Living on borrowed time: Understanding global debt and what it means for investing

In brief

• The word “debt” is often thought of in a negative context, but the usefulness of debt can actually be placed on a spectrum.

• While a healthy amount of debt creation is necessary to support economic expansion, too much debt can drag on growth and/or cause financial distress.

• Global debt levels have been elevated since the Global Financial Crisis (GFC), but trends have varied between developed markets (DM) and emerging markets (EM).

• Elevated debt levels—on their own—do not necessarily foretell a crisis. Moreover, there are potential paths to reduce elevated public and private debt ratios.

• We believe that current debt trends are likely to drag on future economic growth and thus asset class returns, with a range of significant but manageable consequences for investors.

• Investors will need to identify pockets of growth in the absence of broad-based growth; compensate for lower interest rates by sourcing income from a wider variety of asset classes; consider tax-aware strategies to the extent that tax rates creep higher; and be flexible in their tactical and strategic allocations to avoid the most troubled or indebted countries and businesses.
Debt, debt everywhere—but why?

Investors around the world are worried about elevated global debt levels. While there may be more pressing day-to-day market matters, debt remains a persistent underlying concern.

Over the last few decades, U.S. debt levels have risen while interest rates have fallen

Exhibit 1a highlights the increase in debt as a percentage of GDP in the U.S. over the past 45 years. However, this is not an isolated case. Developed market debt levels have increased significantly over the last several decades as 30 years of falling interest rates have made it more sensible and less costly to incur debt. Using the U.S. 10-year Treasury yield as a proxy, interest rates peaked at 15.8% in 1981 following the 1970s oil embargo and inflation spike, before falling to historic lows of roughly 1.5% today (Exhibit 1b). So while the stockpile of debt has grown, the cost to service each unit of that debt has fallen substantially. There is much empirical research that supports the idea that low interest rates lead to more debt creation.¹ There are other drivers of increasing debt levels such as general optimism about future growth prospects and encouragement from the rapid technological innovations that were emerging.

The story is more nuanced for EM. In many of these countries, their financial systems are less mature. The banking system and bond markets are less developed, and access to credit has historically been limited and informal. As these economies reach adolescence, we would expect debt to increase as a natural and healthy amount of financial deepening happens (Exhibit 2, next page). However, debt levels have recently been growing too quickly, as the global search for yield and the boom and bust of the commodity cycle encourage debt issuance in EM.

Globally, then, debt levels have risen dramatically over the last 30 years, driven by low rates, technological innovation, optimism about future growth prospects, along with financial deepening. Some of this debt creation was useful, and some was not. Let us dig into the concept of productive versus unproductive debt.

Higher debt is a natural, expected development of EM bond markets

EXHIBIT 2: GLOBAL BOND MARKET, USD TRILLIONS

Source: BIS, J.P. Morgan Asset Management; data are as of August 5, 2016.

Debt: The good, the bad and the useless

While the word “debt” often carries a negative connotation, it is important to remember that debt can be used in different ways. All debt, like all dietary fat, is not created equal. While common nutritional guidelines tell us that fat is bad and should not be a large part of any diet, we now know that there are healthy fats and unhealthy fats. Healthy fats—from nuts, avocados and olive oil for example—support cellular function, fuel the metabolism and are vital for the body. Unhealthy fats—from fried food, meat and butter—tax the body, can clog arteries in your heart and can lead to a range of health problems down the road. Debt can be characterized similarly as productive and unproductive.

We find it instructive to consider debt through the following lens: For what purpose is the person, business or government using the money? Is it going to enhance productivity or merely serve to increase spending?

Productive debt is like the healthy kind of fat; it can be used to fuel growth and support real economic activity. When a company borrows money to expand its factories, for example, it leads to an increase in employment and output. Another example is a consumer taking out an auto loan for a much-needed vehicle to drive to and from work.

In contrast, unproductive debt is similar to unhealthy fat—undeniably enjoyable in the moment and seemingly harmless, but with a range of potential repercussions down the line. For example, excessive credit card debt that pushes a consumer’s spending beyond sustainable levels or a company borrowing, in part, just to repay existing debt obligations. We note, however, that we would expect companies to take advantage of this low rate environment to strategically refinance their debt obligations, something we have seen since rates fell so dramatically. At the extreme, useless forms of debt can be used to prop up “zombie” companies or to roll over non-performing loans.

Debt helps until it doesn’t: Solvency blues and the big drag

As discussed, not all debt is harmful, especially when borrowing leads to productive economic growth. But economists and investors alike worry about debt for two reasons: its ability to cause acute crises when solvency concerns arise and its ability to operate as a slow but steady drag on growth. Think of two possible outcomes of overindulging in unhealthy fats—at the extreme, blocked arteries can lead to an acute crisis like a heart attack, while a slow and steady drag on your body’s functions would look more like running a 10k very slowly (or not at all).

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In the first outcome, debt can cause acute stress in the financial markets and the broader economy if concerns about the borrower’s solvency arise. Consider the subprime mortgage crisis and the European sovereign debt crisis. Both of these events were characterized by what seemed like sudden anxiety about debt repayment and a stark realization that borrowers had taken on more debt than they could ever pay back. During the European debt crisis, Greece was a striking example. Once investors realized the true state of the Greek balance sheet, lenders revolted, demanding significantly higher compensation for their credit risk, quickly driving yields on 10-year Greek government bonds from single digits to over 30%. This, in turn, made Greece’s financial situation even more untenable than it already was, fueling a vicious cycle.

In the second outcome, unsustainably high debt levels, often described as a “debt overhang,” can manifest as a steady drag on economic growth through various channels. In the corporate sector, organizations with unsustainably high debt levels may have to turn down new investment projects with potentially positive returns as debt service becomes more onerous. In the public sector, debt overhang might divert resources away from productive spending in important areas like education and research and development. Furthermore, elevated sovereign debt levels may force a government to increase taxes and limit its ability to enact stimulative fiscal policy when the economy needs it most.

As for U.S. government debt levels, they warrant attention, and reforms are surely needed over time to address a range of budget concerns. However, we do not see the threat of an acute sovereign debt crisis in the United States.³


Debt trends: Near, far, wherever you are
It is also important to understand the different categories of debt and the varying trends amongst them across developed and emerging economies. For the purposes of this paper, we look at three key buckets of debt: government (or public), corporate and household debt. In doing so, it is clear that debt trends have not been uniform across the public and private sectors, or across DM and EM economies (Exhibit 3). When looking across types and regions, we consider whether debt dynamics present a potential solvency crisis versus a steady drag on growth—a significant distinction for investors to recognize.

Debt levels are generally higher in DM than in many EM countries, but the type of debt differs

EXHIBIT 3: DEBT BY ECONOMIC SECTOR, DEBT OUTSTANDING AS A % OF GDP, 2015

Source: BIS, IMF, J.P. Morgan Global Economic Research, J.P. Morgan Asset Management; data are as of August 5, 2016. Corporate and household debt include loans and bonds.

Within developed markets, governments have taken the debt baton from the private sector. After overheating in the lead-up to the crisis, households and businesses have taken a pause since 2009 to recover, deleveraging significantly since then. This reluctance to borrow (combined with issues around the availability of credit) has hampered economic growth; however, on the positive side, consumers and
businesses are in far better financial shape than before. By contrast, the EM credit cycle is still a few laps behind. EM private debt only began increasing significantly after 2009, and is now reaching a point where it can either boil over into a 2008 DM-style crisis, at worst, or slow down and create an additional headwind to growth, at best.

DEVELOPED MARKETS — A CLOSER LOOK

As mentioned previously, DM countries have been increasing overall debt levels over the past few decades as interest rates have fallen.

During the 2000s, the DM private sector—including both households and businesses—accumulated debt at a rapid pace. Levels rose from 144% of GDP in 2000 to 175% of GDP before the global financial crisis, peaking in 2009 (Exhibit 4). What was all this debt used for? In a nutshell, for households to buy real estate. This trend was especially noteworthy in the U.S., UK and the periphery of the eurozone, all of which subsequently suffered unprecedented housing market busts. The subsequent economic downturn required many households to get their financial houses in order. To aid this process, governments stepped in to help the private sector get back on its feet and out from under a massive debt burden. The various ways governments went about doing so increased their debt burdens, as they forcefully took the baton from corporations and consumers into their own hands.

In the years since the financial crisis, consumers and businesses have been reluctant to take the baton back. Private debt has slowly begun to grow again since the crisis lows, but the pace is far below the pre-crisis trend. DM consumer debt has grown at an average rate of 1.1% from 2010 to 2015, compared to 6.6% from 2002 to 2009. For corporations, the pace has picked up a bit more quickly to 2.3%, but still below the previous pace of 4.8%. On the positive side, the private sector went through a messy—but healthy—process of cleaning up its balance sheet, easing fears of another solvency-fueled crisis. However, this private sector conservatism has persisted much longer than many economists had expected, with significant implications for future economic growth, if it proves to be long-lasting.

DM consumers and businesses have deleveraged post-GFC, while governments have not

EXHIBIT 4: DM SOVEREIGN AND PRIVATE DEBT,* % OF GDP

There is both a supply and a demand explanation for this conservative borrowing behavior. On the supply side, stricter regulations and low interest rates have made banks less able and willing to lend. On the demand side, economic uncertainty, the need to save more to meet retirement needs and the fresh memory of the financial crisis have made borrowers less willing to borrow.4 For example, recent polls show that Americans now prefer saving money to spending it.

4Research shows that personal experiences with a financial crisis permanently changes spending vs. savings behavior. Lee, Jaewoo Pau Rabanal; and Damian Sandri, “U.S. Consumption after the 2008 Crisis,” IMF Staff Position Note, January 2010.
Gallup’s April 2016 Economy and Personal Finance poll showed that 65% of Americans prefer saving, compared to a pre-crisis average of 49%. It is impossible to conclude whether these are structural shifts in the behavior of creditors and borrowers, but should private debt growth be permanently lower than pre-GFC, economic growth will be lower as well.

On the public side, it will be very hard for governments to pass the baton back to the private sector. In previous eras, indebted nations could either grow out of or inflate their way out of debt burdens. But the current environment of subdued global growth and low inflation is likely to persist. Recent rhetoric suggests that the era of fiscal austerity in developed markets may be behind us, with calls growing louder for fiscal stimulus to reignite subdued growth levels (whether this approach is effective is another question). These dynamics suggest that we may have to learn to live with higher government debt for longer.

However, the outlook is not as bleak as it may seem. Despite high debt levels, governments will likely find servicing this debt less worrisome than in the past, as low growth will permit central banks to keep interest rates relatively low. Today, yields below 1% on DM government bonds are commonplace (Exhibit 5), with many countries even seeing negative yields out to 20 years. High government debt levels may continue to be a drag on the economy, but the burden on day-to-day finances of most DM governments is extremely low, keeping solvency concerns at bay.

What would cause yields to pop some day? One answer is a shift upwards in inflation expectations, away from the deflationary mindset that has persisted since 2008. Currently, it seems unlikely that a surge in demand will spur inflation; however, the longer central banks keep monetary policy too accommodative relative to fundamentals, the higher the chance inflation re-emerges with a vengeance down the line.

Some countries may try to outgrow their debt burdens and others can service it very cheaply.

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**EXHIBIT 5: GDP GROWTH, GROSS DEBT-TO-GDP AND BORROWING COSTS**

![Graph showing GDP growth, gross debt-to-GDP ratios, and borrowing costs for various countries.](image)


Growth and debt data are based on the April 2016 World Economic Outlook. Borrowing costs are based on local currency debt. EU overall borrowing costs based on Barclays Capital Euro-Aggregate 7-10 year treasury. South Africa’s borrowing cost is based on 7-year government bond yield due to data availability.
EMERGING MARKETS – A CLOSER LOOK

The EM credit cycle is a few years behind its DM counterparts. Will emerging markets be able to avoid developed markets’ pitfalls?

DM countries built up private credit in the 2000s, but EM did not follow until after 2008 (Exhibit 6). This was when low DM yields found their way into the EM world through three main channels. First, in a direct way, EM external currency bonds saw their yields follow DM yields lower. In addition, starved for yield, DM investors flocked to higher-yielding EM assets—this ensured plenty of demand for EM local and foreign currency debt. This reduced debt service costs and enticed EM borrowers to issue more debt. Finally, local central banks cut EM rates, with the aim of preventing excessive inflows and thus too much currency appreciation.5

Like moths to a flame, EM companies and households found cheap money irresistible. From 2007 to the end of 2015, EM private credit soared from 76% to 135% of GDP. China was responsible for a large share of this increase (please see box, China: A skyscraper within the EM neighborhood). However, even excluding China, the increase has been significant, rising from 64% to 87% of GDP during the same period. EM followed the path DM took in the 2000s, increasing private debt ratios by over 20 percentage points. Government debt levels have also started to increase in recent years, especially in commodity-exporting countries (which face new challenges in funding their spending in an era of low commodity prices).

Will EM follow DM’s experience of private deleveraging, leading to a deep recession? Or will credit growth merely slow, creating an additional headwind to growth, but not triggering a full blown crisis? The reality is that EM debt creation is already slowing, following the latter path. Credit growth has decelerated significantly since 2012 (especially if we exclude China; Exhibit 7). This has been driven by both supply and demand: Lenders have begun to tighten their standards and borrowers have become more cautious. The Institute of International Finance’s EM Bank Lending Survey showed that all bank lending metrics remained in tightening territory during the first quarter of 2016, for the third consecutive quarter. This credit slowdown is one of the main causes behind the recent slump in EM growth (in addition to low commodity prices, weak global trade volumes and a shift in investor sentiment). For investors, it is important to realize that the deceleration in credit growth may mean that the EM growth upswing investors expect may take a bit longer to materialize—but this could be a welcome trade-off for avoiding another full-scale crisis. Going forward, a solvency concern will depend on the health of the financial system within each EM country, justifying a very selective approach to EM investing.

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EM credit growth has already slowed, especially ex-China

EXHIBIT 7: PRIVATE CREDIT,* YEAR-OVER-YEAR % CHANGE

Is there a way out of the rabbit hole?

Fundamentally, an interest rate is the cost of debt, and helps to allocate capital from savers to borrowers. The longer interest rates are kept at levels so low they can be seen as distortionary, the more unproductive debt buildup is encouraged, potentially increasing solvency concerns down the line. Solutions to the debt challenges previously discussed do exist. Debt levels are not on a pre-set track and there are ways to reduce both public and private debt burdens.

Governments can lower high debt levels through the sale of state-owned assets, one-time taxes and changes to entitlement benefits, along with more efficient debt restructuring programs. However, some of these actions are not politically popular, and garnering the political will to implement them will be key. If unpopular actions are needed amongst a backdrop of slower growth and a rise in political populism, it is less likely that these hard choices will be made any time soon.

For private debt issuers, the key is to find ways to balance new borrowing with financial stability.

CHINA: A SKYSCRAPER WITHIN THE EM NEIGHBORHOOD

“Chinese debt” is a concern investors often cite. Why does China, in particular, worry so many people? In the EM debt neighborhood, China is a skyscraper. Not only does it stick out for its size, but it was also built virtually overnight, and concerns abound about the building materials and its foundation. Current private debt is 203% of GDP (Exhibit 8), which is actually comparable to DM countries (Exhibit 4). However, it shot up to this level very quickly: from 111% only nine years ago. The worry is that the skyscraper could collapse if something shakes it, burying the entire neighborhood in rubble. Despite resources available to shore up Chinese debt sustainability, the longer it takes to build the supports, the more likely a collapse becomes. Maintaining stable growth, while at the same time resolving the over-reliance of the Chinese economy on credit, may be impossible. Chinese authorities will likely have to accept lower future growth to avoid an implosion. This trade-off does not present an immediate problem, but investors must closely watch the balance of these risks. The longer the government waits to take action, or relies on piecemeal reforms, the more difficult an orderly resolution will be.

China is a clear outlier within EM when it comes to debt

EXHIBIT 8: PRIVATE CREDIT,* % of GDP

Source: BIS, IMF, INDEC, J.P. Morgan Asset Management; data are as of August 5, 2016. *Private credit includes non-financial corporates and households and bank lending, corporate bonds and shadow banking. Aggregated from BIS underlying data. Numbers may not sum due to rounding.
Productive debt creation—while mitigating the risks that high debt levels pose—is the sweet spot. One approach to deterring companies from creating unproductive debt could be legal changes so that tax policies do not give debt service preferential tax treatment. For example, company dividend payments to shareholders could be made tax deductible, as interest payments to debtholders currently are. This could encourage equity financing over debt financing.

For households, solutions may take the form of changing credit products—whether it be mortgages or lines of credit—to be more innovative and flexible. What are flexible credit products? Think of mortgage payments that decrease when a homeowner loses their job. Or interest rate terms on a line of credit that decrease when a consumer experiences financial hardship. These mechanisms could lead to fewer defaults, as debt payments adjust with economic conditions in order to smooth the credit cycle.

Interestingly and somewhat surprisingly, there is a significant amount of volatility in the month-to-month income earned by U.S. households. Innovation in financial products could help consumers better manage this volatility, not only decreasing solvency concerns, but also possibly encouraging more borrowing by consumers.

**Investment implications**

Debt levels are just one of many considerations when investors are thinking about constructing a portfolio. In the developed world, the debt baton seems to have been passed from the private to the public sector, for now. This means high government debt levels are likely to remain a drag on growth; to assume otherwise does not currently seem realistic. The private credit cycle will likely take longer to move into a new upswing because of borrowers’ and lenders’ more cautious behavior—also capping the potential economic growth upside. For emerging markets, it is likely that the private credit cycle has already gone from being a tailwind for growth to a headwind, postponing the long-awaited rebound in those regions.

Altogether, this likely means that lower global growth and anchored rates will persist, which will have an impact on asset class returns. With this new reality, investors should think about four things:

1. **Looking for growth in a subdued growth world.** Broad market indexes are expected to post tepid returns going forward—which would be exacerbated if economic growth slows. Such conditions make the case even stronger for finding companies that are growing earnings faster than the market average, or that are fundamentally mispriced.

2. **Searching for yield in flexible ways, since interest rates are expected to stay depressed relative to history.** For example, focusing on companies with strong cash flow and scope to grow their dividend payout ratios. In addition, investors should look beyond traditional sources of yield and consider alternatives such as real estate, preferreds and private credit.

3. **Making sure to take advantage of tax-efficient investment strategies in light of the fact that taxes may rise.** Whether this is through investment vehicle choice (municipal bonds, tax-managed products, etc.) or through financial planning and guidance, both suggest the need for sound advice from a financial advisor or planner.

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7,8 Diana Farrell and Fiona Gregg, “Weathering Volatility, big data on the financial ups and downs of U.S Individuals”, JP Morgan Chase Institute, May 2014.
4. Being flexible and nimble in asset allocation to avoid pitfalls. This could include multi-asset investing that folds in skilled expertise across asset classes and emphasizes diversification, as well as unconstrained forms of investing not tied to a specific benchmark.

The solution is not to wait in cash for a debt collapse; rather, investors should think about proactive solutions that still allow them to meet their investment goals.
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