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Rising Interest Rates and Over-Indebtedness

In our August letter we pointed out that the turnaround in global economic growth would continue to reduce central bank enthusiasm for QE (bond purchases) and lead to sustained upward pressure on bond rates. To date, central banks are holding the line on short rates, keeping them near zero. It is only a matter of time before that ends. Rising short rates will add to the upward push on bond yields. Under "normal" circumstances, this pressure would be seen as a regular late cycle occurrence. However, the financial world is currently a long way from normal.

Super-easy monetary policy, involving central bank asset purchases of nearly US$9tn since 2007 and extraordinarily low interest rates have been used successfully since 2008 to prevent a banking collapse and depression. However, they have had two other very significant effects.

One of these has been to create pockets of speculation in interest-sensitive areas—some equity sectors, such as the NASDAQ and high-dividend paying stocks, real estate and, in particular, fixed income products. A number of key emerging market countries are also on the list. The carry trade, whereby investors borrow cheaply in an anticipated weak currency (the yen for example) and invest in fast-rising assets in another country with an expected rising currency has been massive. Now that the carry trade is unwinding, emerging markets are looking particularly vulnerable, including China, Brazil and particularly India, where the rupee has fallen nearly 25% since May.

The other major effect of the cheap monetary policy has been to encourage an increase in private debt in many countries (e.g. Canada, Brazil, China and Indonesia) while at the same time making it easy for sovereign debtors (excluding the PIIGS) to finance their fiscal profligacy. The seriously troubled sovereign debtors have been forced into draconian fiscal tightening which has had the primary effect of collapsing their economies and tax revenues, causing debt:GDP ratios to actually rise. Others have reduced deficits somewhat but total debt is still rising and the important ratio of gross debt to gross national savings is still deteriorating in most countries.

As interest rates rise and the speculation that was based on ultra-low rates unwinds, we could well find that, once again, the world still owes too much money.

The Debt to Cash Flow Yardstick

Almost a year ago, we published a report on the use of gross national savings as a yardstick to assess the sustainability of a nation's aggregate debt level.[1] This is akin to using debt to cash flow to assess the financial health of a company, and it can be applied to whole countries or regions, or to subsectors within countries like households or non-financial corporations.[2]

The method has a number of advantages over the traditional metric of debt:GDP. GDP is a lagging indicator, particularly in the midst of a financial bubble or during the

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[1] Boeckh Investment Letter, Special Report "*Deleveraging and the Global Debt Crisis*", October 23, 2012, written with co-author Bruce Ramsay, who developed the debt-to-cash flow approach for examining countries' debt dynamics. See http://www.endingoverlending.com.

[2] The debt-to-cash flow approach is limited by data availability for some countries, particularly emerging markets, as well as the difficulty of assessing the liabilities of countries with very large financial sectors, including the U.S., U.K., Japan and Switzerland.

recovery from one. For example, the false prosperity created during Spain's property bubble made the country's balance sheet look good. In Q2 2007, national savings peaked a full 12 months before GDP began to slow. Chart 1 shows debt:GDP and debt-to-cash flow (DCF) for Spain. Chart 2 shows the impact of austerity on savings: the improvement in net private savings was more than offset by the deteriorating public fiscal position.

Chart 1

Spain: GDP and National Savings

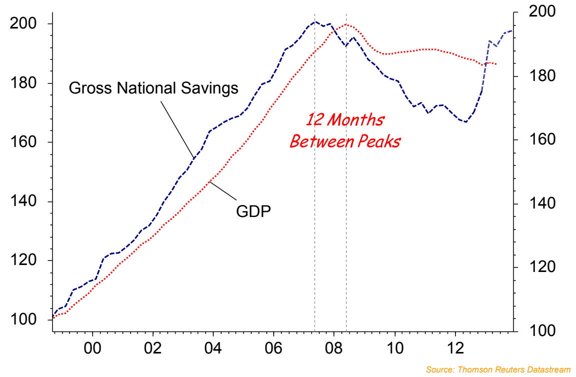
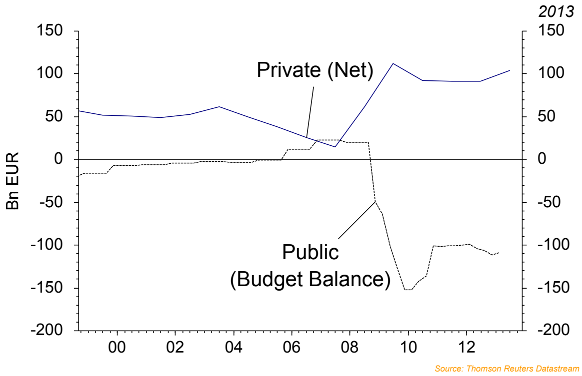


Chart 2

Spain: Public and Private Sector Savings



Further, debt:GDP provides little sense of the timing of a crisis, as there is no absolute level which serves as a threshold. There is controversy surrounding the 90% government debt:GDP level as an indicator of declining future growth, but many countries have accumulated debt up to and beyond this level with impunity. Japan is a good example, with gross government debt over 240% of GDP currently. There is no absolute level which provides a reliable predictor of a crisis, given variables such as reserve assets and carry trade flows. On the other hand, national savings relative to debt provides a much clearer threshold for predicting crises or the recovery from them, and with more precise timing.

The nations that achieved extreme levels of leverage on a DCF basis going into the crisis, the PIIGS, have managed to achieve a significant improvement in their debt dynamics (Chart 3). Since the crisis, we have seen their DCF level fall precipitously, mostly due to bankruptcies, defaults and financial sector bailouts, rather than repayment and increased total savings. While the trajectory that Greece, Ireland and Portugal are on is much improved, DCF levels of 60x and higher still remain unsustainable. DCF levels will need to approach 30x to truly declare these countries “out of the woods.”

France, Italy and Japan (Chart 4) are also at risk, given their elevated DCF levels and the steep rise over the past few years. Japan and Italy continue to show a rising debt burden, while France has achieved some limited deleveraging. The critical factor for these countries will be implementing reform, particularly of public sector liabilities. Prime Minister Abe has shied away from the tougher, necessary reforms in Japan, and France’s Hollande has recently flubbed the attempted reform of France’s bloated pension system, opting for further tax hikes over a reduction of payouts. In the case of Japan, savings have collapsed in recent years, causing the DCF ratio to spiral upwards beginning in 2008. From this perspective, Japan looks to be at an extreme level of risk for a financial crisis. A successful implementation of Abenomics would require national savings to rise substantially in short order through a combination of increased private sector savings and a public budget close to balanced. This is where rising exports and achieving the 2% inflation target will be critical, both of which are looking increasingly unlikely.

Chart 3

Extreme Leverage Nations

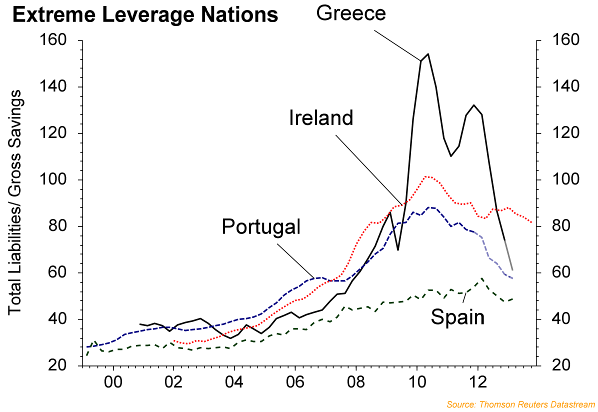


Chart 4

Risk Zone Nations

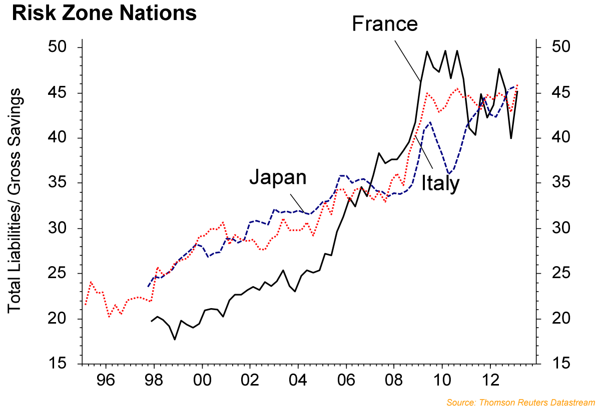


Chart 5

Warning Leverage Nations

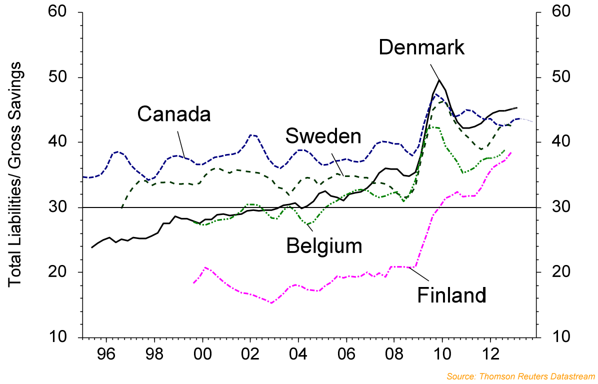
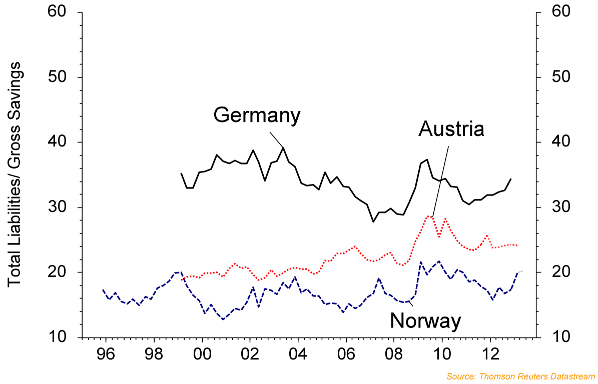


Chart 6

Optimum Leverage Nations



Alarmingly, many countries that had stable debt dynamics heading into the financial crisis now appear to be sliding into dangerous territory, shown in Chart 5, “Warning Leverage Nations”. Canada, Denmark, Sweden, Belgium and Finland are moving towards high debt to cash flow levels. Generally, this is a reflection of easy household access to credit and large budget deficits. While not yet dangerous, these trajectories needs close watching.

Germany, Austria and Norway are among the very few exceptions to global over indebtedness (Chart 6). Financial discipline combined with a relatively strong savings have kept these countries out of the trouble zone.

These charts show that five years from the financial crisis, too many countries remain in dangerous territory. No country has yet succeeded in reducing aggregate debt levels (Charts 7 & 8), with the exception of the U.S., which after a small decline, is now on the rise again also. Rather, debt has been shuffled around from one sector to another—typically from the private to the public sector. Austerity in the eurozone has done nothing to improve the sustainability of the debt burden: aggregate liabilities continue to rise and national savings have only made a marginal recovery.

Chart 7

Aggregate Liabilities*: PIIGS

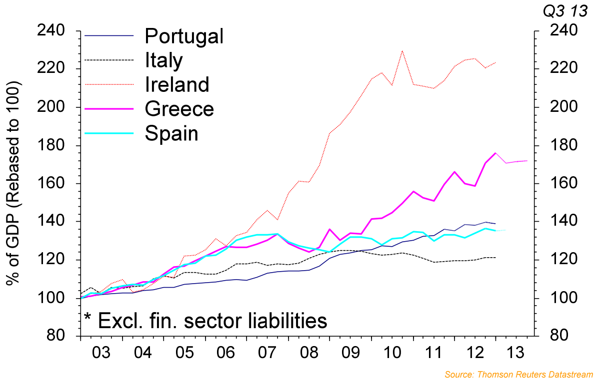


Chart 8

Aggregate Liabilities*: On the Rise

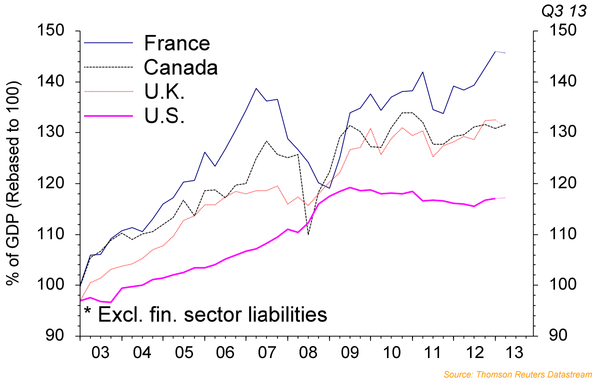


Chart 9 shows gross savings margin, calculated as gross saving divided by GDP, for several countries. Gross savings above about 20% of GDP is ample to finance investment domestically. When the savings margin falls below about 15%, abundant foreign capital is generally needed to finance investment, as in the case of Greece and Ireland. The chart shows a significant improvement in the savings margin for both, at 10% and 15% of GDP respectively. To put this in context, Canada's savings margin fell to a low of about 16% in the 1990s financial crisis and it took until the early 2000s for it to sustainably return above the 20% level (Chart 10).

Chart 9

Gross Saving as % of GDP

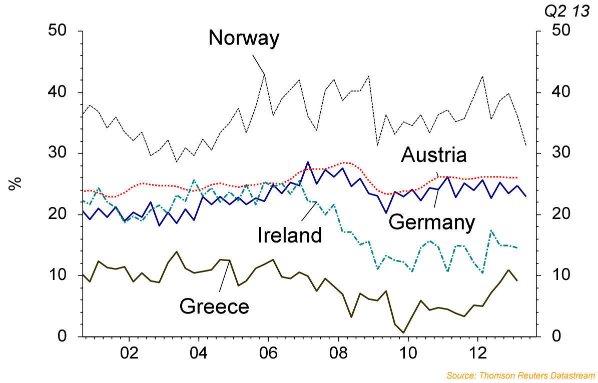
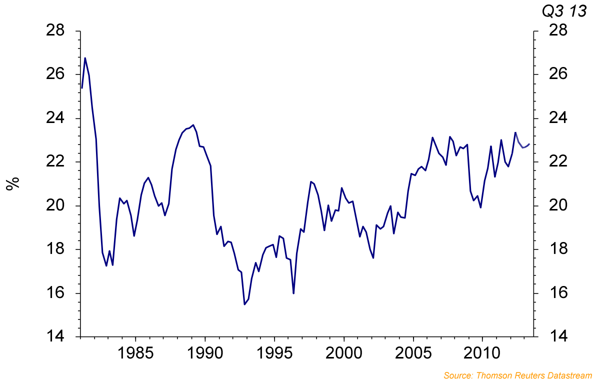


Chart 10

Canada: Gross Saving as % of GDP



Public Sector Debt

The measure of cyclically-adjusted primary budget balance artificially puts austerity in a positive light for some of the most seriously over-indebted countries (Chart 11). On this measure, troubled eurozone nations look to have made excellent progress, with many forecast to achieve a primary surplus in the next two years.[3] However, applying the cyclical adjustment to potential GDP is problematic when it is unclear to what extent potential output has been damaged, and unemployment, particularly for youth, remains devastatingly high in Spain (56.1%), Italy (39.1%) and even France (25.7%). If we adjust U.S. employment for the pre-crisis participation rate, the unemployment situation appears much worse (Chart 12). This points to a significant long-term decline in the level of potential output.

[3] OECD Economic Outlook

Chart 11

Primary Budget Balance (OECD Forecast)

As % of POTENTIAL GDP

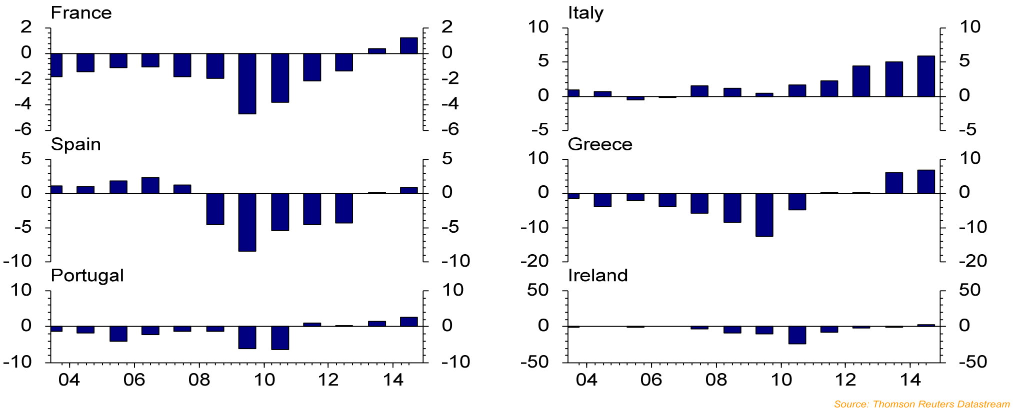
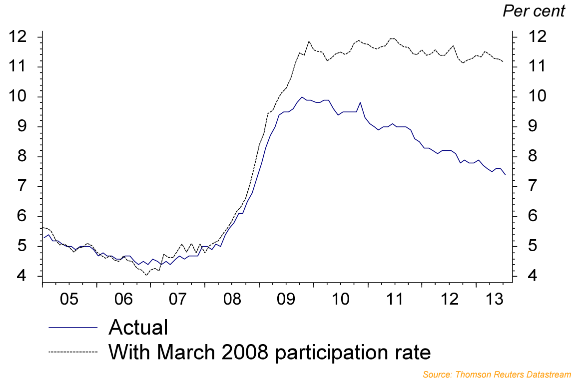


Chart 12

US Unemployment Rates



Furthermore, the primary budget balance is a snapshot measure of the difference between current government revenue and spending, stripped of interest payments on debt and, in the case of the cyclically-adjusted primary budget balance, automatic stabilizers and cyclical differences in tax revenue. It is a useful measure of a government's deliberate spending and revenue choices, but gives a very incomplete picture of long-term fiscal health. To more realistically evaluate public sector liabilities, it is also necessary to factor in the amount governments must pay in interest, the dynamics and composition of the existing stock of debt, and, most significantly, pensions and other contingent liabilities. Pensions already cost an average of 10% of GDP across the EU, projected to rise to 18% of GDP in 2060 while the number of workers per retiree will halve over the same timeframe. The IMF estimates contingent liabilities related to social security at 357% of GDP for Italy, 265% for France and 221% for Germany. European schemes are largely pay-as-you-go. We have difficulty believing Europeans will tolerate deep cuts in the welfare state.

Countries can reduce their debt burden in several ways: inflation, default, savings and growth or some combination of each. China's deceleration, and the difficulty in implementing growth-stimulating reforms in countries as diverse as Japan, most of the eurozone, and India means that it is going to be increasingly difficult to grow out of excessive debt. Ample slack in labor markets and globalization have kept a lid on inflation, allowing extraordinary liquidity to remain in place for the past four years without triggering price pressures. However, the breathing room created through abundant liquidity has not resulted in significant deleveraging where it is needed. Rather the opposite has occurred: leverage has built up in a number of new places, while growth continues to remain sub-par.

Investment Conclusions

The recent spike in global bond yields, along with the deceleration of emerging market economies and downward pressure on their currencies points to a difficult environment for stocks over the coming months. Chart 13 shows the selloff in EM currencies over the past months. EM's currently hold substantial foreign exchange reserves, about $250bn in India's case (a decline of only $21bn since April). In comparison to the 1997 Asian crisis, the currency declines look mild so far (Chart 14). However, given the weak global economy, it is difficult to predict how severe the current balance of payments problem may get.

Chart 13

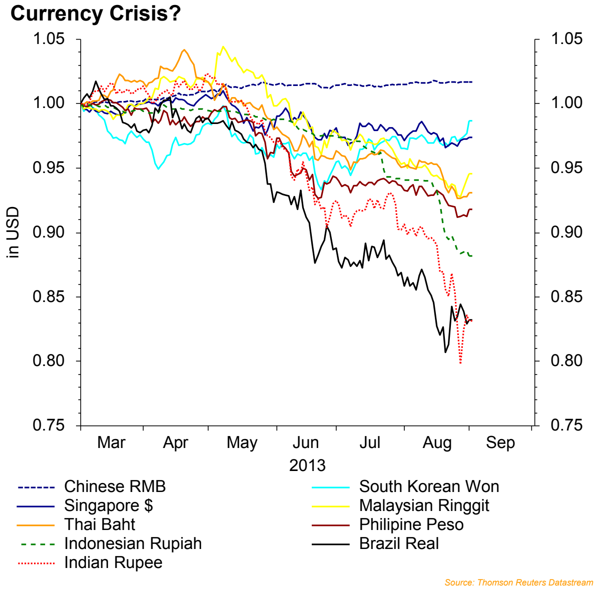
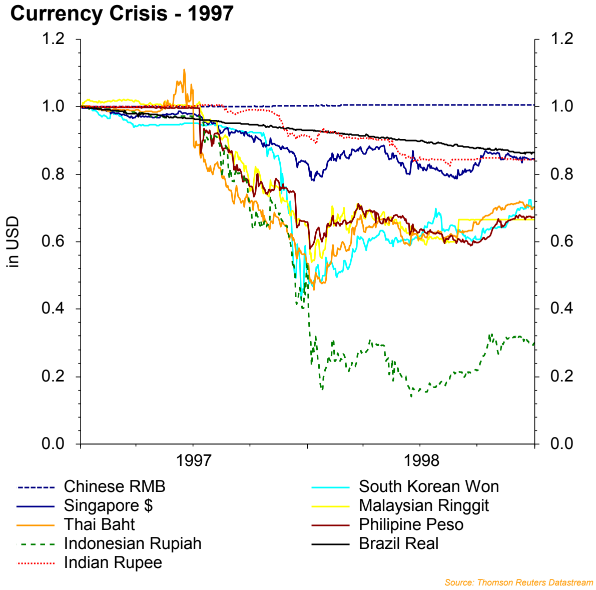


Chart 14

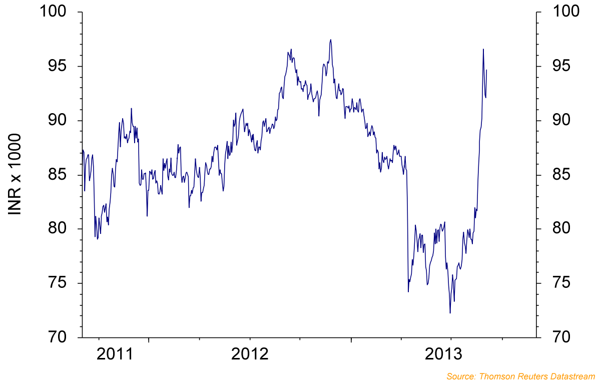


We continue to believe that Fed QE tapering will be a slow process. However, as EM's sell U.S. Treasuries to support falling currencies, this will effectively tighten monetary policy in the U.S. in a manner that the Fed has little control over. Steady but sub-par growth in the U.S. means that there is little margin for error. High global debt loads require much faster growth than we are currently seeing in order for deleveraging to occur without triggering a recession. However, faster growth could trigger a snap back in price inflation and a much steeper rise in interest rates. In short, policy makers will have a very narrow path to negotiate a return to monetary equilibrium in a benign fashion. This means that risks will remain elevated for the stock market.

The implications of this medium-term outlook are bullish for gold. EM central banks are unlikely to sell gold to finance currency interventions unless conditions become catastrophic. If that were to happen, the impact of this is likely to be offset by the EM private sector seeking inflation protection. In rupees, gold is near its peak price (Chart 15), justifying the long-held belief there that gold protects wealth in the long run. The same is true virtually everywhere in the world if time horizons are suitably long.

Chart 15

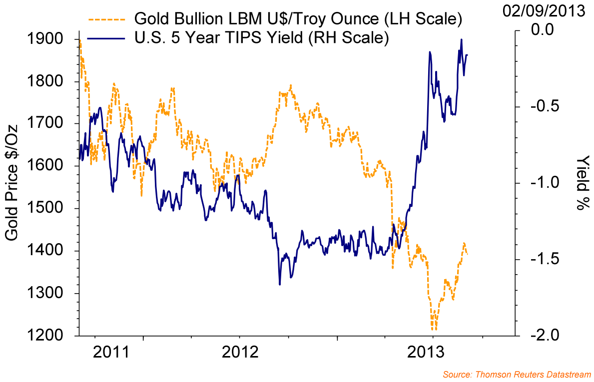
Gold in Indian Rupees



If growth isn't sufficient to reduce the real debt burden, then inflation and default will have to play a bigger role. Chart 16 shows the recent recovery in gold prices, which occurred despite the rise in real interest rates over the past months. ETF sales have bottomed, after unprecedented sales this year. Our guess is that the low is in for the gold correction that began in September 2011. The path ahead will likely remain volatile as there are many cross-currents of deflation, inflation and currency instability. The U.S. dollar is likely to remain strong which will naturally maintain a headwind for gold. But longer run, there is little or no prospect that monetary stability on a global scale will be achieved.

Chart 16

Gold & Real Interest Rates



Oil prices have spiked upwards in the past week or so due to the growing potential for U.S. involvement in Syria and the risk of a wider conflict. Spreads between Brent and WTI (Chart 17) closed sharply since June (recovering somewhat since), due to the reduction of the transport bottleneck within the U.S., particularly regarding shale oil getting to Gulf Coast refiners, as well as improving growth expectations in the U.S. and the rising cost base of new domestic production. However, Canadian producers have largely been left out of the rally in WTI, as northern transport bottlenecks continue to result in a bitumen bubble in the tar sands (Chart 18). Setbacks to pipeline plans, for example the Northern Gateway corridor to the B.C coast, and the recent rail accident in Eastern Quebec will likely continue to act as a headwind.

Chart 17

Crude Oil Prices

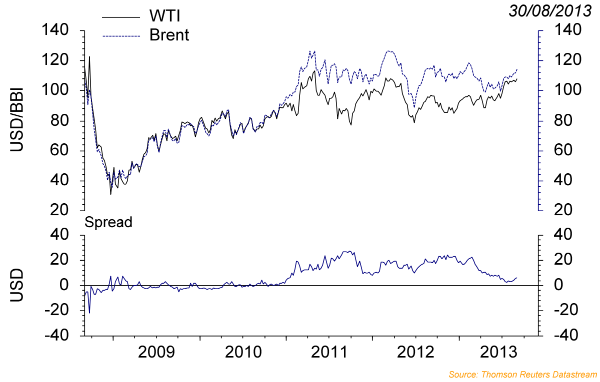
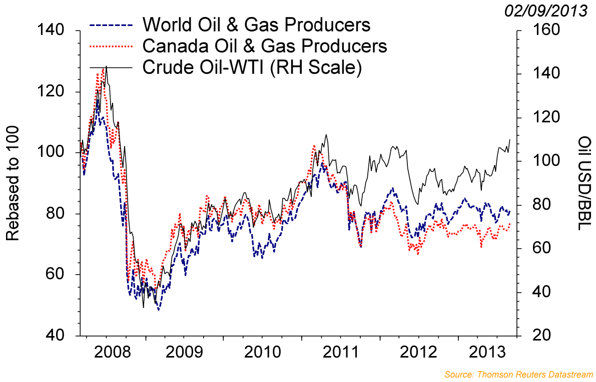


Chart 18

Crude Oil & Producers



We are recommending investors continue to maintain a conservative asset allocation: minimize exposure to bonds, keep duration short and stay below benchmark on equity allocations. The fall has frequently been a period when stocks get beaten up due to building pressures. Despite rising valuations in the "dividend aristocrats," this sector will likely continue to outperform as fixed income investors have few alternatives.

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