Aberdeen Standard Investments

Macroscope:

Global imbalances – sustainable for now

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Executive summary

Rising prices for risk assets against the backdrop of a still slowing global economy make it critical for us to evaluate the extent of any systemic financial imbalances that could derail the recovery altogether and spark a large correction in asset prices.

According to IMF analysis, the most acute debt imbalances are to be found in the US sovereign sector and coporate leveraged loan market, the Chinese non-financial corporate and household sectors, and the household sectors in smaller advanced economies like Australia, Canada and the Nordics. To that mix we would add the sovereign sector in the Eurozone periphery.

However, some of these imbalances are either not systemic (small-economy household leverage), or are unlikely to unwind over near-term investment horizons (sovereign debt in the US and other countries issuing in their own currencies).

The systemic imbalances we worry most about are China's excessive private sector debt, the leveraged loan market in the US, and high public debt in peripheral Eurozone economies led by populist governments. In China's case, its low external debt and solid public balance sheet imply that a hard landing is a greater medium than short-term risk. And while interest rates remain low, levered loans and weak public balance sheets are more likely to amplify than cause the next downturn.

The upshot is that, although the world is suffering from pockets of imbalances, in the aggregate we do not see these as either systemic enough or likely enough to unwind over the near-term to make us think that the current business cycle expansion will come to an end this year.

'The key takeaway is that although there are pockets of severe imbalances in the global economy, they are either concentrated in non-systemically important countries or unlikely to unwind in the near-term'

Global overview

Global imbalances: sustainable for now

Jeremy Lawson,
Chief Economist

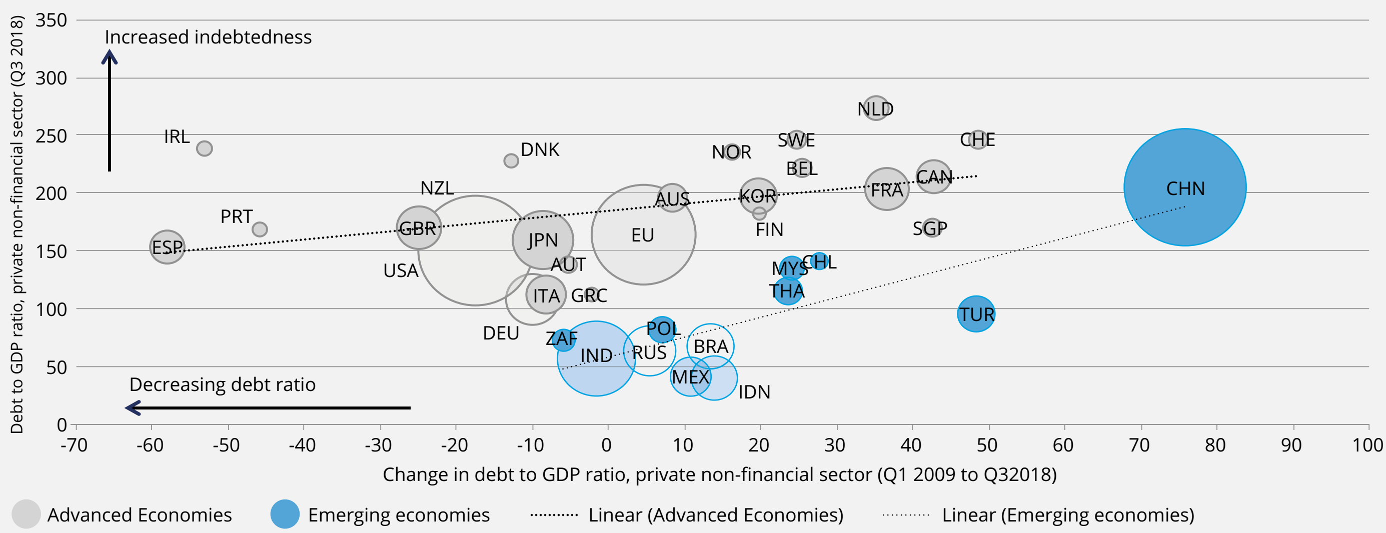
As risk assets continue to rise amid slowing global growth it is important to understand which countries and sectors have the largest debt vulnerabilities and whether the triggers exist for them to unwind in the near term. The IMF's Financial Stability Report divides the world into five systemically important regions – the United States, Euro Area, Other Advanced Economies, China and Other Emerging Markets – and the key sectors within them such as non-financial corporations, households, sovereigns and banks. It then compares leverage for each year since 2000 with its average over the period. Sector leverage is deemed acute when it is in the top 20% of the post-2000 average for all advanced or emerging economies.

The good news is that there are few imbalances in systemically important regions that are both acute and have a high likelihood of correcting this year. In the US, the sovereign sector is over-levered but low interest rates should allow that to be sustained. Excesses in the leveraged loan market are a bigger problem but are more likely to amplify the next downturn than cause it. In the Eurozone, no sector is acutely over-levered although non-financial corporate and sovereign leverage are above average and the aggregate picture masks imbalances in individual countries. The Eurozone is also vulnerable to imbalances unwinding elsewhere because of its dependence on external demand. Meanwhile, household leverage has reached excessive levels in Other Advanced Economies and in particular Australia, Canada and the Nordic countries, although they are not large enough economies to precipitate a global recession.

Other Emerging Markets are in a strong position compared with their histories, with no sector in aggregate having leverage in the top 40% of the post-2000 average. China is another story, with the non-financial sector especially over-levered, while household leverage has also been rising rapidly. Of all the global imbalances, it is China's that worry us the most. However, China does benefit from its debt build up having been internally financed and the sovereign's ability to socialise significant private sector defaults.

The key takeaway is that although there are pockets of severe imbalances in the global economy, they are either concentrated in non-systemically important countries or unlikely to unwind in the near-term, especially if the world's major central banks keep policy rates low and remain highly sensitive to economic and financial conditions. As the largest single driver of global growth over recent years, it is China's imbalances that are the biggest risk to the global expansion and it is there our attention is most keenly focused in case an aggressive and destabilising deleveraging cycle commences.

Chart 1: Private sector imbalances vary considerably across countries



Bubble size determined by economies GDP based on PPP valuation of country GDP in billions of international dollars.

Source:Haver, IMF WEO, BIS (as of Q3 2018)

‘US corporate debt, and in particular leveraged loans, provides the largest threat to the domestic economy.’

United States

A leveraged loan mountain

James McCann,
Senior Global Economist

One of the classic imbalances that used to spell trouble for the business cycle was excessive inflation. Often, accelerating wage and price growth weighed on margins and household purchasing power, forcing central banks to step in. However, the Fed has little to fear from such risks at present and is debating the merits of allowing inflation to run a little hotter as part of a 'make-up' strategy following years of below-target inflation. Indeed, the flatter and more stable Philips Curve has reduced the risk of inflation breakouts, with the past two US recessions having been driven by the financial cycle.

On this front, the story is more mixed. Starting with the good news, aggregate household balance sheets seem to be in good shape. The ratio of personal debt to disposable income is falling and, at 95%, is close to a twenty-year low. This reflects less leverage in the mortgage market, with mortgage debt down from a peak of 95% of disposable income in 2008 to 64% at present. Over this period, credit card debt has also fallen, although there has been a large increase in student debt and auto loans.

The corporate sector poses more problems. Although the IMF does not regard economy-wide corporate leverage as an acute problem, US businesses have levered up significantly since the crisis, with the private non-financial sector debt-to-GDP ratio rising to 47% at the end of 2018 (see Chart 2). Leveraged loans have grown especially rapidly, swelling to $1.2tn, with over 50% of last year's new issuance provided for firms with debt levels more than five times earnings. Worse, underwriting standards have deteriorated; around 80% of deals in 2018 were covenant light, providing fewer investor protections (see Chart 3). There is also evidence that non-price credit terms have eased, with borrowers using flattering earnings projections to secure financing. In response, recovery rates for defaulted loans have fallen to 69%, down from the pre-crisis average of 82%.

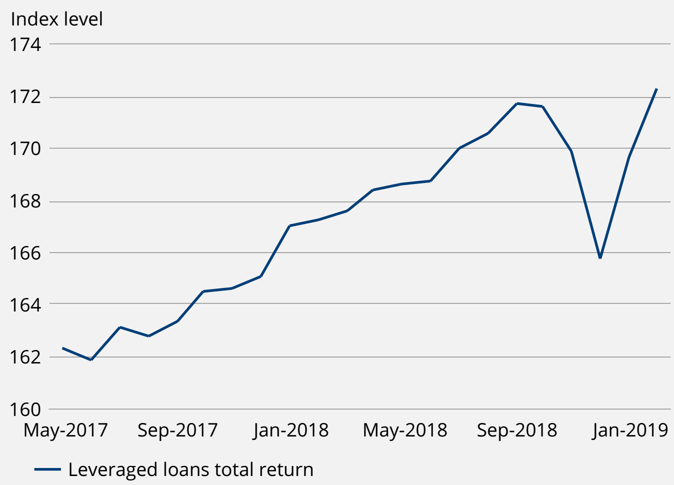
This imbalance could prove damaging for the real economy. Highly levered companies may struggle to make interest payments if their earnings falter. This could spark a rise in defaults which would likely cause a sharp drop in liquidity in the asset class which has become an important source of corporate funding. This would spark a credit squeeze as firms struggle to refinance. The Fed is concerned about these risks, launching a review of the sector through the Financial Stability Board. In the US, there is regulation to prevent lending to companies with debt exceeding six times their earnings, but this is regularly ignored. The Fed's challenge is that it lacks the legal mandate and tools to deal with these imbalances.

Overall, we do not think US private sector imbalances are severe enough to bring the expansion to an end on their own. But the unwinding of excesses in the corporate and especially leveraged loan market will amplify the downturn when it does come, especially with the country's fiscal space somewhat constrained by the structural gap between revenue and spending.

Chart 2: Corporates back on the debt train

Source: Federal Reserve Board, Haver, ASIRI (as of December 2018)

Chart 3: Jittery markets



Source: Bloomberg, ASIRI (as of February 2019)

‘In aggregate, systemic imbalances appear modest rather than severe. The main risk to the cycle is a hard Brexit or an external shock.’

United Kingdom

Stalling not falling

Luke Bartholomew,
UK Economist

January's UK GDP estimate was stronger than expected, with growth coming in at 0.5% m/m. The bulk of this increase reflected the reversal of December's sharp fall, highlighting the high volatility of monthly series. Recent business surveys had pointed to a sharper slowdown, suggesting that sentiment surveys may overstate weakness at times when political noise is high (see Chart 4). Looking through the volatility, the three-month moving average was just 0.2%, demonstrating that the economy has lost significant momentum as Brexit uncertainty has weighed on activity in general and investment in particular.

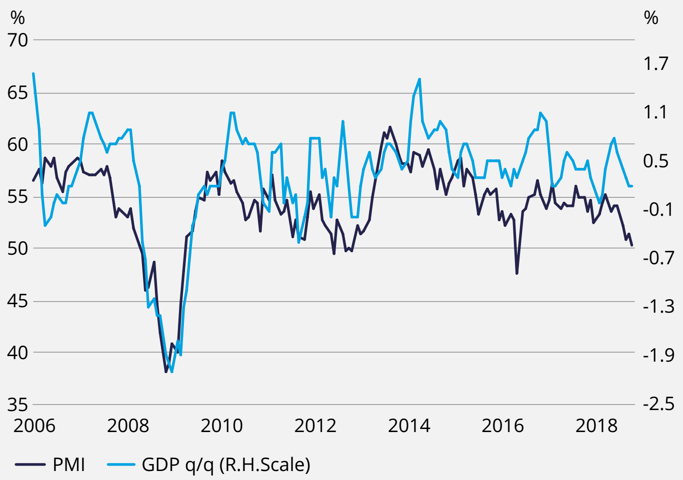
With Parliament having voted to take 'no deal' Brexit off the table, the risk of crashing out of the EU has fallen substantially. However, while risks have diminished, uncertainty will last even longer as the Article 50 process is extended. This may prolong the wait for more clarity about the the future relationship and renders a substantial near-term pick-up in investment unlikely.

Perennially weak investment has long been a feature of the UK's imbalanced growth, which over time has likely contributed to falling potential growth. The Bank of England recently revised down its estimate of potential growth to slightly below 1.5%. The risks to this forecast are probably skewed to the downside, as a less open trading relationship with the EU and tighter controls on immigration are likely to push down potential growth further. Weak potential puts a cap on how high interest rates can ultimately rise, and will make it harder to counteract the next recession as the lower bound becomes a more binding constraint.

Another imbalance facing the UK is its persistent current account deficit. The depreciation of sterling following the referendum, along with stronger global growth, drove solid export growth in 2017 which helped reduce the deficit (see Chart 5). During this period, the UK was in what Ben Broadbent has called a "sweet spot" for exporting. However, with global growth slowing and the boost from sterling depreciation fading, export growth slowed sharply in 2018. Fortunately, it is highly unlikely that the UK would face a situation where there is a sudden stop in capital inflows and a forced rapid reduction in domestic demand. Even less of a concern are the UK's public finances. Although public debt as a share of GDP is still high relative to longer-term averages, the structural budget deficit has fallen substantially and, with interest rates likely to remain low over the medium to long term, there is ample scope to loosen fiscal settings in the event that growth slows more severely.

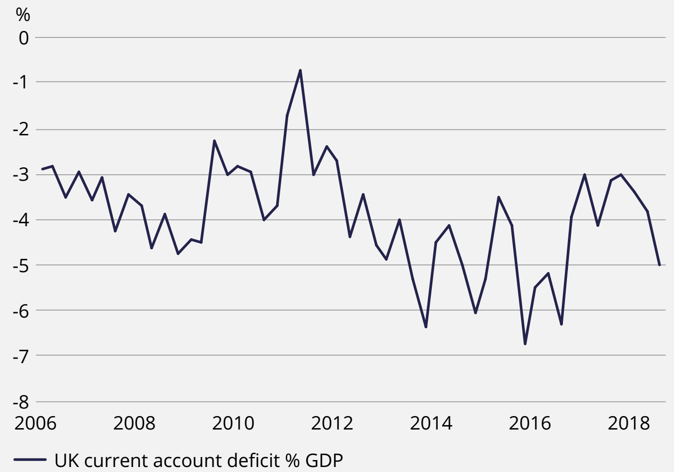
Household leverage is quite high in the UK, at least compared to long-run historical averages, and has picked up recently as households have tried to smooth through the real income shock following the referendum. However, there is not an automatic level at which leverage becomes unsustainable. Leverage is still below the levels of 2007, the banking sector is well-capitalised and lower real rates combined with financial deepening make historical comparisons less relevant. This suggests the risk of an endogenously generated debt shock is relatively mild. The bigger risks to the UK come from Brexit and external shocks.

Chart 4: PMIs overstating weakness



Source: ONS, Markit, Haver, ASIRI (as of January 2019)

Chart 5: Recovery stalling



Source:ONS, Haver, ASIRI (as of Q3 2018)

‘The Eurozone economy is uniquely vulnerable to domestic and external economic imbalances, given its institutional structure.’

Europe

Uniquely vulnerable

Paul Diggle,
Senior Global Economist

The Eurozone's inadequte institutional sructures leave it uniquely vulnerable to imbalances. Significant pockets of imbalances are present within the currency union, including high public debt levels and negative net international investment positions in some countries, and between member states, including differing trend growth rates and cost competitiveness. These mean that the Eurozone is vulnerable to the current slowdown morphing into a full-blown recession, although for now this is not our base case.

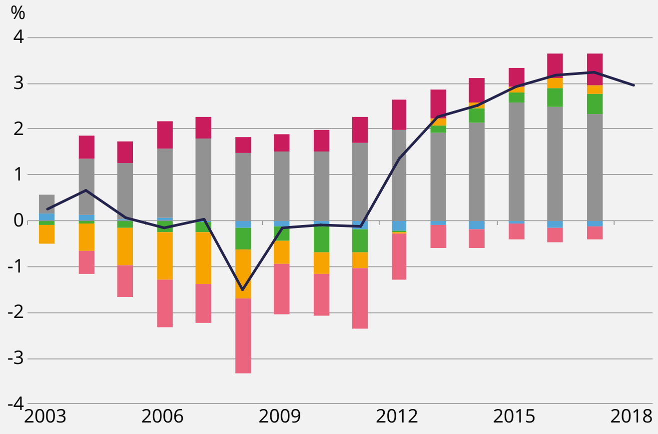
One way to group imbalances is in terms of 'stocks' and 'flows'. The stock imbalances that plague some European economies are high public debt levels and large negative net international investment positions. Italy, Portugal, Belgium and Greece all have public sector debt-to-GDP ratios in excess of 100%. Admittedly, public sector debt ratios are now declining in almost all member states. But a growing number of countries are expected to run pro-cyclical budgetary loosening in coming years. Meanwhile, private sector indebtedness is most acute in European economies outside the Eurozone – Norway and, particularly, Sweden, have very elevated private debt-to-GDP ratios that pose financial stability concerns.

The Eurozone as a whole now runs a large current account surplus (see Chart 6), but a history of big external deficits in certain Eurozone economies has left them with large negative net international investment positions. Spain's is some 80% of GDP, while those of Portugal, Ireland, Greece and Cyprus exceed 100% of GDP. In part, these are the result of internationally orientated service sectors and, in Greece's case, large external public debt at highly concessional rates. But substantial negative international investment positions leave these economies reliant on financing from abroad, which may dry up in stress situations.

The flow imbalances that are most problematic are weak potential GDP growth, low inflation and, as a result, large competitiveness differentials between member states, putting them on divergent paths and contributing to the build-up of stock imbalances. Unfortunately, the same member states burdened by high debt levels are generally also those with little ability to rely on growth and inflation for a reduction in debt ratios (see Chart 7), leaving little scope for private and public savings to cushion negative output shocks.

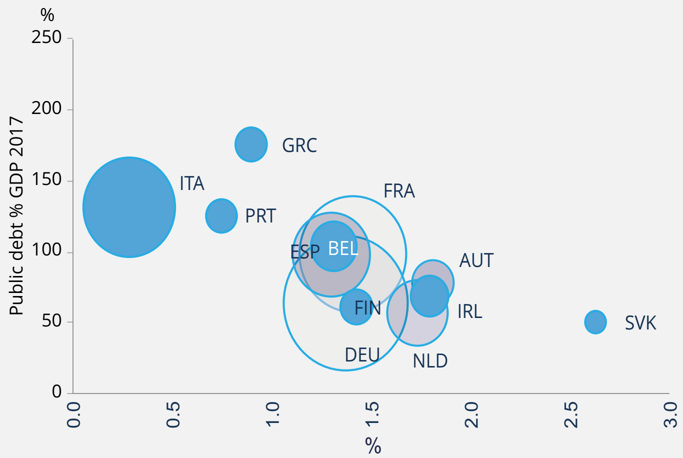
All in all, the fact that European imbalances built up in the years leading up to the sovereign debt crisis have not been completely unwound, and in some cases are showing signs of re-building. These, together with the populist political pressures pushing against structural reforms at the national or Eurozone level, represent a latent vulnerability, particularly if the external environment worsens rather than improves. For now, that is not our base case, and we detect signs that the negative data flow is starting to bottom out. But at some point, Europe's imbalances will come home to roost.

Chart 6: Largest surplus in the world



Source:Statistical Office of the European Communities, Haver,ASIRI (as of Q4 2018)

Chart 7: Debt highest where growth is lowest



Source: European Commission, Oxford Economics, Haver, ASIRI (as of 2018)

‘Despite persistently low interest rates over two decades, the Japanese financial cycle has remained muted. Banks are the greatest vulnerability, particular to a large adjustment in interest rates.’

Japan and developed Asia

The never-ending financial cycle

Govinda Finn,
Japan and Developed Asia Economist

Interest rates in Japan hit zero 20 years ago and have hovered close to that level almost without disruption ever since. Nevertheless, the latest Bank of Japan assessment gave the financial system a clean bill of health: "The funding conditions for firms and households have been highly accommodative, but the financial cycle has shown no signs of overheating as observed during the bubble period in the late-1980s." How have persistently low interest rates not created large imbalances?

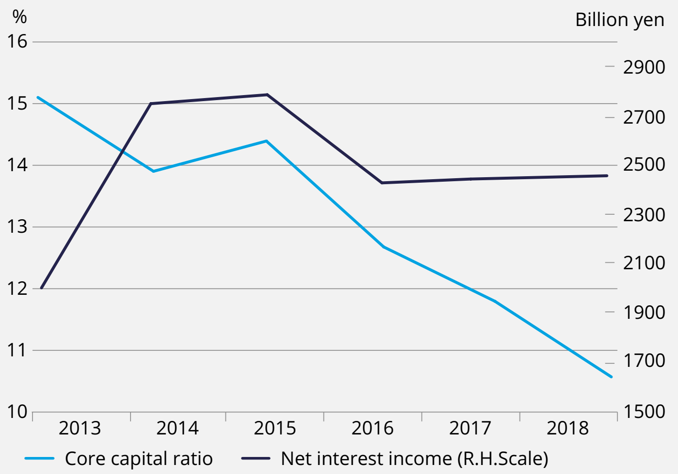
The most common explanation is that structural factors, like demographics and inflexible product and labour markets, have stifled and extended the current cycle. However, this is disputed by the BOJ, who argue that tight monetary policy in the past was the primary cause. Six years since the ascension of Governor Kuroda, and despite aggressive easing policies, the financial cycle remains muted. Another explanation is that the Bank's analysis is too backward-looking – emphasising the risks that fuelled the bubble period rather than future risks building in Japan's banking sector due to unconventional policies.

Three key risks that are worthy of attention. First, a sustained period of weak profitability is reducing the capability of banks to absorb losses from earnings. Weak earnings in the banking sector are not typically considered a systematic risk; earnings are highly cyclical and regulators demand offsetting capital cushions. However, poor earnings increase the likelihood that capital buffers kick in. This should augur for even greater provisions, although the country's major banks look relatively well-capitalised (see Chart 8). Second, ultra-low interest rates and high levels of competition may have resulted in excessive compression of lending spreads, which are close to zero. While credit risks appear modest with non-performing loans at record low levels (see Chart 9), it may not take large shock to turn low-yielding loans into non-performing loans.

A final threat comes from interest rate risk related to banks' securities holdings. Amid subdued core earnings, banks have bolstered income from market operations. The search for higher yields has pushed some into unfamiliar asset classes like AAA rated collaterised loan obligations. However, sudden changes in conditions can result in meaningful market losses, like in US Treasuries when Japanese banks were caught out by last year's rate rises. An even bigger risk may lurk at home. A rise in interest rates in Japan would cause the value of banks' holdings to fall sharply. Again, the primary concern from yen interest rate risks relates to regional banks which have the biggest exposures.

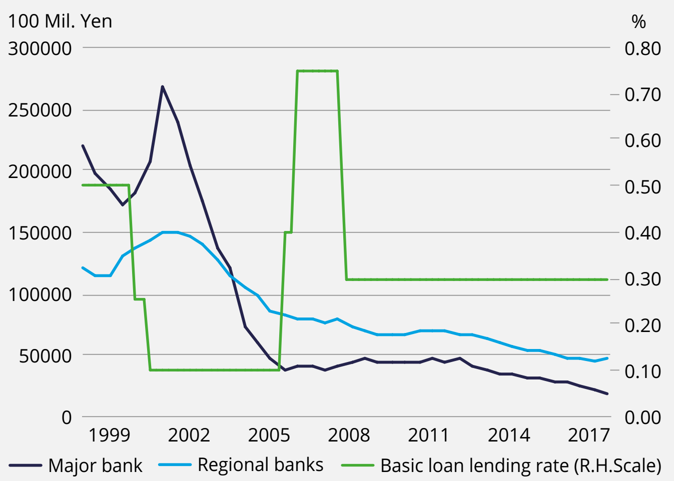
These risks appear to have been belatedly recognised by the Financial Services Agency. Last week, it proposed stress tests on all the nation's regional banks, focused on the impact of a credit or interest rate shock. Banks that fail these tests will be targeted for profit improvement plans. The recommendations of the regulator will be closely watched.

Chart 8: Falling profits and provisions



Source: Bloomberg, ASIRI (as of December 2018)

Chart 9: Credit complacency



Source: Financial Services Agency, Bank of Japan, Haver, (as of February 2019)

'Excess leverage in China is the biggest systemic risk emanating from emerging markets; although the country's strong external position and unique institutions reduce the risk of a dangerous unwind in the near term.'

Emerging markets

No hard landing in China - yet

Jeremy Lawson,
Chief Economist

It is not an overstatement to say that the fate of the global economy in 2019 rests in the hands of China's policymakers. Even taking into account the likely overestimation of growth, China has likely accounted for more than around a third of global nominal GDP growth since 2009 in USD terms (see Chart 10). Moreover, the country's financial and economic cycles have been the most important driver of the global cycle over that period. There have been many positive by-products of this drive for growth, not least of which have been the enormous gains in Chinese living standards. However, it has also come at a large price, in the form of an enormous increase in economy-wide leverage. China's private non-financial sector debt-to-GDP ratio was above 200% of GDP as of the end of 2018, up more than 80 percentage points (ppts) since 2008 (see Chart 11).

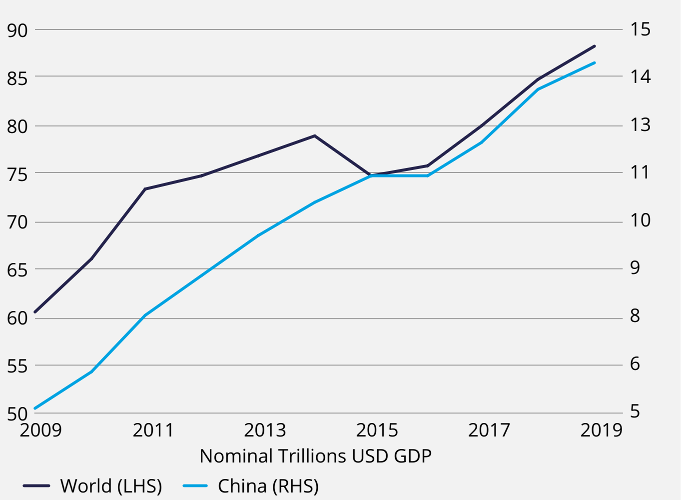
Such large and rapid rises in debt are almost unprecedented but it is the composition and inefficiency that concern us the most. The banking sector's balance sheet is well over 300% of GDP, more than three times the emerging market average. Moreover, the rapid expansion of lending has been funded from an opaque array of 'shadow' sources, including wealth management products and trusts. In the first phases of the boom, most of the debt was extended to non-financial corporations, many of which are state-owned enterprises. But more recently the household sector has joined in, and debt ratios also exceed safe levels.

As leverage has increased, credit efficiency has also declined markedly. According to calculations by Chen and Kang (2018), RMB6.5 trillion in new credit was needed to raise nominal GDP by RMB5 trillion in 2007-08. By 2015-16, that had increased to RMB20 trillion. This is partly because credit continues to flow excessively to the industrial sector and state-owned firms, starving comparatively more productive service sector and genuine private enterprises of the credit needed to fuel their expansion.

Will 2019 then finally be the year that these imbalances unwind? If China were a typical emerging market economy, then maybe. But China is not typical. Unlike most past emerging market credit booms, China's has primarily been internally financed and thus China's external debt to GDP ratio remains very low. In addition, the ratio of public debt to GDP is relatively modest amid a strongly state-controlled economy and relatively closed capital account. Both afford options for socialising the losses from rising defaults and recapitalising the banking sector that are not usually available to emerging economies when deleveraging kicks in.

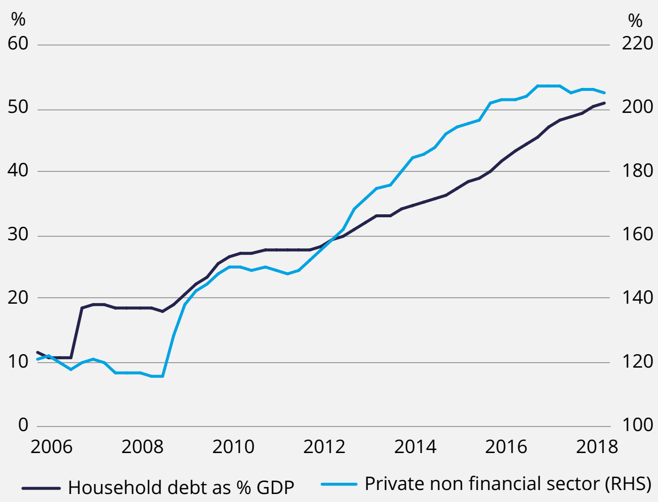
The upshot is that, although we endorse the consensus that the Chinese economy is significantly over-levered, and that credit efficiency is low relative to the past, we do not think that 2019 will be the year these imbalances unwind. Indeed, we think there is scope for the economy to respond to the policy loosening put on place over the past 12 months. The upswing will be modest compared with past cycles, but any pick-up will be welcome in a global economy in desparate need of positive growth drivers.

Chart 10: China is the biggest driver of global growth



Source:IMF WEO (as of March 2019)

Chart 11: : The inexorable rise of Chinese debt



Source:Haver,BIS (as of Q3 2018)

‘Among the imbalances we have identified, excess debt in the leveraged loan market and small-cap equities appear to be the most mis-priced by investors.’

Global markets

Nothing to see here?

Gerry Fowler,
Investment Director, Global Strategy

More than ten years on from the global financial crisis, aggregate global debt levels have pushed through their pre-crisis peak and remain a headache for policy makers. Responses to the crisis and the sluggish recovery from it varied across countries, but generally included a mix of regulatory change and aggressive monetary and fiscal stimulus. These have helped reduce the imbalances that led to the crisis but have created new imbalances that are not priced into most assets.

For example, rapid growth in household debt and bank leverage were key causes of the US crisis. A decade later, regulatory tightening, bank recapitalisastion, negative real interest rates, and massive expansion of public and central bank balance sheets, have all supported deleveraging in those previously over-levered sectors, but leverage has increased substantially in the government and corporate sector. The latter is the most important imbalance to monitor.

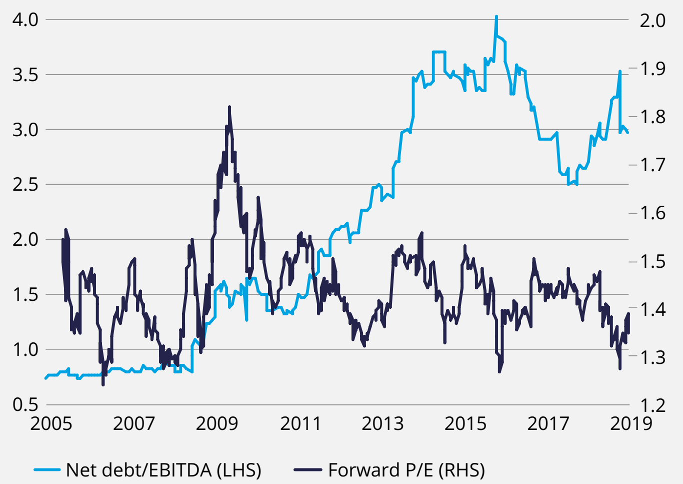
The expansion in corporate debt has been most notable in smaller companies, where the level of net debt to EBITDA has risen to five times earnings for the Russell 2000 index, compared with only 1.5 times for the S&P 500 (see Chart 12). Higher financial leverage equates to higher risk for which investors should apply a valuation discount. Instead, the estimated price-to-earnings multiple for small-cap stocks is still 1.4 times that of the large-cap stocks.

Globally, banks have been forced to retreat from loan markets due to higher regulatory capital requirements. Consequently, the bond and levered loan markets have helped support increased corporate leverage across many markets. Both have grown significantly, but the strong investor appetite for private markets assets has allowed the levered loan market to expand particularly rapidly. A recent Bank of England report suggested that the global leveraged loan market is now as large as US$2.2 trillion – with US$1.8 trillion of that financed by private markets investors. For reference, the US sub-prime mortgage market at its peak in 2006 was a little over US$1 trillion in size, although the systemic risks were larger.

In the secondary market for loans, investors have been reluctant to price the risk that comes from higher debt levels and in many cases, deteriorating covenants. The spread of the S&P/LSTA leveraged loan index yield over LIBOR has been steadily decreasing through this cycle (see Chart 13). Even recently, when financial markets sold off due to concerns about Fed tightening, the spread only widened modestly (although the absolute yield level peaked at 7% – similar to the 2016 high).

Ten years on from the crisis, debt imbalances have subsided in some places but expanded in others. As long as interest rates remain low, the risks of these unwinding in a way that precipitates the end of the cycle are moderate. But another interest rate shock, or a further slowing in global growth, would be more destabilising, particularly for those assets inefficiently pricing in such risks. If investors were to differentiate more on the basis of balance sheet quality, we would expect to see more divergence in performance.

Chart 12: Small vs large company debt not obvious in stable valuations



Source: Bloomberg (as of March 2019)

Chart 13: Long yield spreads declining despite deteriorating quality

Source: Bloomberg, ASI (as of March 2019)

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