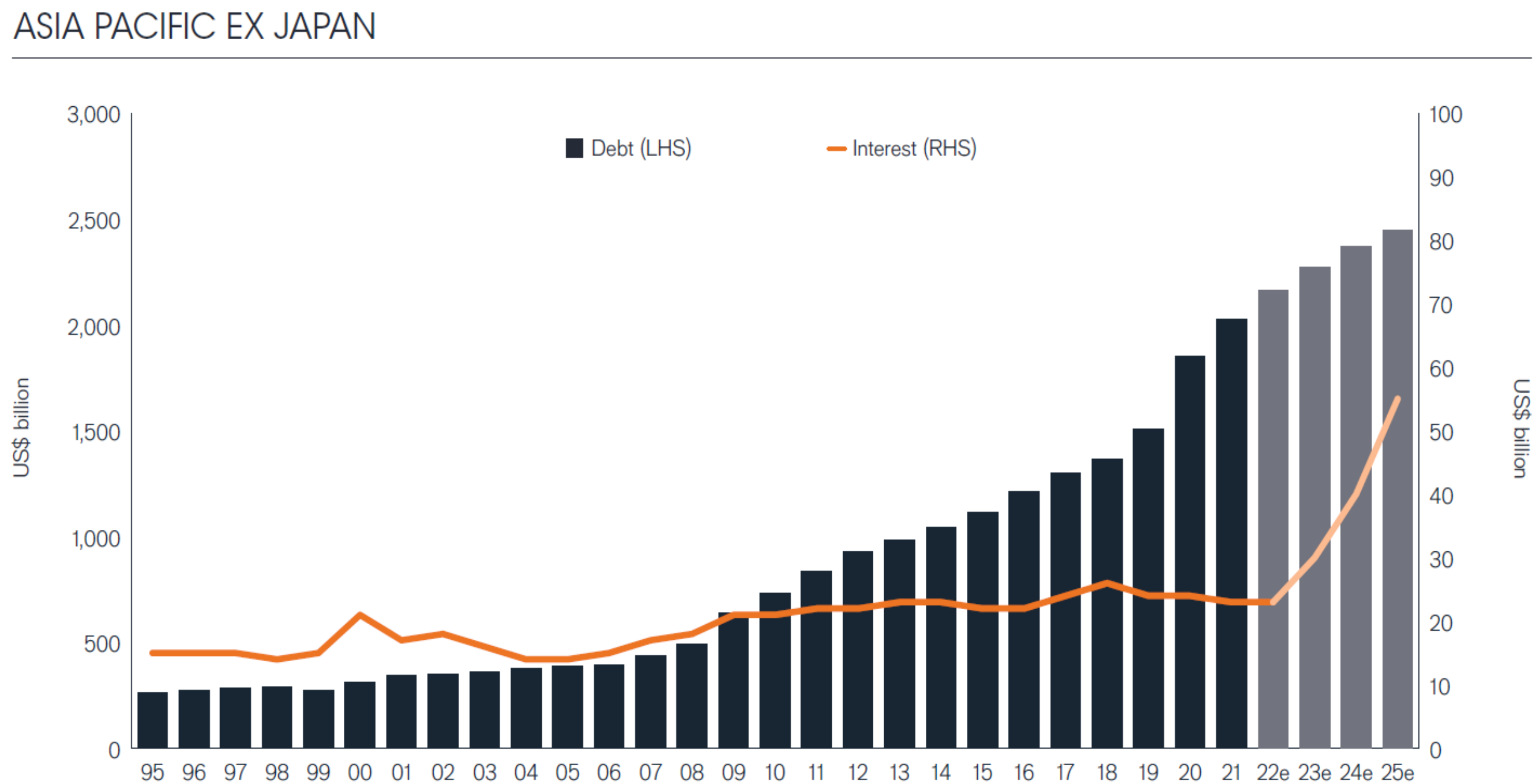
- … but likely loss of majority in HoR may block big spending bills



Source: Janus Henderson

In Asia ex-Japan, debt service costs remain low

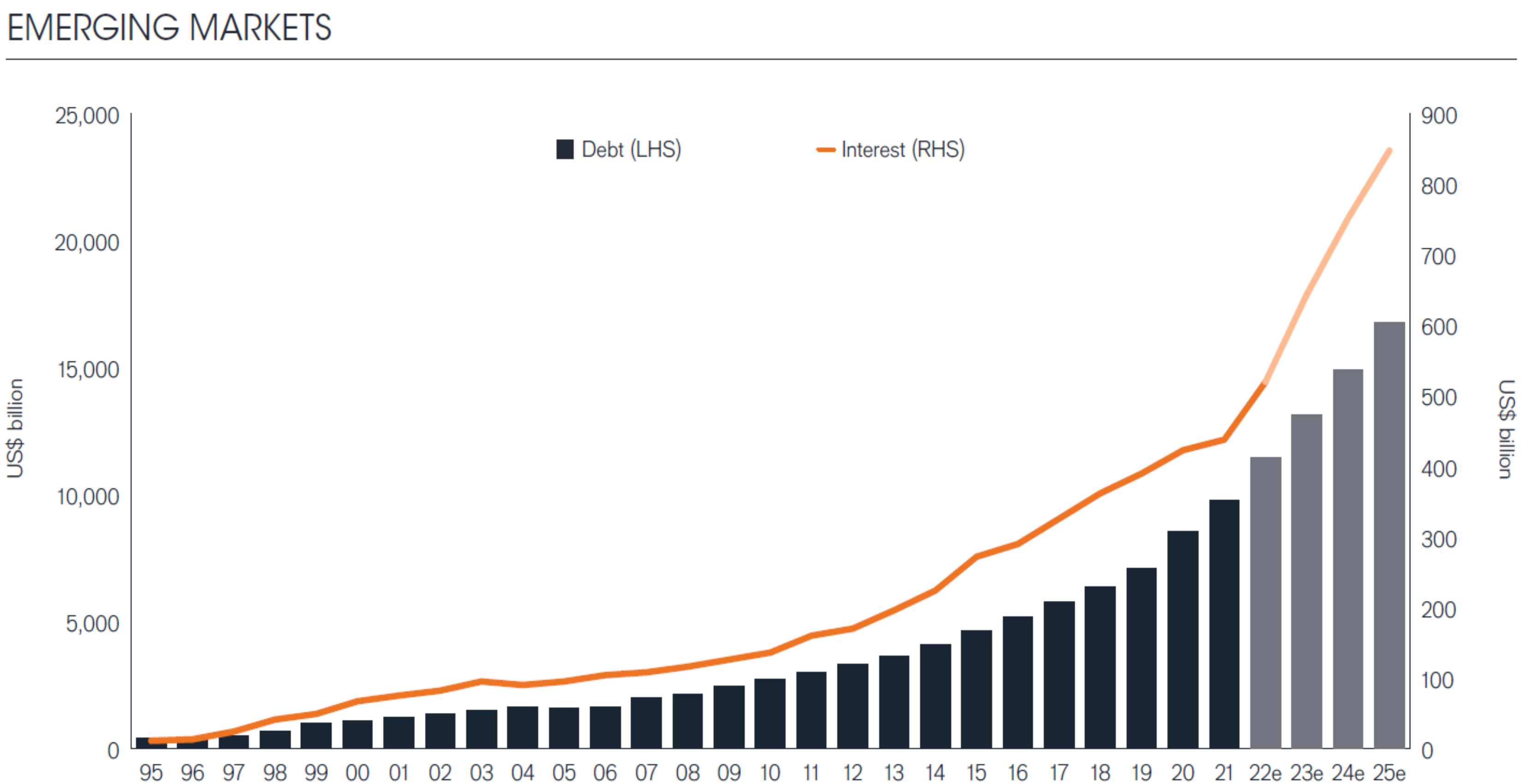
- Debt service costs to reach 2.2% by 2025



Source: Janus Henderson

EM debt markets have a painful road ahead

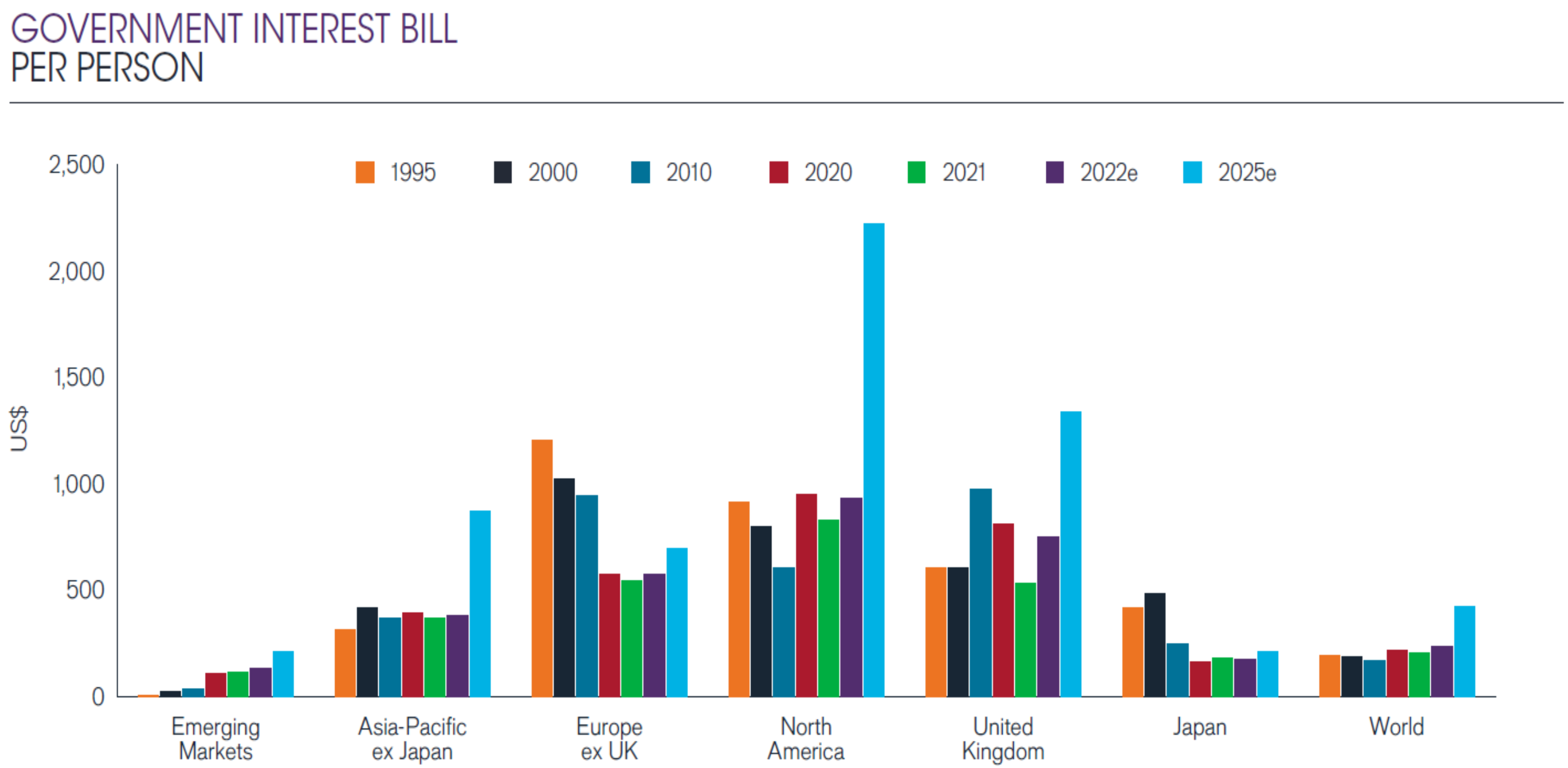
- Debt service costs to hit 5% by 2025



Source: Janus Henderson

Japan is best able to restrain debt service costs …

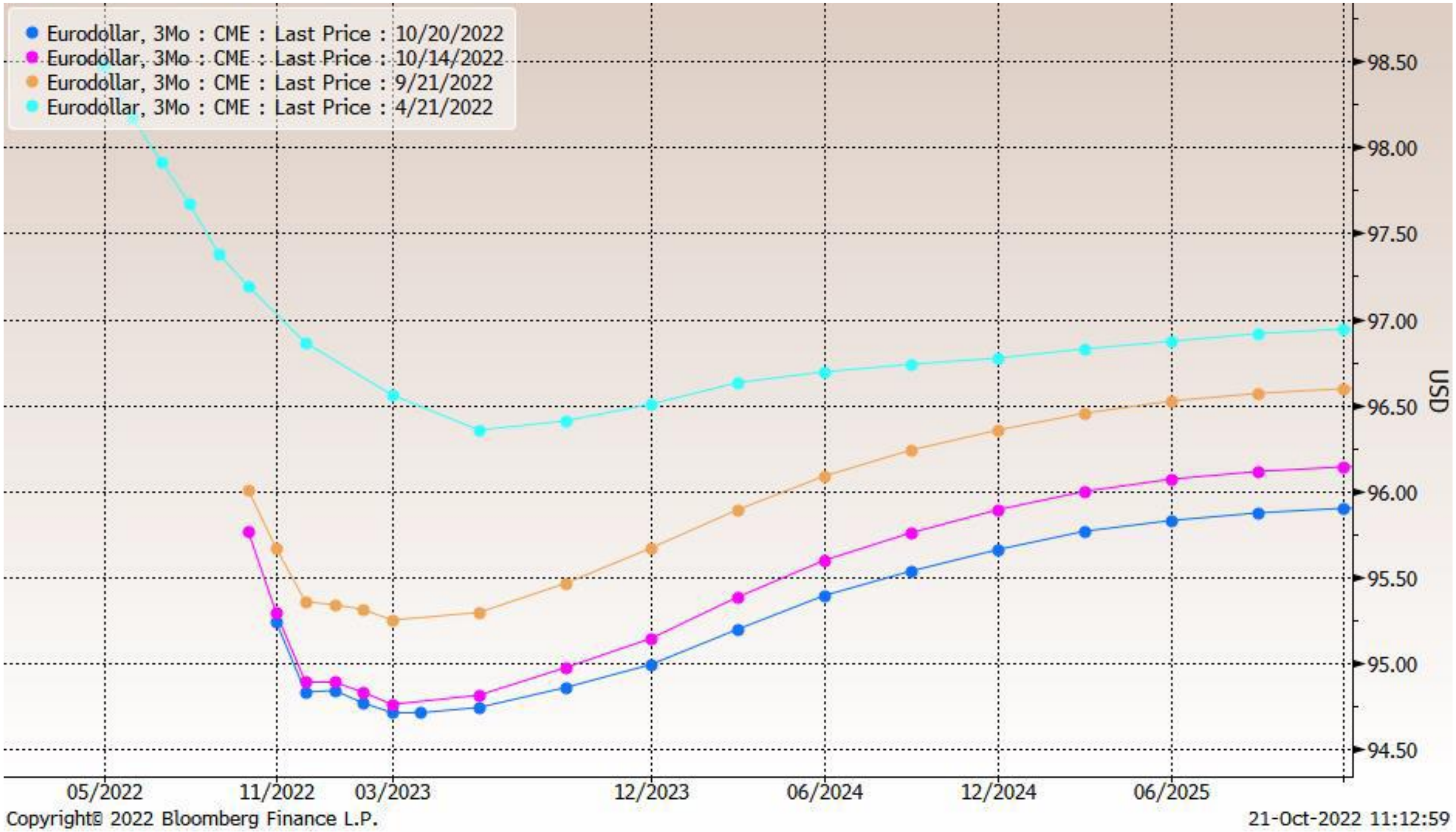
- … and US and UK the least able



Source: EIU, Janus Henderson, March 2022

Market expects a 5% Fed funds rate early next year

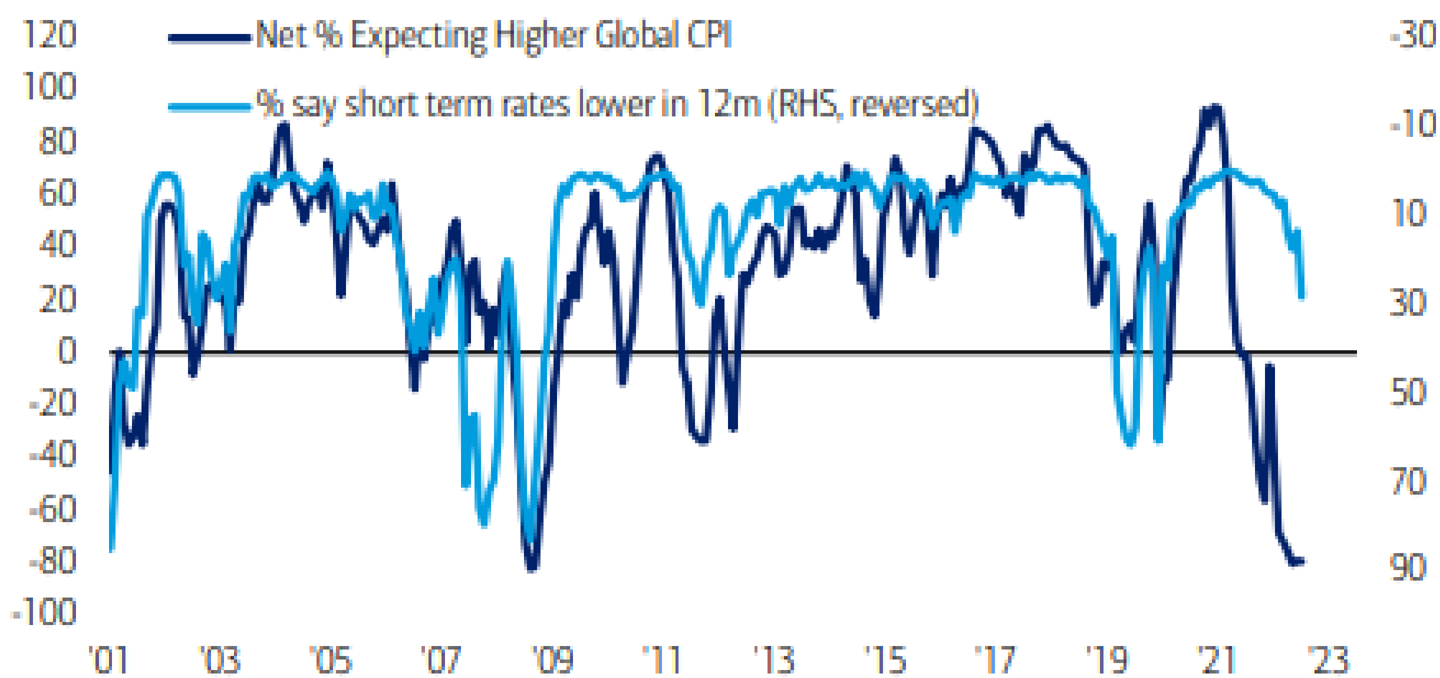
- Tempting for Fed to declare victory too soon?



Frightening consensus about falling inflation!

- Much less agreement over falling rates

FMS inflation expectations vs short rate expectations



Source: BofA Global Fund Manager Survey

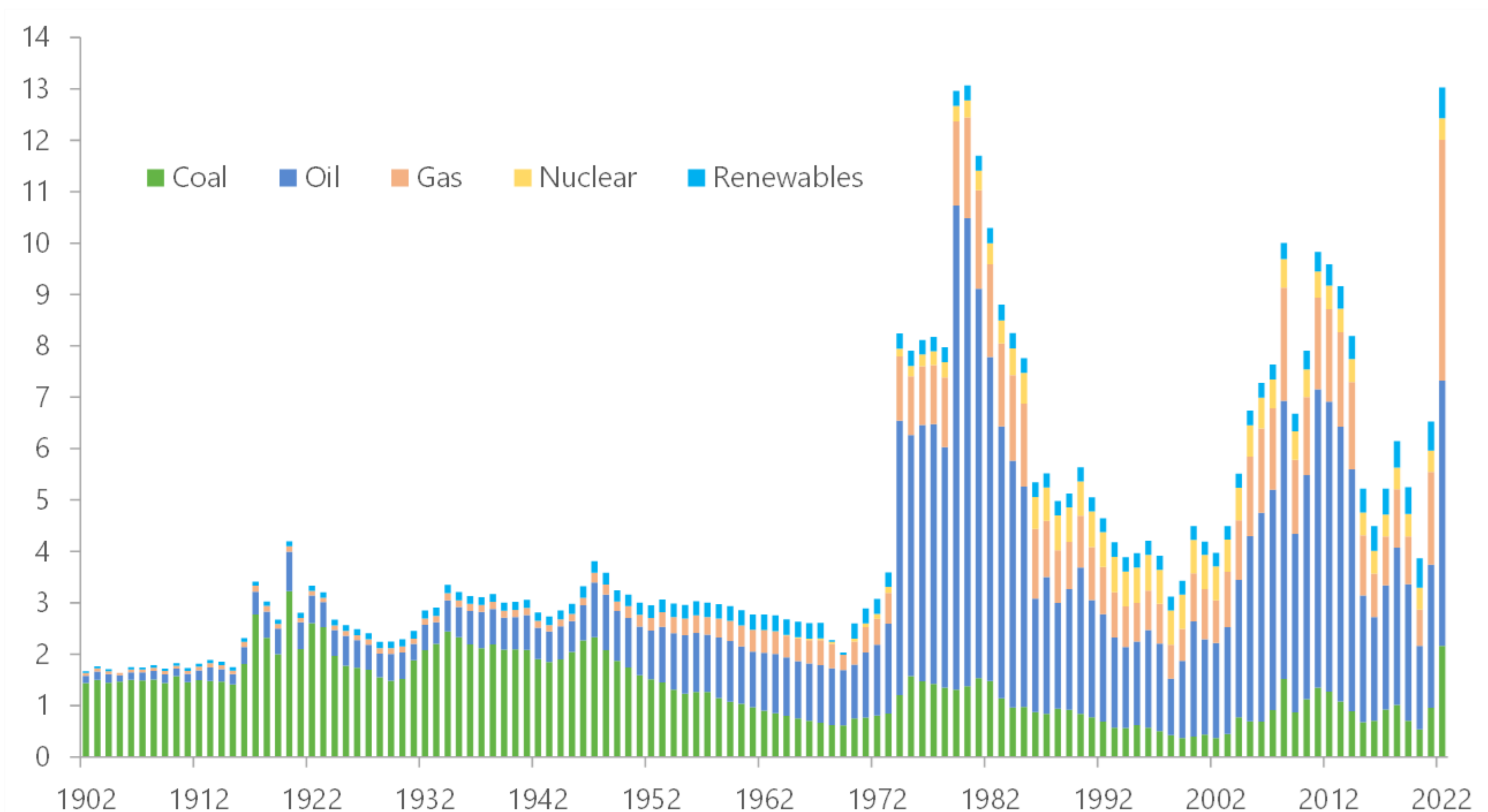
BofA GLOBAL RESEARCH

Recognising the damage to the supply side

- Argument for persistent inflation rests on
  a) the lack of political staying power to mount a successful anti-inflation campaign
  b) the failure of higher prices to call forth additional supply
- Food and agriculture
- Fossil fuel dilemma and resulting underinvestment
- Demographics of truckers and engineers
- Tightness in shipping markets – slow steaming, use of ships as floating storage, additional demands of offshore wind industry, etc.

Heading for the biggest energy price shock of all time

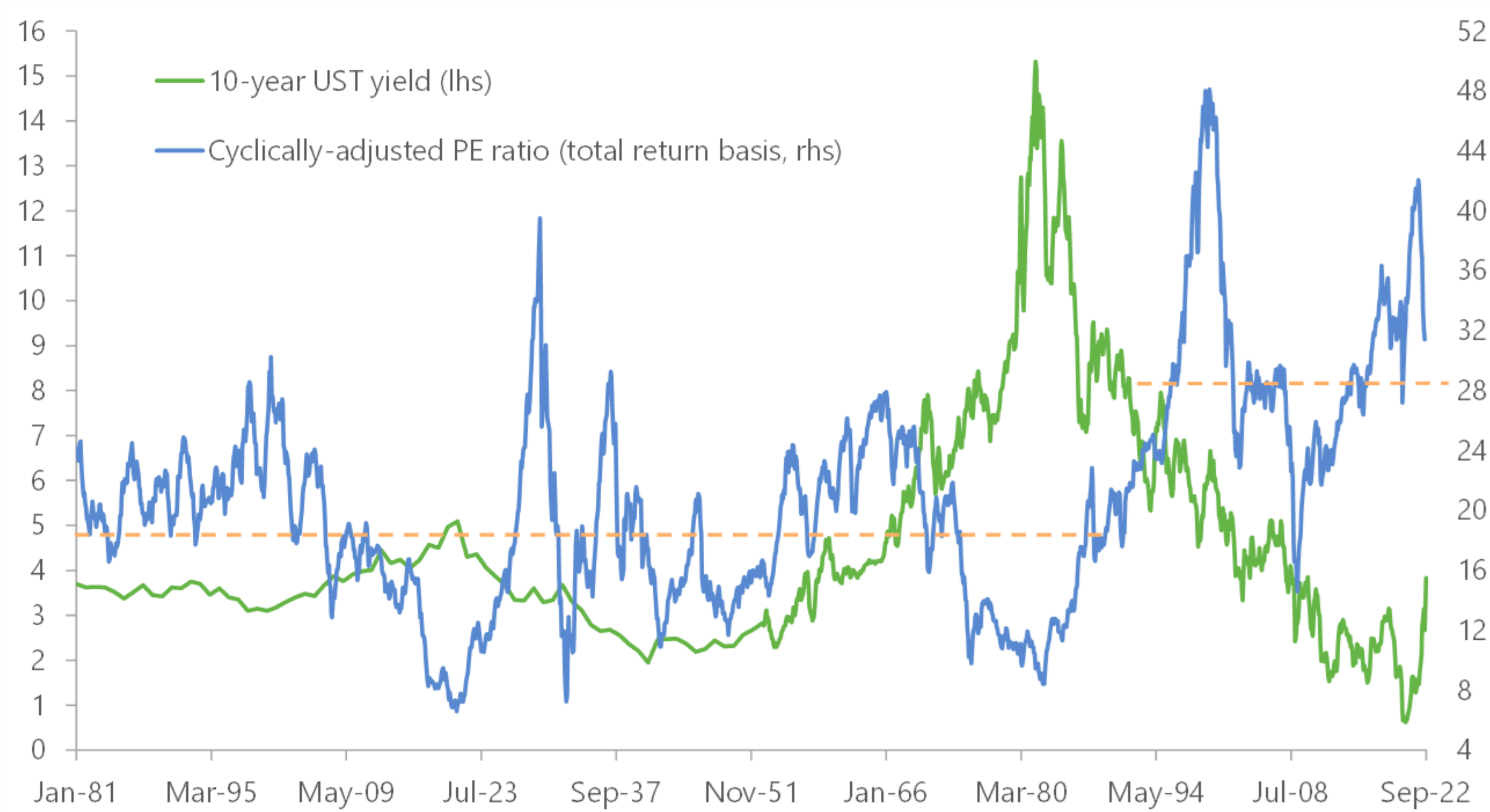
- Global spending on primary energy, % of GDP



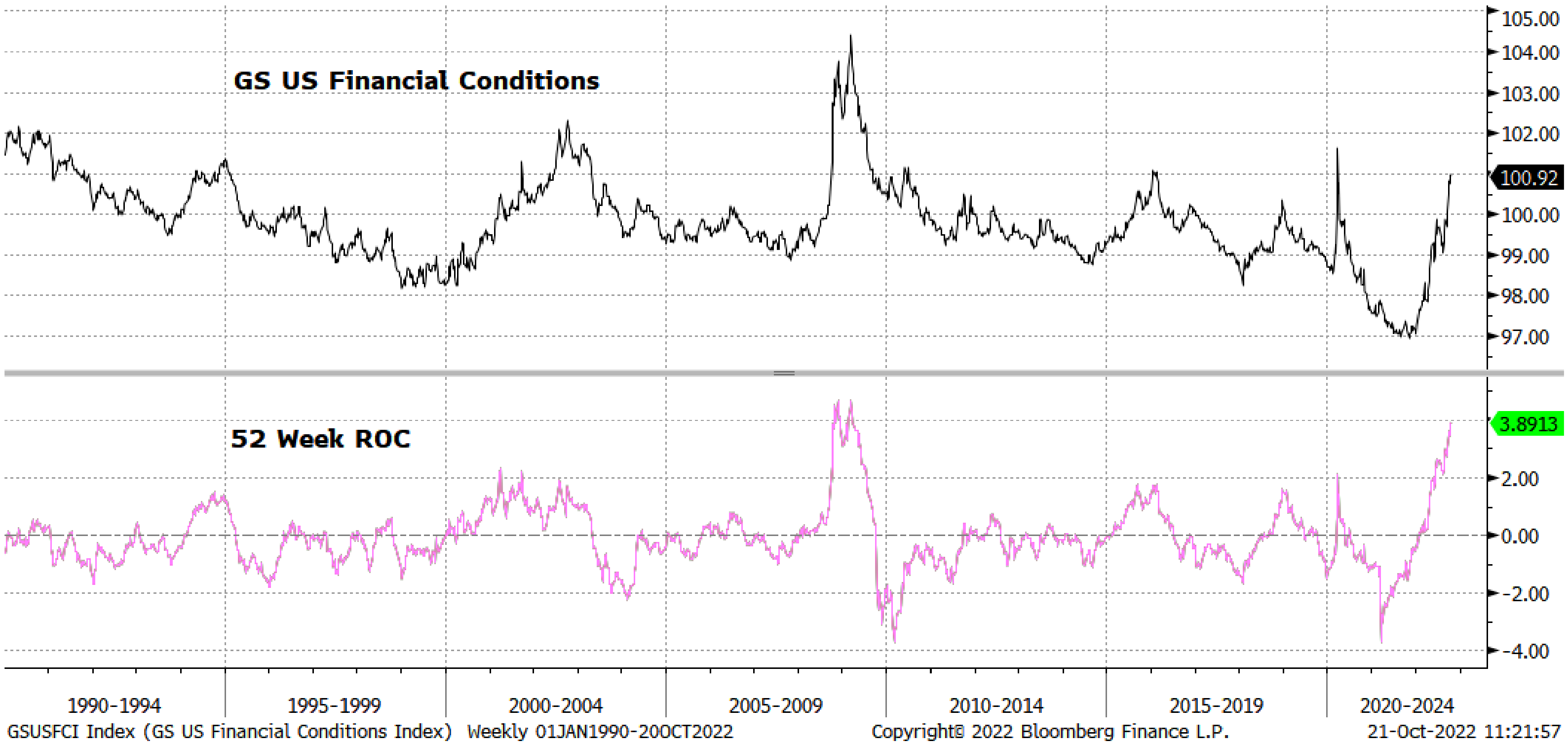
Economic Perspectives

Inflationary persistence poses ongoing threat to PERs

- Unless inflation plunges, the 'put' will be needed



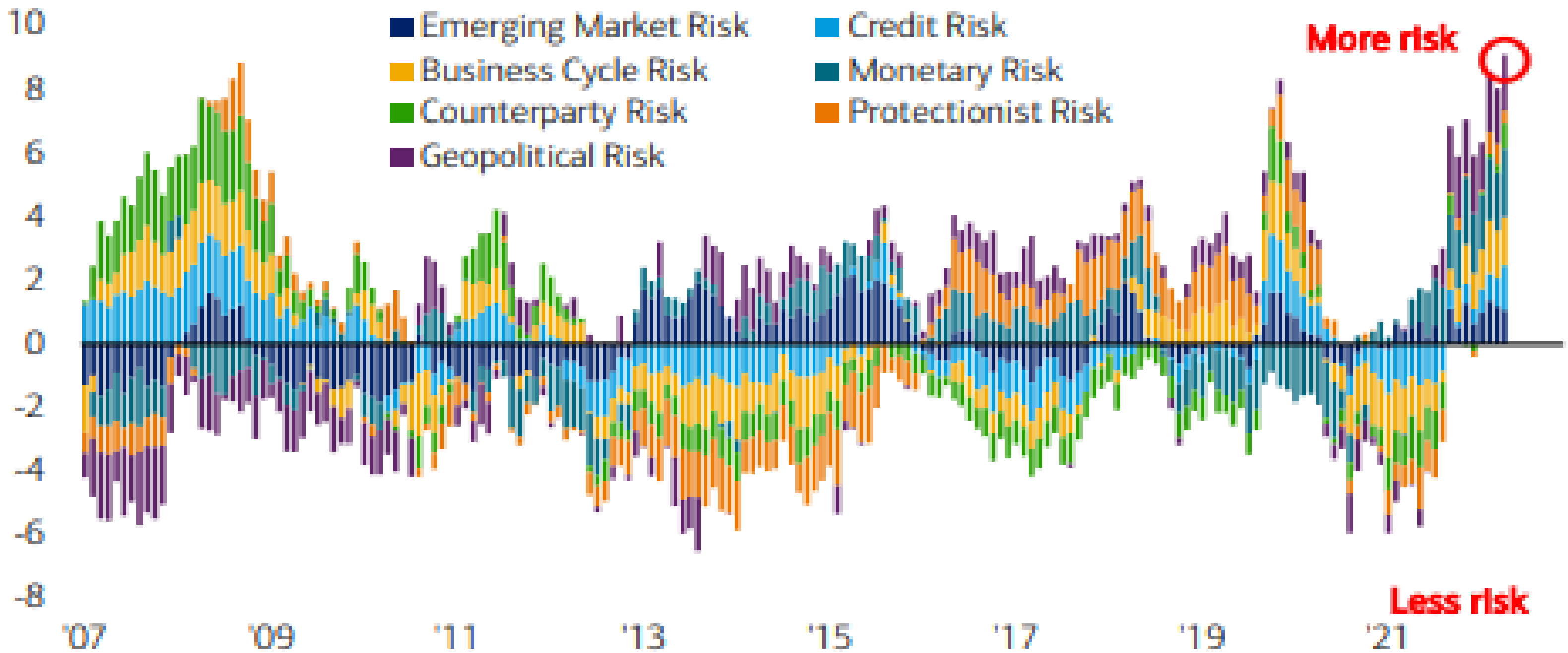
CBs are steering a course for financial instability



Risk perceptions have risen markedly

Chart 16: Most categories of risk have worsened in October '22 (vs September)

At this time how would you rate these potential risks to Financial Market Stability?



Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

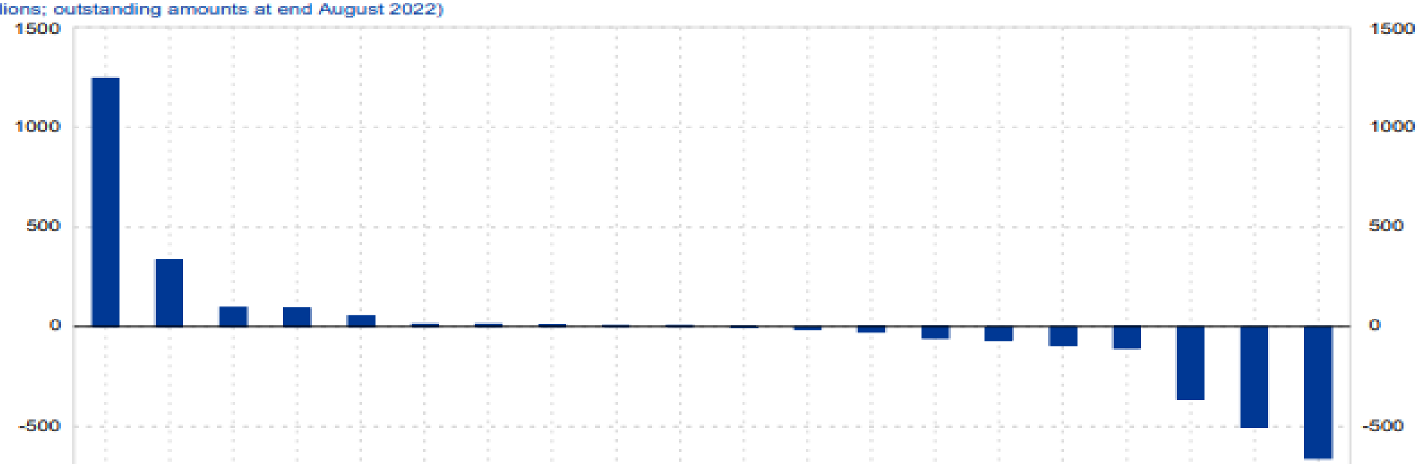
Italy's Target-2 balances are exploding

1.1 Historical data
(EUR billions; outstanding amounts at end of period)

	ECB	BE	DE	EE	IE	GR	ES	FR	IT	CY	LV	LT	LU	MT	NL	AT	PT	SI	SK	FI	U4 [1]
2008	234.9	-104.2	115.3	-	-44.4	-35.3	-35.0	-117.7	22.9	-6.5	-	-	42.1	-0.7	-18.8	-35.7	-19.0	-3.6	-	5.2	0.4
2009	4.0	-42.5	177.7	-	-53.5	-49.0	-41.1	-62.0	54.8	-7.1	-	-	52.5	-0.8	15.4	-19.6	-23.4	-3.3	-14.5	9.5	3.2
2010	-22.4	-13.9	325.6	-	-145.2	-87.1	-50.9	-28.3	3.4	-6.4	-	-	67.9	-1.2	40.5	-27.5	-59.9	-2.1	-13.3	19.7	1.1
2011	42.2	-52.9	463.1	0.6	-120.4	-104.8	-175.0	-77.4	-191.4	-7.9	-	-	109.4	-0.4	152.8	-34.6	-60.9	-2.7	-13.6	66.0	7.9
2012	-2.2	-38.2	655.7	1.7	-79.3	-98.4	-337.3	-54.8	-255.1	-7.5	-	-	106.2	-0.2	120.8	-39.9	-66.0	-4.4	0.9	70.6	27.4
2013	-6.7	-15.5	510.2	1.8	-55.1	-51.1	-213.7	-16.2	-229.1	-6.8	-	-	103.7	-0.7	46.1	-39.2	-59.6	-1.0	2.7	22.2	8.0
2014	-23.6	-12.4	460.8	3.2	-22.7	-49.3	-189.9	-17.0	-208.9	-2.5	-0.8	-	105.1	-1.9	19.4	-30.1	-54.6	2.4	2.2	19.7	0.9
2015	-83.8	-7.7	584.2	2.8	-3.0	-94.4	-254.1	-29.2	-248.9	2.4	-1.3	0.2	147.6	-0.9	54.7	-29.2	-61.7	0.2	0.5	20.1	1.5
2016	-159.7	-18.6	754.3	0.9	-1.0	-72.3	-328.1	-13.8	-356.6	5.9	-5.3	-3.6	187.4	1.0	87.0	-31.2	-71.6	-1.2	-5.1	22.0	9.5
2017	-222.8	-36.1	906.9	0.9	1.9	-59.4	-373.7	30.0	-439.0	7.4	-6.3	-4.0	192.1	4.3	71.0	-45.9	-81.2	-1.4	9.0	40.4	6.1
2018	-246.5	-52.9	966.2	0.8	14.3	-28.6	-401.9	-2.3	-482.0	7.8	-6.2	-5.8	213.0	4.5	92.6	-45.6	-82.8	1.2	9.7	39.8	4.6
2019	-236.1	-63.7	895.2	0.6	35.4	-25.7	-392.4	28.5	-439.4	8.5	-3.8	-0.9	192.4	5.6	46.4	-46.6	-77.0	3.4	9.3	57.1	3.3
2020	-341.5	-65.9	1,136.0	-1.0	46.1	-80.3	-500.0	58.3	-516.0	8.4	-4.8	5.8	259.3	6.1	38.4	-37.4	-80.2	6.8	7.7	49.5	4.7
2021 Q1	-344.5	-35.8	1,082.0	-0.6	59.7	-88.7	-487.7	19.5	-515.6	9.3	-5.3	9.7	288.5	5.8	8.5	-25.7	-77.9	10.1	8.5	76.6	3.8
Q2	-343.1	-30.6	1,101.9	-0.8	70.8	-92.2	-503.9	-20.0	-521.5	10.1	-6.3	10.9	319.8	6.7	13.8	-34.5	-84.3	9.7	9.4	79.5	4.5
Q3	-364.2	-51.7	1,115.1	0.3	73.3	-92.2	-487.2	-18.9	-513.5	11.3	-6.5	10.8	309.4	6.3	19.5	-39.1	-81.6	10.1	5.7	88.6	4.4
Q4	-340.4	-85.7	1,260.7	0.6	84.8	-104.2	-512.8	25.8	-590.0	12.6	-5.3	14.9	326.6	7.3	-22.5	-57.4	-79.3	9.2	23.9	25.3	5.8
2022 Mar.	-317.4	-61.3	1,170.0	-1.9	87.7	-110.8	-536.1	-21.0	-596.6	13.5	-6.5	10.7	322.2	7.2	53.1	-49.3	-73.4	11.2	28.8	64.3	5.8
Apr.	-364.5	-75.8	1,135.4	-2.1	88.6	-106.1	-505.3	-39.5	-573.0	13.3	-6.7	10.8	335.1	6.7	70.0	-38.1	-70.3	11.4	32.2	72.7	5.2
May	-358.2	-64.2	1,159.7	-2.1	87.2	-106.9	-526.0	-28.3	-596.9	12.5	-7.1	10.8	350.3	6.7	72.2	-46.4	-69.0	12.1	26.0	62.6	5.0
June	-340.8	-22.2	1,216.5	-2.6	101.2	-108.0	-516.1	-104.6	-627.7	12.8	-7.1	10.8	350.6	7.2	44.7	-51.6	-64.5	11.3	16.2	67.4	6.5
July	-347.5	-24.5	1,166.2	-2.9	98.1	-108.9	-494.9	-44.2	-640.1	13.0	-7.4	12.2	349.6	6.4	65.1	-53.0	-66.0	10.8	11.2	50.7	6.0
Aug.	-362.2	-24.8	1,245.0	-2.8	98.0	-106.3	-501.1	-91.9	-658.8	13.4	-8.4	12.8	337.3	6.1	92.9	-57.4	-66.8	10.7	5.9	52.0	6.4

1) Extra euro area aggregate (changing composition): since 1 February 2016, the extra euro area countries of which the NCBs participate to TARGET2 are Bulgaria, Croatia, Denmark, Poland and Romania. Lithuania was also participating as an extra-euro area country with its NCB until 31/12/2014, Latvia until 31/12/2013, Estonia until 31/12/2010 and Slovakia until 31/12/2008. Individual TARGET balances of euro area NCBs are not provided for dates before the accession of their countries to the euro area.

1.2 Last reference period
(EUR billions; outstanding amounts at end August 2022)

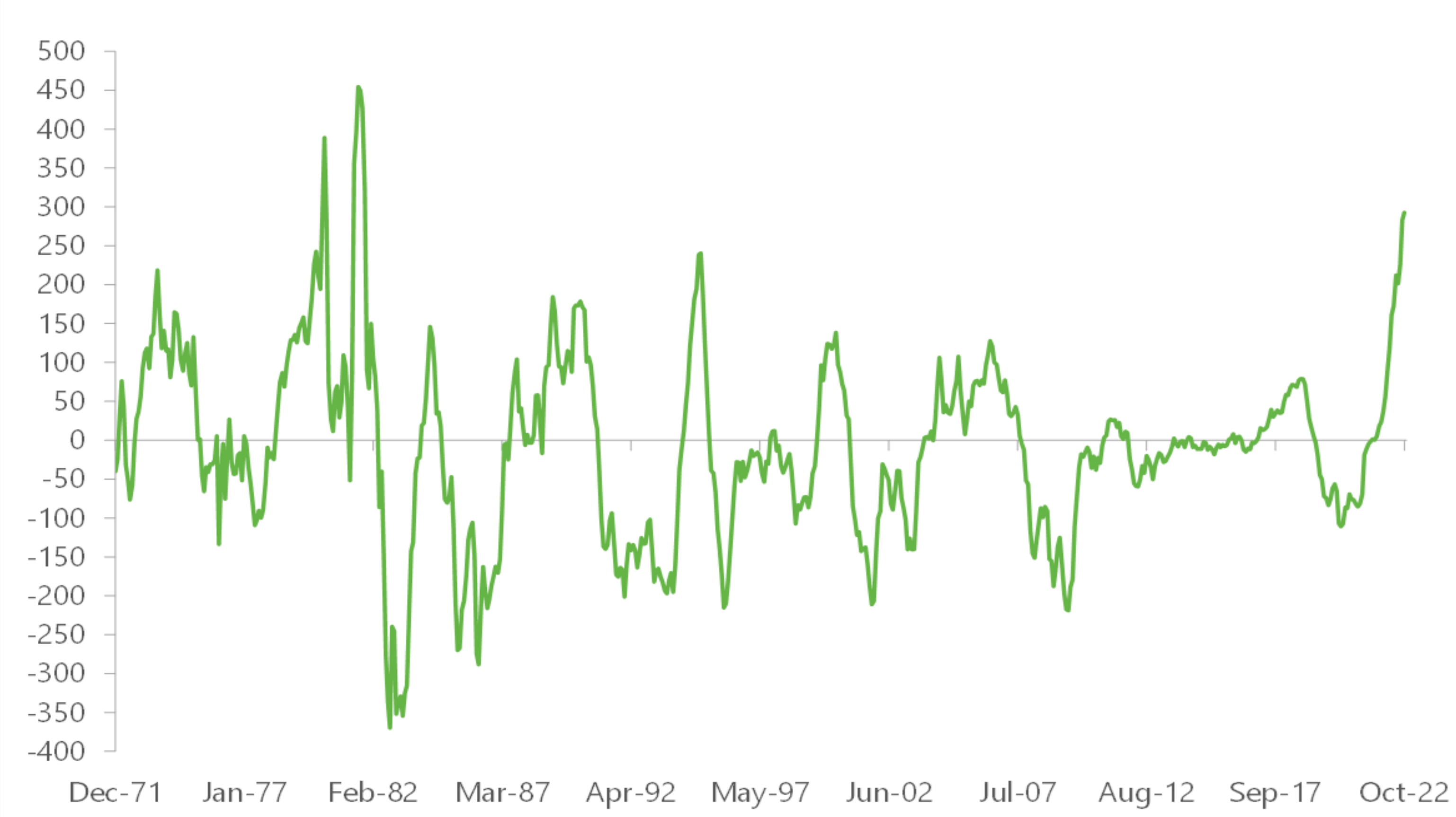


Reasons to expect the Fed to flinch

- Intense political pressure – from right and left
- Too quick to assume that lower gasoline prices will secure low CPI inflation
- Prior beliefs of central bankers regarding falling r-star and secular stagnation
- Extension of losses in S&P 500 prompted by loss of earnings momentum and inflation persistence
- Fear of being blamed for a financial market crisis

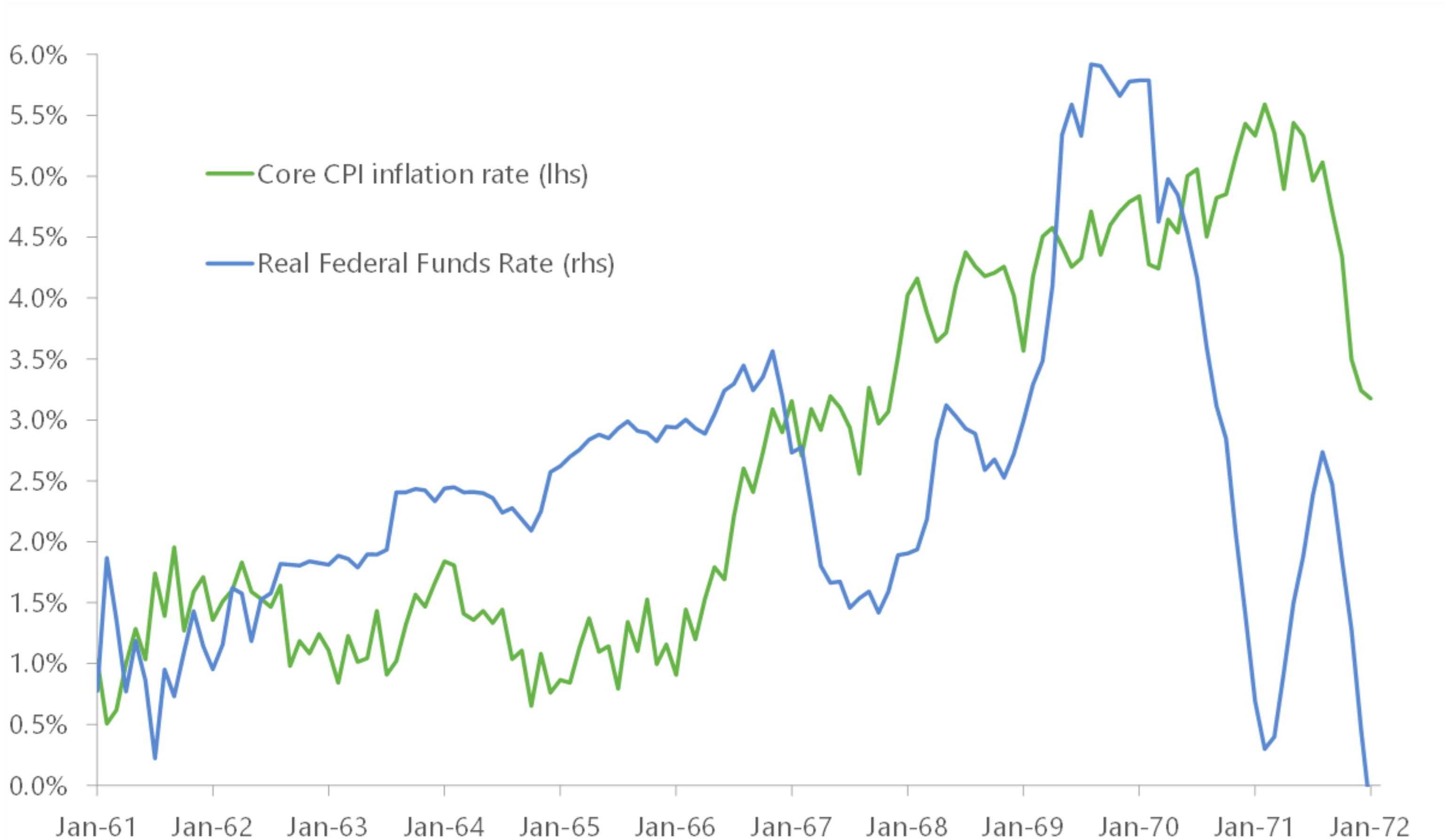
Volcker or Burns? Will tightening be aborted?

- Measure of change in monetary stance, developed markets (12m change in 2-yr govt bond yields)



Burns Fed bottled the inflation challenge in 1966

- US core inflation and (ex-ante) real policy rates



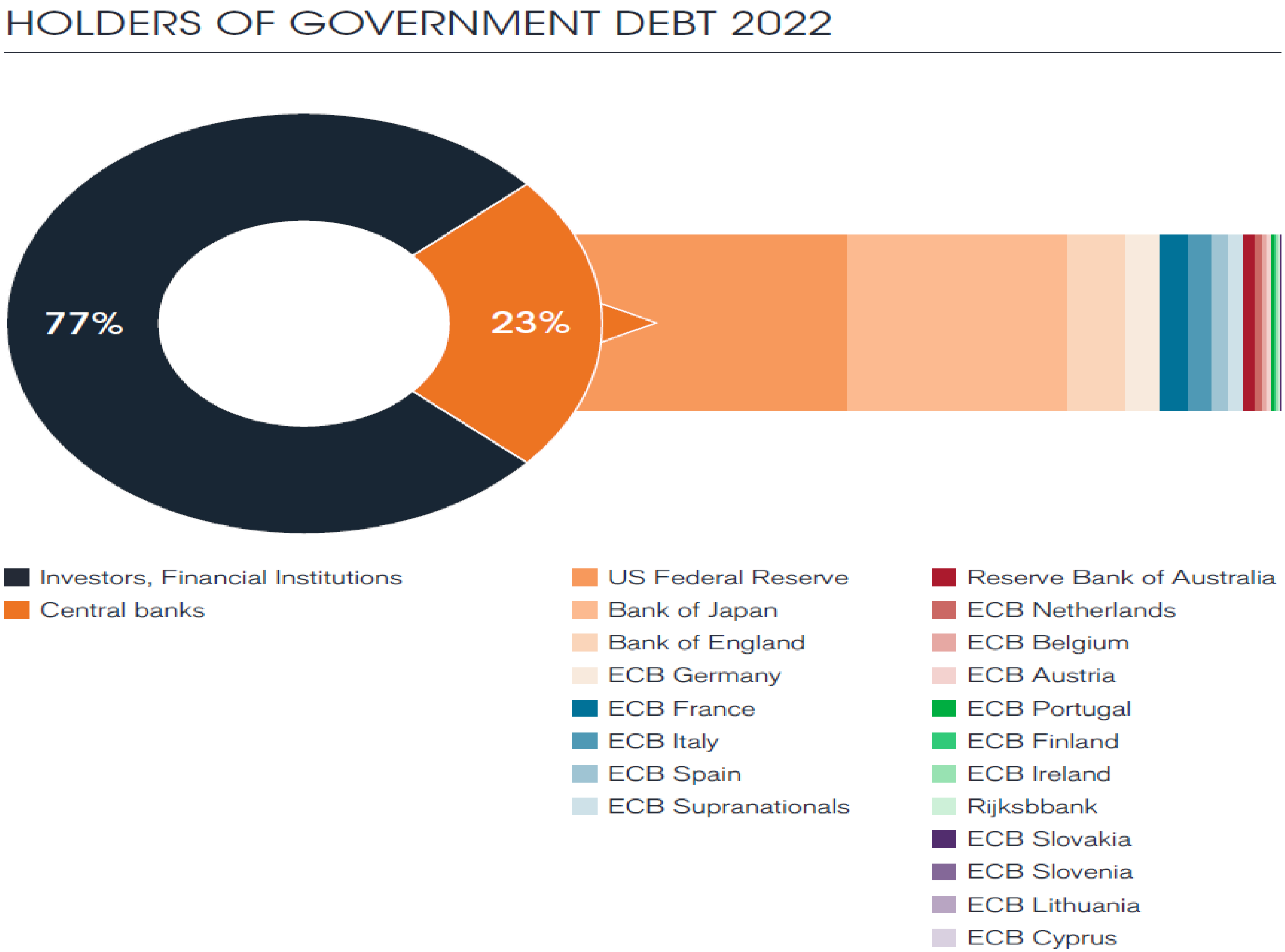
Geopolitics>National politics>Economic policy

- It's not "The economy, stupid!" – it's the shifting geopolitical landscape and the polarisation of national politics. The government budget has become the primary tool for managing economic outcomes
- Central banks are ciphers in the drama, sometimes appearing to act independently, but politically constrained
- Central bank balance sheets are at the disposal of the political process

What Covid did next!

- Nominal GDP growth is much higher than debt growth and likely to remain so
- But higher proportion of household income taken by debt service costs, so less discretionary income
- Greater pressure on welfare systems, preventing budget deficits from normalising
- Weakening structural demand for government debt instruments, requiring central banks to intervene
- Perpetuating the inflationary cycle

Dramatic increase in CB ownership of sovereign debt



Source: Janus Henderson

Persistent inflation as a political compromise

- From a US/Western European public policy perspective, inflation has become the cure, not the disease
- In the context of the Covid policy response, the authorities engineered an ‘unanticipated’ inflation as the essential ‘second act’ of financial repression.
- While there were many who *did* anticipate the inflation, the professional consensus failed dismally to identify what was happening
- The purpose of the inflation is to devalue claims on the public sector and pension promises in general

Persistent inflation: the radical scenario

- Shares the perception of near-term threat that is characteristic of the 'thunder and lightning' scenario, but sees inflationary forces as more powerful and resilient.
- US economy contracts in 2023 and inflation falls back into 3%-5% range, but the distributional impacts of food, energy and shelter inflation force the administration to reintroduce emergency support measures
- Fed lacks the moral authority to keep tightening into a downturn, even though inflation is excessive

Persistent inflation: the radical scenario

- The *de facto* tightening of credit conditions – as lenders shut up shop and borrowers face less attractive terms – and financial conditions raises concerns over financial stability
- Fed is compelled to cut short *both* its programme of funds rate increases and its quantitative tightening
- It no longer has the freedom to pursue its inflation objective. Inflation is unfettered, a free variable in the system
- Structural elements of inflation persist, relating to market structures, demographics and geopolitics

Persistent inflation: the radical scenario

- In this scenario, there is no prospect of a return to pre-Covid ‘normality’
- The ‘policy box’ is broken: no way back to a balanced budget; no way back to a full funding rule, as QE becomes an essential tool; Fed loses its capacity to pursue the objective of low inflation; and markets are segmented and fragmented.
- Political imperatives push towards inflationary budget finance (capex) as a pragmatic response to the post-Covid stagflation. Fighting to preserve the social contract at expense of fiscal probity.

The imperative of an upward sloping yield curve

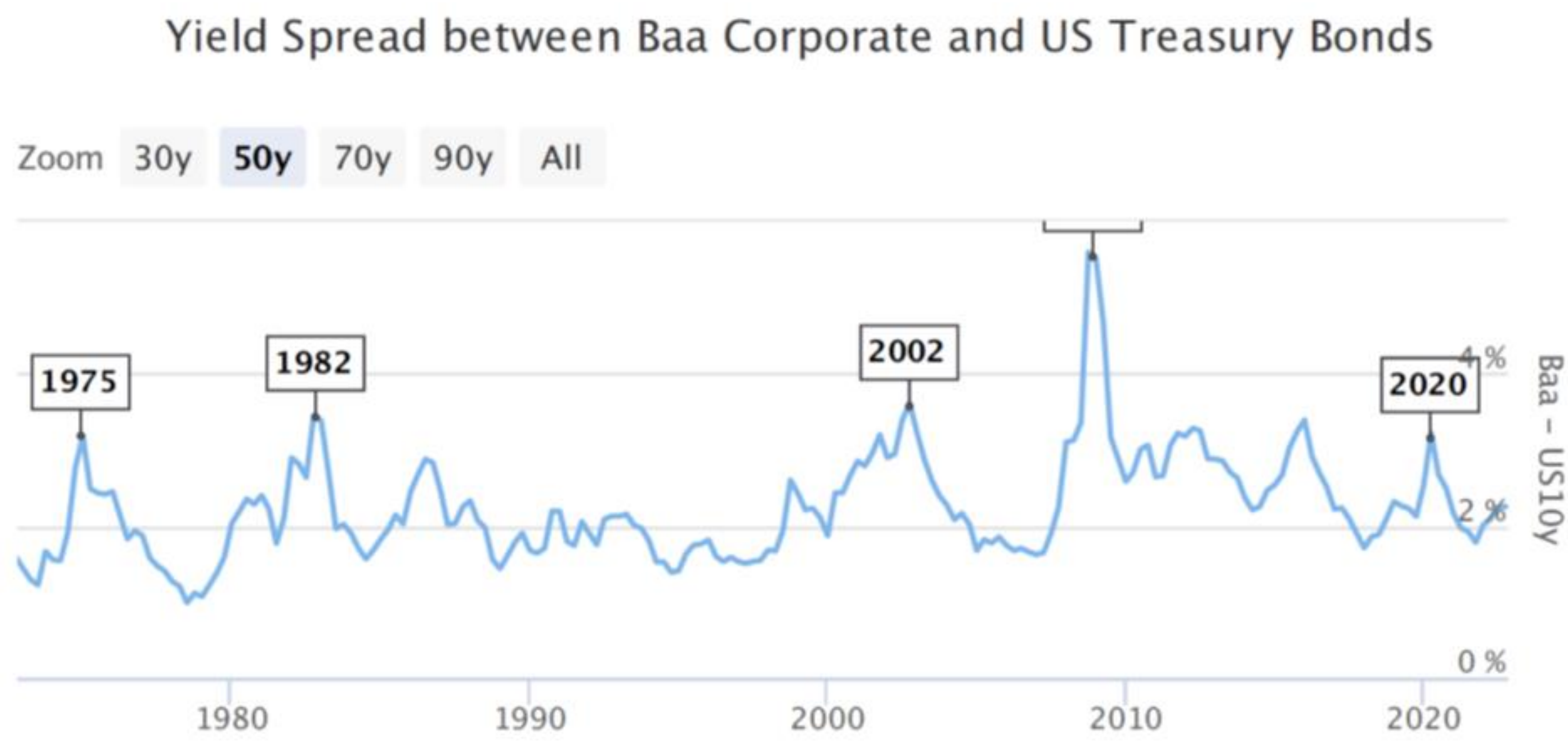
- For financial stability reasons, the curve must not be allowed remain inverted
- US yield curve has broken into 2 parts: a monetary expectations segment and an asset purchase segment
- Unless rates beyond 5 years keep rising, then the scope for monetary tightening is capped
- Loss of economic momentum is typically associated with fixed income rallies
- Strong possibility that the Fed will abort its planned rate hikes in next 3-6 months

Recapping the "Tottering Twenties"

- Inflation likely to remain elevated for a few years, resulting in a significant reset of the general price level for Western countries
- As global economy weakens, CBs will turn out to be paper tigers and inflation expectations will adjust (upwards) to the new reality
- CBs will focus their attention on financial stability and the suppression of credit spreads
- Currencies will become increasingly volatile as countries' perceived risk profiles shift around

All quiet on the Western front?

- Quality corporate credit spreads are still tight

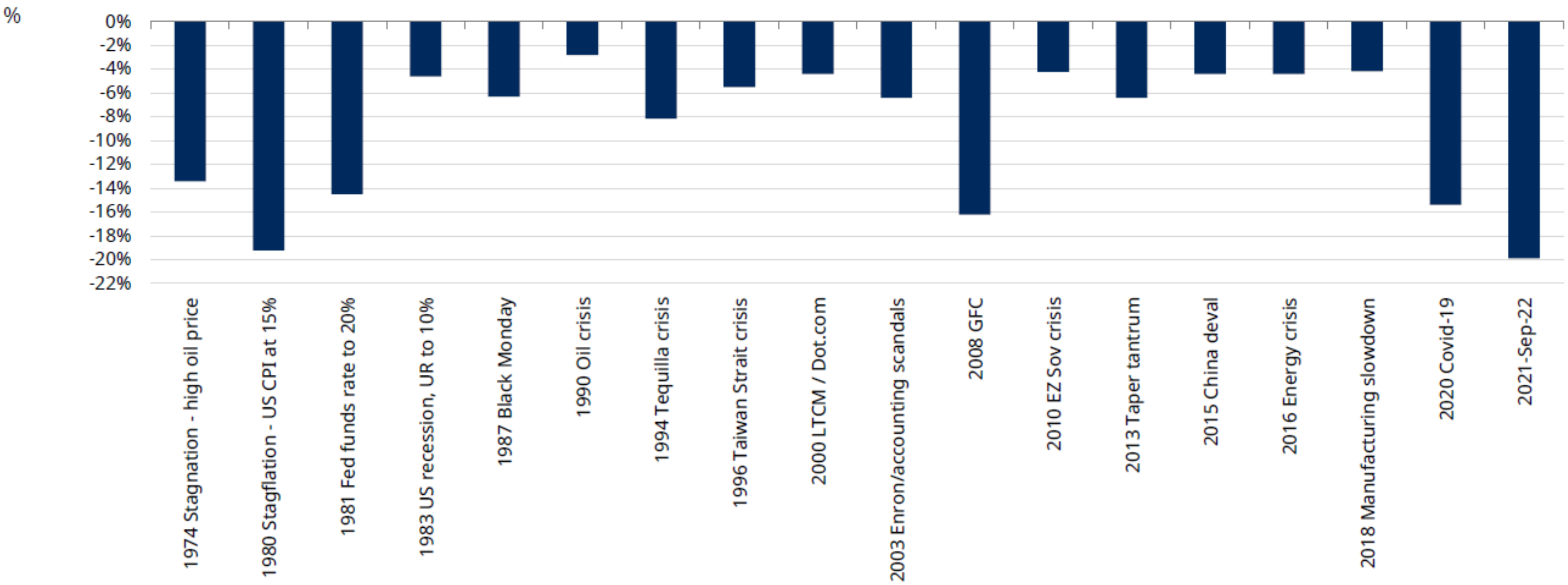


The re-pricing of corporate credit

What has happened?

The most severe drawdown peak to trough in credit during the last 40+ years

Peak to trough drawdown for Bloomberg $ IG Corp Index



Source: Bloomberg, as of September 2022.

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Schroders

Signs of a crack in the pricing of weakest credits

- Is the Fed willing to trigger a fracture in credit?

Threat of debt default looms much larger, post-Covid

- UK credit spreads nearly as wide as in 2020

Source: Bloomberg

Predictions

- The Fed ‘put’ will be reinstated once the S&P500 has lost 30%-40% from its highs
- The mounting risk of financial instability will take precedence over near-term inflation control
- The administration will relax the fiscal stance, out of necessity
- Credit spreads will widen appreciably and debt delinquencies and defaults will jump
- Bond rallies will be powerful, but temporary; UST 10Y yield to peak at more than 5% in 2024-25

Economic Perspectives

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