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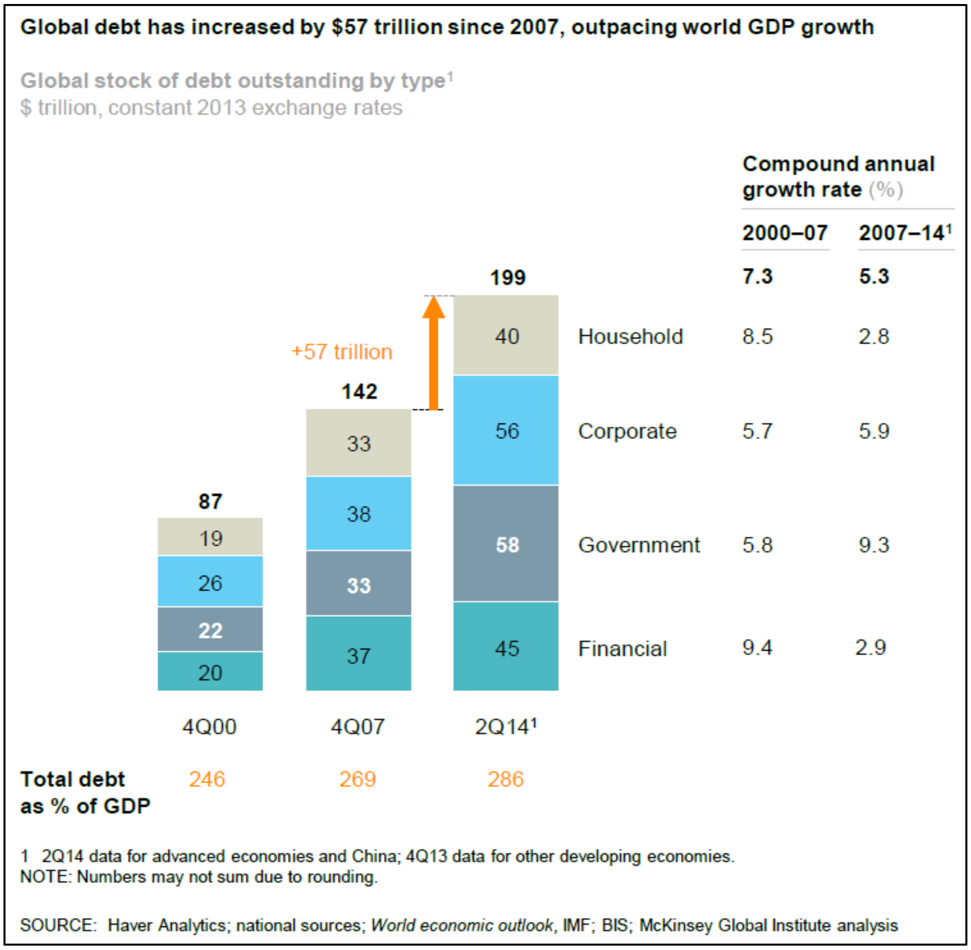
Debt is a Deflator

Central banks worldwide now face a common enemy – deflation. According to Reuters, a total of 24 central banks have taken actions to ease monetary policy since the beginning of 2015, the most aggressive being Denmark which cut interest rates four times in less than three weeks and intervenes regularly in the currency market to prevent the appreciation of the Krone versus the Euro. America, Britain, Euro zone and Japan all are aiming for 2% inflation, but the consistency in undershooting the target has been the frustration of many head of central banks.

Deflation is the general condition where prices go down. This can be caused by increased productivity or decreased demand. Technological advances enable goodies and gadgets to be produced cheaper hence be priced lower. Think about how much the cost of a laptop has declined for the past two decades while computing power has skyrocketed. On the other hand, prices will also come down because of slack demand as vendors have to clear out their inventory. It has been a long and important debate among economists whether recessions are caused by insufficient demand or productivity gains.

The reason why central banks fear deflation is the rise of debt. Deflation is great for savers. If you have money in the bank earning 0% interest, but there is 3% deflation, you are actually doing pretty well; you can buy more goods with the same amount of money. But it is the opposite for debt; it is unpleasant to have debt with fixed face value when prices and wages are coming down.

After the subprime mortgage crisis of 2008, it was widely expected that the whole world will deleverage. It has not happened. In fact, debt continues to grow, both in absolute terms and relative to GDP in nearly all countries. Global debt has risen by $57 trillion since 2007 to $199 trillion in 2014; raising the ratio of debt-to-GDP by 17 percentage points to an incredible 286%. Governments have borrowed heavily to fund bailouts in the crisis and to prop up demand in the recession, while corporate and household debt has been rapidly increasing as a percentage of income. Government debt increased by $25 trillion, with $19 trillion from advanced economies as G20 nations collectively urged policy makers to use fiscal stimulus to boost growth during their meeting in Washington in November 2008. Meanwhile, corporations are taking advantage of the low interest rates to issue ever more debt to fund equity buybacks, enriching shareholders in the short-term; at the expense of capital expenditures for the reasons we will discuss below. Although the growth of debt was not as much as seven years before the crisis, it is more worrying now in an environment of slower growth. That is why central banks are trying so hard to create inflation, to reduce debt in real terms.



A recent report by McKinsey Global Institute(1) shows that excluding the financial sector, there are 9 countries which have debt-to-GDP ratio above 300% in 2014. Japan tops the list at 400%. The country we are based in, Singapore is 3rd at 382% which is unusually high but does not constitute too much concern. For some nations that serve as business and financial hubs, debt incurred by corporations and the financial-sector is used to fund activities in other sectors and nations, so its relationship to the host country's GDP is not a stand-alone indicative measure of risk. Singapore has the highest ratio of non-financial corporate debt in the world, at 201% of GDP. However, nearly two-thirds of companies with more than $1 billion in revenue are foreign subsidiaries. The same characteristics apply to Ireland, United Kingdom and The Netherlands.

(1) McKinsey Global Institute, February 2015. *Debt and (Not Much) Deleveraging.*

Change in debt-to-GDP ratio since 2007 by country

Ranked by real economy debt-to-GDP ratio, 2Q14[1]

Advanced economy | Developing economy | ↑ Leveraging | ↓ Deleveraging

Rank	Country	Debt-to-GDP ratio[1] %	Real economy debt change, 2007–14 Percentage points Total	Government	Corporate	Household	Financial sector debt change
1	Japan	400	64	63	2	-1	6
2	Ireland	390	172	83	90	-11	-25
3	Singapore	382	129	22	92	15	23
4	Portugal	358	100	83	19	-2	38
5	Belgium	327	61	34	15	11	4
6	Netherlands	325	62	38	17	7	38
7	Greece	317	103	70	13	20	1
8	Spain	313	72	92	-14	-6	-2
9	Denmark	302	37	22	7	8	37
10	Sweden	290	50	1	31	18	37
11	France	280	66	38	19	10	15
12	Italy	259	55	47	3	5	14
13	United Kingdom	252	30	50	-12	-8	2
14	Norway	244	13	-16	16	13	16
15	Finland	238	62	29	17	15	24
16	United States	233	16	35	-2	-18	-24
17	South Korea	231	45	15	19	12	2
18	Hungary	225	35	15	21	-1	10
19	Austria	225	29	23	6	0	-21
20	Malaysia	222	49	17	16	16	6
21	Canada	221	39	18	6	15	-6
22	China	217	83	13	52	18	41
23	Australia	213	33	23	-1	10	-8
24	Germany	188	8	17	-2	-6	-16
25	Thailand	187	43	11	6	26	21
26	Israel	178	-22	-4	-21	3	-2
27	Slovakia	151	51	28	8	14	-5
28	Vietnam	146	13	10	-1	5	2
29	Morocco	136	20	8	7	5	3
30	Chile	136	35	6	20	9	9
31	Poland	134	36	14	9	13	9
32	South Africa	133	19	18	2	-2	-3
33	Czech Republic	128	37	19	9	9	4
34	Brazil	128	27	3	15	9	13
35	India	120	0	-5	6	-1	5
36	Philippines	116	4	-3	9	-2	-5
37	Egypt	106	-9	9	-18	0	-8
38	Turkey	104	28	-4	22	10	11
39	Romania	104	-7	26	-35	1	-4
40	Indonesia	88	17	-5	17	6	-2
41	Colombia	76	14	1	8	5	3
42	Mexico	73	30	19	10	1	-1
43	Russia	65	19	3	9	7	-4
44	Peru	62	5	-10	11	5	2
45	Saudi Arabia	59	-14	-15	2	-1	-8
46	Nigeria	46	10	7	1	2	-1
47	Argentina	33	-11	-14	1	2	-5

1 Includes debt of households, non-financial corporations, and government; 2Q14 data for advanced economies and China; 2013 data for other developing economies.

NOTE: Numbers may not sum due to rounding.

SOURCE: *World economic outlook*, IMF; BIS; Haver Analytics; national central banks; McKinsey Global Institute analysis

While China quadrupled its total debt since 2007 to reach $28 trillion and accounts for 37% growth in global debt, it has relatively low debt about 200% to GDP ratio due to rapid economic growth. Developing countries have accounted for 47% of growth in global debt since 2007. However, these countries started from a very low base. On average, their debt is just 121% of GDP, compared to 280% in advanced economies. This recent growth in emerging-market debt mainly reflects healthy financial deepening to satisfy the credit demand for rapid urbanization, industrialization and building much-needed infrastructure.

Debt keeps a lid on global growth. In essence, debt is future consumption brought forward. The money borrowed for current consumption will have to be paid back over time and will not be available to other purchases. Debt can be used in many productive ways, by purchasing assets to generate higher income in future: education, machinery, infrastructure etc. Unproductive debt is incurred to fund current consumption, benefits or entitlements.

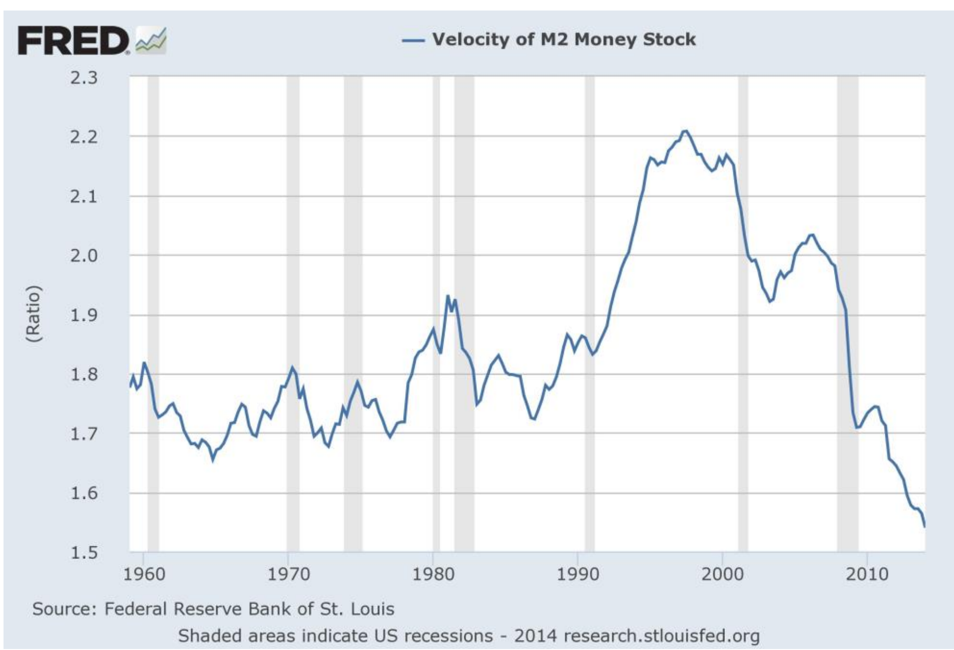
If an individual has a significant amount of debt and its income drops by 25-30%, it may become impossible to repay that debt and also cover necessities of life. For example, Greece has not really added to its outstanding debt over the past three years but the economy growth and therefore its tax revenues have collapsed by about 25%. Since money has to be set aside for debt service, it is future consumption denied. Thus, it is little wonder that demand has fallen after the crisis and deflation is coming out of the woods. Resultant high levels of debt from funding of unproductive activities are associated with slower GDP growth in the long term and will lead to a deflationary spiral – a vicious cycle of falling consumption and employment, potentially causing long and deep recessions.

High levels of debt also have a profound impact on investors return. When economies are debt-constrained, capital looking to be invested in fixed-income asset finds fewer creditworthy opportunities available. In search for yield, capital begins to accept lower interest payments.

The current low-interest environment is not just a product of central banks' easing, but also arises from insufficient attractive opportunities to invest in the real economy.

Nevertheless, we cannot help but wonder whether the route to battle deflation at any cost might be overdone. In the old days, the job of a central bank was to prevent excessive inflation, promote economic growth and keep people in jobs. They were not always really serious about the latter two and granted sometimes they did a bad job to tame inflation. But around 1980, they got serious and started drastically raise interest rates to combat inflation. Price stability was achieved and inflation became a negligible factor in making economic decisions.

One could argue that it was never the idea for central bankers to create jobs necessitated by their mandates. Monetary policy is only able to provide the environment in which people are encouraged to make decisions for the long-term: to work or start a business, save for retirement and invest in the future and in future generations etc. It came to a turning point when policy makers were rendered powerless and incapable to act by the crisis and people started to look towards central banks for salvation; compelling them to act. More than happy to oblige or maybe out of necessity, high-powered money were injected into the fractional reserve banking system (where 1 dollar can become 10 or more), staving off the meltdown and propping up the balance sheets of the banks that where too-big-to-fail. The reason we are not experiencing excessive inflation with the dramatic expansion of the money supply yet is because the velocity of money has fallen since then (to all-time low, we must add). Basically, when there is lots of economic activity, there are lots of money changing hands; the opposite we now have. The new money created (USD 3 trillion by the Fed) is sitting idle on the balance sheet of the banking sector and not being lent out in a big way.



The unintended consequence of this undertaking is central banks became more influential and powerful than ever. When central banks speak (or is going to speak), markets move. Every word coming out from their mouths are tabulated, scrutinized in detail and interpreted in different ways to lay down the foundation of the market's expectations. The job of a central banker should be a boring one, pulling levers at the background and act infrequently; definitely not being permanently in the spotlight. Some analysts worry that some unknown factor will cause the velocity of money to rise significantly and risk creating too much inflation too fast. We have to understand that, to a certain extent, the world we live in is dynamic and cannot be perfectly simulated by models central banks employ (they didn't see dot-com bubble and the sub-prime bubble coming). In some ways, having mild deflation – cleaning up after the excesses of the near past – could in fact turn out to be better than having a full-blown inflation coming down the road, which will be hard to combat, now so much debt is created out there.

To observe the impact of deflation in the real world, we can look at Japan which had probably the biggest boom-bust cycle of any developed country in the modern era, even bigger than the 2000 dot-com bubble in US. To give some context, the Tokyo Imperial Palace grounds were valued as more than all the real estate of California during the height of the 1980s property bubble. The ensuing bear market lasted for two whole decades (stocks were down 80%) and they had years of deflation.

Yet, Japan remains one of the richest countries with the highest standard of living. There has been sufficient food and no civil unrest. Deflation might be annoying but too much inflation might be worse – a look at Weimar Germany, Zimbabwe or Argentina confirms this. People go angry or die in a shortage. Given the choice, many people would rather live in Japan than Argentina.

Today, modern central bankers are trying to create some moderate inflation. Others haven't forgotten how awful it was in the 70s. The important question here is what if central banks not only succeed, but succeed too well? Worse, what if the results are irreversible? We hope it may not happen, but the premise in investing is to deal with uncertainty and such tail risks, however impossible to quantify. We do enjoy the windfall of higher asset prices for now (though expected future yield suffers) but still ask investors to be prepared for a less rosy scenario.

It would be our pleasure to discuss strategies to protect portfolios and hedges against tail risks.

Best regards,

Your Helvetic Team Singapore

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