

HOW INDEBTEDNESS IMPACTS RETURNS

Debt, debt everywhere: The implications of a high debt world

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IN BRIEF

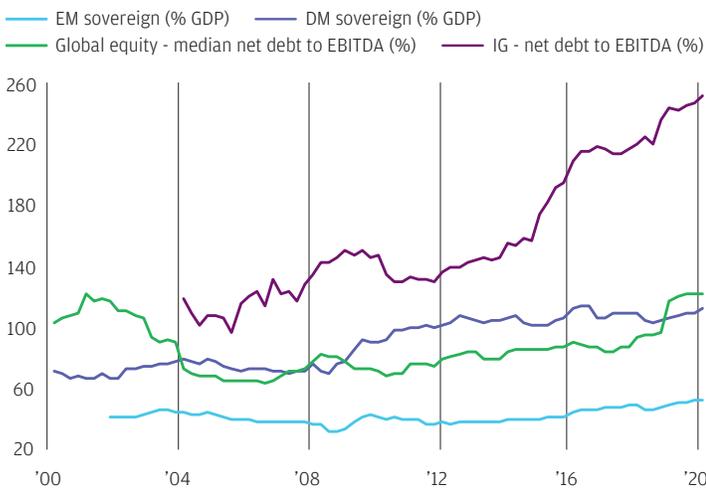
- Our assumptions of a persistent new high debt reality - due to increased market tolerance for debt, and the depressed real short rates now enabling fiscal stimulus - have implications across asset classes. Overall, a high debt world should add to economic volatility and market volatility over the new cycle.
- Higher debt levels increase the inflation risk premia we assume over our horizon for developed and emerging sovereign bond markets. Active use of fiscal policy should lead to greater differentiation among government bond markets, especially in emerging economies.
- U.S. corporations levered up in the last cycle, and unlike in past recessions, we do not expect this to reverse, at least not in the early part of the cycle. Instead, we expect this anomalous leverage cycle to lead to tighter spreads per turn of leverage. Still, our aggregate corporate spread assumptions, while unchanged, are high relative to long-term history.
- For equities, high corporate debt loads should enable continuing high shareholder payouts (though at reduced levels vs. recent years) but drag on net margins; revenue growth, however, will likely determine whether higher leverage helps or hurts equity returns - the jury is still out. We expect debt to exert the most pronounced effects on U.S. equity markets and the least in Japan.

We are living in a time of high and rising debt. The phenomenon affects most asset classes across the public and private sectors and emerging and developed economies.¹ That high government debt levels persist over our forecast horizon is one of the key views in our 2021 Long-Term Capital Market Assumptions (LTCMAs). Aggressive central bank action suppressing interest rates over recent decades has been one driver of rising debt levels. Other, less obvious reasons may also explain them: changing demographics, for example, and declines in underlying economic volatility.² We are living in a time of growing debt tolerance: There is a rising willingness of investors to accept it and of policymakers to adopt it, and a greater capacity of economic systems to carry debt loads.

In the near term, debt ratios are set to rise further, and sharply, as the COVID-19-induced recession lifts debt levels while causing (likely temporary) drops in the denominator (e.g., GDP). Over our long-term forecast horizon, we expect more fiscal stimulus than at any point in modern financial history, reaching levels seen only in wartime. While we do see high corporate debt drifting back toward historical levels over time, we do not expect corporates to delever during the crisis, so credit and equity investors should also confront higher leverage, on average (EXHIBIT 1).

Government debt levels have risen across developed and emerging markets, and corporate debt levels in the global equity universe alongside them

EXHIBIT 1: GOVERNMENT DEBT-TO-GDP AND CORPORATE DEBT-TO-EBITDA



Source: Bank for International Settlements, Bloomberg, Datastream, J.P. Morgan Asset Management; data as of March 31, 2020.

¹ For a detailed exploration of rising government debt levels in this edition of our LTCMAs, see John Bilton et al., “The fiscal decade: The promises, problems and potential of fiscal stimulus,” *2021 Long-Term Capital Market Assumptions*, J.P. Morgan Asset Management, November 2020.

² See Karen Ward and Benjamin Mandel, “Will debt be a drag? Dealing with the upward drift in government debt,” *2019 Long-Term Capital Market Assumptions*, J.P. Morgan Asset Management, November 2018, and Michael Hood and Benjamin Mandel, “Fiscal therapy: Multi-asset implications,” J.P. Morgan Asset Management, September 2016.

High fiscal spending is necessary to support economic growth in the post-COVID-19 world, and low interest rates are one factor allowing more fiscal spending than in previous cycles. Said another way, our 2021 LTCMAs’ equilibrium steady state implies a bigger government presence in the economy. This paper will examine some issues arising from this new high debt reality for major asset classes, assessing the likely trade-offs and implications for returns.

DEVELOPED MARKET SOVEREIGN DEBT: EXPECT LOWER REAL RATES, HIGHER INFLATION RISK PREMIUM

What conditions facilitate prolonged government indebtedness? The key one is a conscious policy decision to depress real short rates, giving governments the ability to finance large fiscal deficits to pay for high fiscal spending. Major central banks have already signaled their intentions to keep rates low through strong forward guidance or by moving toward average inflation targeting. The LTCMAs factor in this easy monetary stance and financial repression by lengthening the periods over which short and long rates normalize, which in turn leads to lower average expected rates over the next cycle.

Persistently high government indebtedness coupled with easy monetary policy affects our view on the distribution of risks around inflation. To reflect the possibility that coordinated policy could lead to sustained higher inflation, we adjust our inflation risk premium higher for developed markets. We also lower our real yield estimates to reflect the view that central banks will likely keep rates low for a prolonged period. This change in the composition of our equilibrium 10-year bond yield assumptions is a direct result of elevated indebtedness over our forecast horizon.³

Coordinated monetary and fiscal policy regimes will create winners and losers.⁴ After the 2008-09 recession, most major developed markets used monetary policy, implementing quantitative easing (QE) with a fairly uniform impact. This led to strong co-movement, which worked to lower rates. Fiscal policy implementation, however, can differ by country, depending on the economy’s underlying structure. Moreover, countries’ available fiscal space⁵ and policy effectiveness will be central to determining market pricing of reflating inflation expectations and/or boosting productive capacity.

³ Please see the 2021 LTCMA Fixed Income Assumptions chapter for country-by-country details on changes we make to our LTCMA equilibrium assumptions.

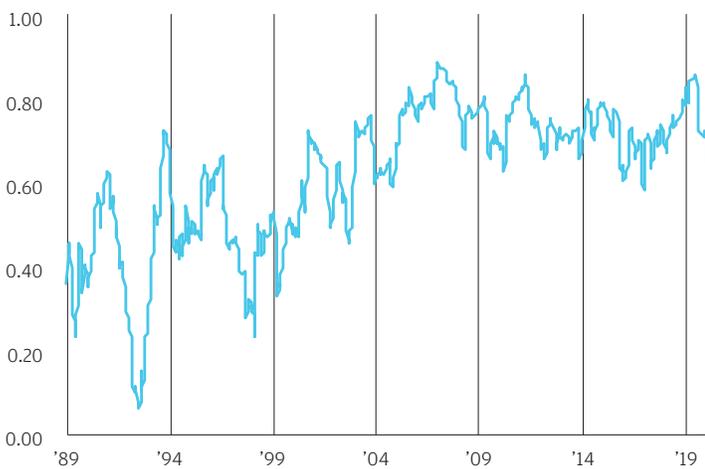
⁴ As discussed in Bilton et al.

⁵ The capacity of an economy to deploy fiscal stimulus and expand its deficit without blowing up debt-to-GDP ratios, causing government bond yields to surge or undermining the country’s currency.

While fiscal policies will differ by country, monetary and fiscal policy regimes will be coordinated within a country. We expect this phenomenon to create more differentiation globally. For example, we have more confidence that U.S. policymakers can successfully raise inflation expectations than we do in the case of Europe or Japan. For these reasons, the longtime co-movement of developed market (DM) government bonds is at risk of dissipating over time (EXHIBIT 2). As we discuss below, the lessening of co-movement should most clearly manifest in emerging markets but is a possibility for developed market sovereign debt as well.

Strong co-movement was a symptom of declining rates, but now that fiscal policies will differ by country, the longtime co-movement of DM government bonds is at risk of dissipating

EXHIBIT 2: CORRELATION AMONG DM SOVEREIGN BONDS (10-YEAR)



Source: Bloomberg, J.P. Morgan Asset Management; data as of October 9, 2020. Correlations calculated on trailing 52 weeks' 10-year government bond yield changes among the U.S., the UK, Germany, Japan, Canada and Australia.

EMERGING MARKET LOCAL DEBT

The state of emerging market (EM) sovereign issuers has evolved since past cycles. Market participants' tolerance for higher debt ratios, a low inflation landscape and a yield-starved investor base have combined to change EM fiscal authorities' and central banks' reaction functions.

Following the crises of the 1990s, many EM countries implemented policy changes that left them more resilient to financial stress

EXHIBIT 4: CHANGES IN EM COUNTRIES' INSTITUTIONAL FRAMEWORKS, LAST 10 YEARS (% OF EM GDP)

Emerging markets with fiscal rules		Emerging markets with inflation targets		Emerging markets with flexible exchange rates		Emerging markets with central bank transparency	
1999	7.7	1999	14.0	1999	11	1999	2.6
2015	29.0	2017	44.4	2017	26	2014	5.1

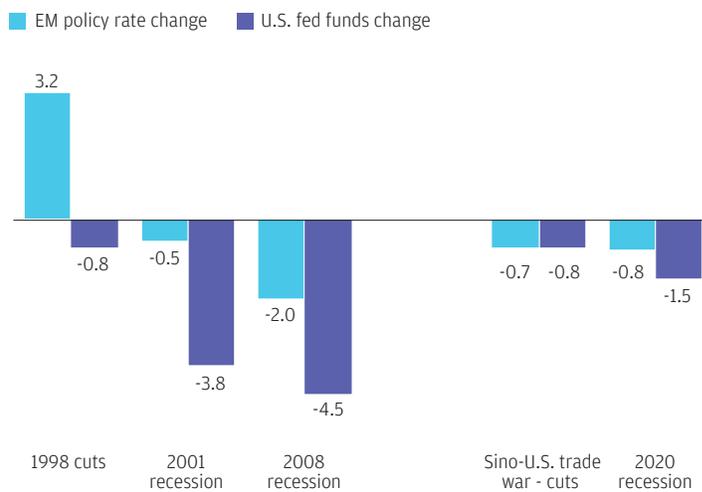
Source: Dincer and Eichengreen (2014), Global Debt Wave, World Bank; data as of June 30, 2020. Central bank transparency as defined in N. Nergiz Dincer and Barry Eichengreen, "Central bank transparency and independence: Updates and new measures," *International Journal of Central Banking*, March 2014.

The way EM policymakers responded to past crises followed a well-established pattern: seeking to restore confidence by raising interest rates, withdrawing liquidity and cutting back markedly on fiscal deficits. (China is a different case; see box, **CHINA: UNIQUE LATITUDE TO INCREASE LEVERAGE, BUT NOT WITHOUT SOME CONSEQUENCES.**)

This time has been different. In response to the COVID-19 recession, EM central banks have cut interest rates even in the face of currency weakness; injected significant amounts of liquidity; eased regulations to keep money and bond markets functioning; and even undertaken QE, to varying degrees, to keep bond yields broadly stable (EXHIBIT 3).

EM central banks were able to loosen monetary policy amid the COVID-19 outbreak

EXHIBIT 3: CHANGE IN POLICY RATES IN 2000, 2008 AND NOW FOR EM AND DM CENTRAL BANKS (% CHANGE)



Source: Bloomberg, J.P. Morgan Asset Management; data as of June 30, 2020.

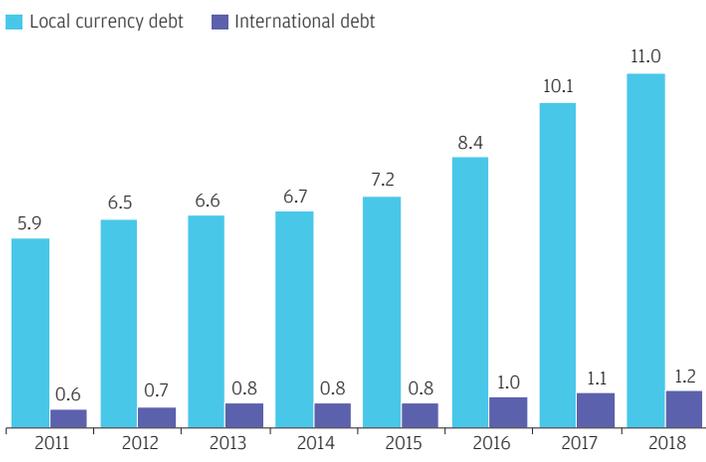
What changed? (1) This recession was not due to an EM financial imbalance; (2) prevailing rates in developed markets are low to negative; and (3) EM credibility in confronting financial crises has undergone structural changes, which we now address.

After struggling with financial crises in the 1990s, EM countries have implemented a variety of policy changes that have left them more resilient to financial stresses (EXHIBIT 4). They have:

- Adopted independent, inflation-targeting regimes, helping anchor inflation expectations despite sizable currency devaluations.
- Implemented flexible exchange rates that dramatically lower the chances of disruptive breaks with a currency peg.
- Adopted fiscal rules bolstering the credibility of their paths to debt sustainability.
- Issued a growing share of debt denominated in local currencies, leaving them less vulnerable to external financial conditions, particularly moves in the U.S. dollar and Treasury rates (EXHIBIT 5).
- Built up more assets to finance these liabilities in case of emergency, evidenced by larger currency reserves.

Local currency debt has accounted for most of the increase in EM debt

EXHIBIT 5: EM GENERAL GOVERNMENT DEBT (USD TRILLIONS)



Source: Global Debt Wave, World Bank, June 30, 2020.

These policy trends are evident in aggregate, although with considerable variation across countries. This heterogeneity is reflected in the market responses to recent QE policies in EM countries as, for the first time, many EM central banks are engaging in unprecedented QE in response to the COVID-19 recession to help fund burgeoning fiscal deficits. Those doing so include 11 of the 19 countries in the benchmark EM government debt index,⁶ representing two-thirds of index capitalization. EM countries that entered this recession with a proven ability to keep inflation and inflation expectations in check have been rewarded with generally flatter curves and lower yields than countries that entered it with fiscal or monetary vulnerabilities.

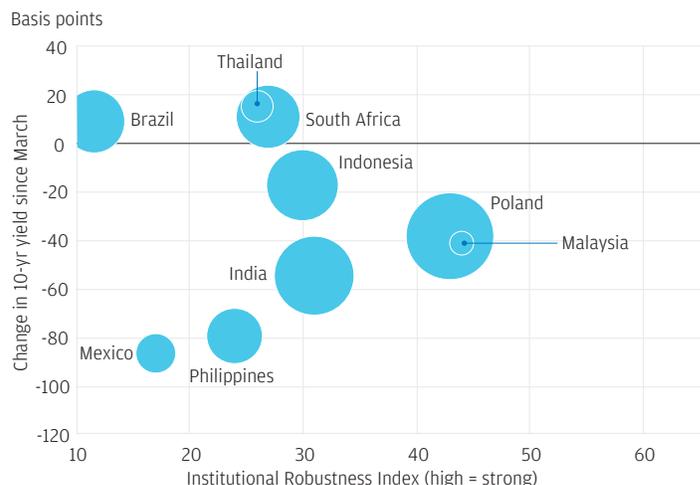
Our proprietary Institutional Robustness Index measures market perceptions of policy credibility and plots this vs. changes in local debt yield curves since March 2020. Tellingly, countries with strong

institutional robustness have seen little or no steepening of yield curves or concerns that QE may introduce medium-term inflation risk (EXHIBIT 6). Following QE announcements, credible policymakers have been rewarded with DM-like yield curve performance while less credible central banks have struggled with market concerns that policy today will stoke rising, even runaway, inflation in the future.

Those that entered this recession with stressed fiscal balances, high inflation expectations and low prospects for reform retain steeper yield curves in our equilibrium assumptions, despite enacting QE. We expect markets will require higher risk premia over the coming years from those sovereigns to compensate for greater policy and inflation uncertainty.

EM countries with strong perceptions of institutional robustness have not seen QE announcements spur yield curve steepening

EXHIBIT 6: INSTITUTIONAL ROBUSTNESS INDEX (HIGH = STRONG) VS. CHANGE IN YIELD CURVE SINCE COVID-19



Source: J.P. Morgan Asset Management; data as of August 8, 2020. Bubble sizes represent volume of announced QE as a % of GDP.

EM hard currency debt

EM hard currency debt has also benefited from the aforementioned structural changes in EM countries. But the set of 73 EM countries issuing hard currency debt in the benchmark index, the EMBIG,⁷ is much broader than the local debt group, and we have concerns regarding its lower quality tier. The index’s inclusion of several frontier countries over time has also increased the number of fiscally vulnerable countries. Even after stripping away new inclusions, the EMBIG’s rating quality degraded during the last cycle (EXHIBIT 7). In turn, the number of defaults associated with the pandemic-induced global recession is already one of the largest on record. Argentina, Ecuador and Lebanon had defaulted as of

⁶ The JPMorgan Government Bond Index - Emerging Markets Global Diversified Indices (GBI-EM GD).

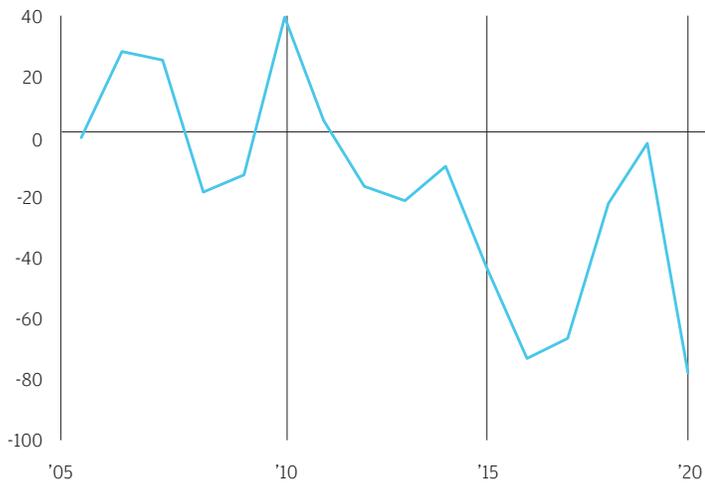
⁷ The benchmark EM hard currency index, made up of 73 sovereign debt issuers, is the Emerging Market Bond Index Global Diversified (EMBIG-DIV).

publication time, for a 2020 notional (par value) annual default rate of about 9%, the second-largest rate in the index’s history.

It took years for the EMBIG countries to build up their fiscal imbalances; it will take time to improve them. Countries that default will face lengthy negotiations with private creditors and multilaterals before very likely going through structural reform, during which time, should that occur, their fiscal flexibility would be limited. For this reason, we think there will be a higher percentage of low quality bonds in the index over the next 10 to 15 years, on average, and we raise our equilibrium spread this year by 25 basis points (bps) to 3.75%.

EM hard currency debt experienced net downgrades during much of the last expansion

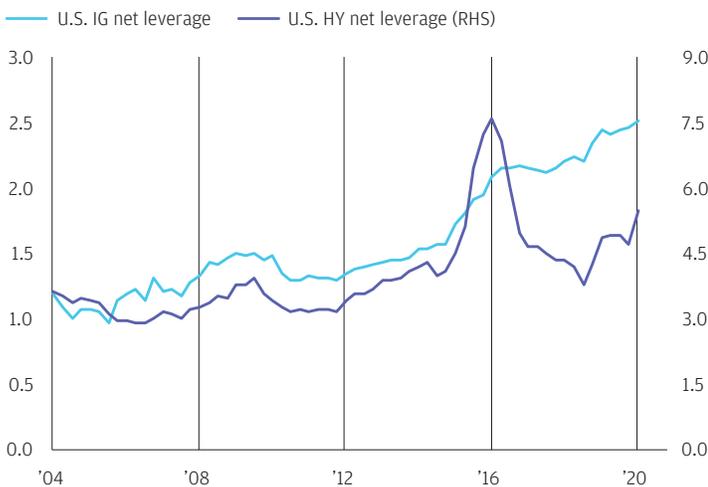
EXHIBIT 7: EMBIG-DIV NET UPGRADES BY NUMBER OF ISSUERS



Source: J.P. Morgan Securities, J.P. Morgan Asset Management; data as of August 31, 2020.

While metrics among U.S. corporates have been on a secular rise ...

EXHIBIT 8A: DM CREDIT: NET LEVERAGE (NET DEBT/EBITDA)



Source: J.P. Morgan Securities, BofA Securities, J.P. Morgan Asset Management; data as of March 31, 2020. Data range is March 2004-March 2020.

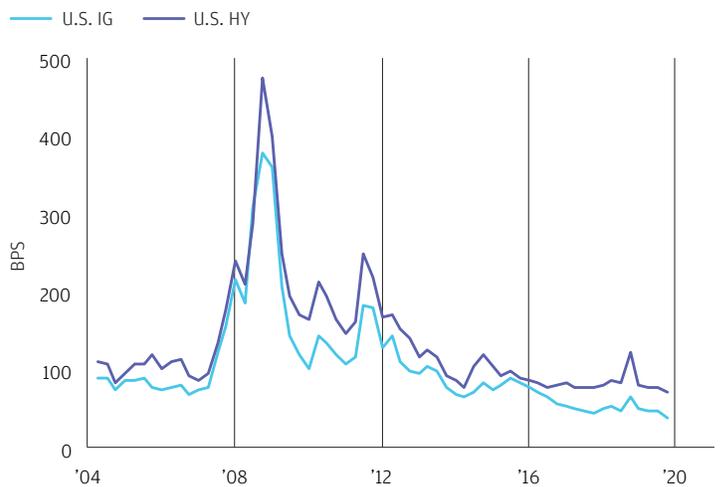
DM CREDIT: UNUSUAL LEVERAGE TRENDS DON'T MOVE OUR UNDERLYING SPREAD ASSUMPTIONS

With the cost of borrowing in secular retreat in recent years, U.S. corporates seem to have levered up their balance sheets, in turn boosting return on equity (RoE) and consequently share prices. Over the previous credit cycle, strong investor demand and increased competition among lenders loosened lending standards, worsened credit quality and increased leverage metrics and duration across the rating spectrum, for both investment grade (IG) and high yield (HY) borrowers.

Over the period from 2007 to December 31, 2019, shortly before the start of the pandemic, HY issuers’ balance sheet leverage rose from around 3x net debt-to-EBITDA to 4.7x. IG leverage also increased, from 1.0x to 2.5x over the same period (EXHIBIT 8A). Low Treasury yields created a “search for yield” dynamic in which fixed income products saw demand for their carry characteristics, particularly in the late stages of the last business cycle, when equity multiples appeared stretched. Spreads generally tightened throughout the last business cycle (with the notable exception of the energy-led spread collapse of 2015-16). The result was that spread per turn of leverage trended downward in the last cycle (EXHIBIT 8B).

... investors looked through the rise in leverage, causing spreads per turn of leverage to decrease over the last expansion

EXHIBIT 8B: SPREADS PER TURN OF LEVERAGE (BASIS POINTS)



In the past, a recession would have reversed this downward trend in spreads per turn of leverage as investors became painfully aware of the risks of overlevered balance sheets. This recession, however, has been unique. Strong fiscal and especially monetary policy responses amid the public health crisis have provided U.S. corporates cheap bridge financing. Credit spreads quickly normalized once the Federal Reserve provided an unprecedented backstop to the corporate sector that (with all-time low Treasury yields) encouraged companies to take on more debt. As a result, U.S. corporates will move through the early part of this cycle with an unusually high degree of leverage.

What are the impacts of this high debt reality? We believe the Treasury rate will continue to drive leverage dynamics in the corporate bond market. Our projections call for a long period of low rates, with Treasury yields eventually normalizing to 3% within our LTCMA horizon. Ultimately, rising rates should incentivize DM companies to delever their balance sheets as the cost of servicing debt starts to rise again.

The projection for elevated leverage metrics (even after incorporating some decline eventually) has the greatest effect on our IG spread assumptions. Our credit spread assumption, 160bps, is higher than the historical average, reflecting both the buildup in BBB concentration and the asset class's higher duration. Our HY assumption, 500bps, remains around its historical average. This is because we anticipate that a higher proportion of companies will be caught with too much leverage and will be downgraded to a CCC rating, but that this will be offset by a similar proportion of safer BB rated companies that, absent the increase in leverage, might have been rated IG.

THE IMPACT OF HIGH DEBT LOADS ON DM EQUITY MARKET RETURNS: NOT NECESSARILY NEGATIVE

In a world in which companies have shifted away from equity to a debt-heavy financing model, we see the clearest impacts on our assumptions in two areas. In financing terms, high debt loads should enable continued elevated payouts to shareholders through dividends and buybacks. In operating terms, high debt loads should be a drag on net margins via elevated interest payments. Sustainably higher equilibrium valuation levels (P/Es) are part of the picture as well, but more due to an environment of sustained low interest rates and ample liquidity than high debt *per se*.⁸

The overall impact on returns from high debt levels is not necessarily negative, depending on the balance among these factors. The deciding factor is likely to be debt's impact on economic and hence revenue growth, which may well outweigh other factors. And here the jury is still out. Our LTCMA equity assumptions framework models returns in a structured fashion derived from a number of drivers (**EXHIBIT 9**; also, see the Equity Assumptions section).

Aggregate revenue growth: No change

Revenue growth assumptions in our equity assumptions framework are largely driven by export-weighting our regional GDP assumptions. These have risen in this year's forecasts due to our expectations of a recovery from depressed levels, not to faster debt-fueled spending *per se*. However, this is an area of uncertainty -

⁸ This approach contrasts somewhat with widely used discounted cash flow models in which a shift toward debt financing usually is largely captured via a lowered cost of capital used to discount future flows. The cost of debt is lower than the cost of equity almost by definition, while debt usually also enjoys a tax advantage.

How do high debt levels impact equity returns? The answer depends on a balance of factors

EXHIBIT 9: EVALUATING THE IMPACT OF HIGHER DEBT USING OUR LTCMA EQUITY ASSUMPTIONS FRAMEWORK

Equity assumptions	Isolated impact of higher debt on our base case 2021 LTCMA equity assumptions*	Our base case 2021 LTCMA equity assumptions vs. last year*
Revenue growth	No change	Higher
+ margins impact	Lower	Higher
Earnings growth	Lower	Higher
Gross dilution	No change	No change
Buybacks	Higher	Lower
EPS growth	Varies	Higher
+ valuation impact	Higher	Lower
Price return	Varies	Lower
Dividend yield	Potentially higher	Lower
Total return	Varies	Lower

Source: J.P. Morgan Asset Management; assumptions as of September 30, 2020.

* Our base case assumes the MSCI AC World Equity index. Please refer to the 2021 LTCMA Equity Assumptions for more details.

should high debt levels (private and public) have a large impact in either direction on GDP and revenue growth, that could well outweigh most other factors. We see upside risks mainly in the U.S., Australia, the UK and Canada, and downside risks in Brazil, Mexico and Russia.⁹

Margins: Downward pressure from rising interest costs

We expect the corporate debt outlook to be a negative for net margins and thus earnings growth. Rising bond yields (whether spread- or duration-driven) imply higher interest expenses, although the overall impact depends on the timing of rising debt costs vs. falling debt levels. Given that bond yields are expected to rise only later in our LTCMA horizon, the immediate impact should be modest. Further, this impact is overpowered in this year's assumptions by the now-depressed starting level of earnings and margins, which should rise cyclically as the economy recovers.

A more speculative negative impact might come from politics: Limiting the tax deductibility of interest payments is a prominent part of the U.S. discussion around how corporations should be taxed. If enacted, it would raise all-in interest costs.

Net dilution: Buybacks decline vs. recent years but remain above historical averages

In our framework, higher debt levels allow companies to make higher payouts to shareholders, reducing shareholder dilution and boosting return on equity by minimizing equity capital on balance sheets. As debt levels decline over our LTCMA time horizon, this should lead to downward pressure on payouts, reinforcing the near-

⁹ As discussed in Bilton et al., "The fiscal decade."

term negative impact from the cyclically depressed level of earnings, making payouts less affordable. Taken together, we see lower buybacks across most countries, although they remain above long-run averages.

Politically driven changes may have an impact here as well, since governments may exert moral or legal pressure on buybacks. If payouts were consequently to shift toward dividends, that might have a negative impact on after-tax returns for some types of investors.¹⁰ However, it would have little or no impact on our return assumptions.

Valuations

In our equity returns framework, higher debt allows companies to boost RoE via larger shareholder payouts. In combination with a historically very low cost of debt, this should boost equilibrium valuations. We have long nodded to this factor in our equity assumptions by using equilibrium P/E assumptions that are modestly above long-run averages.

Regional considerations

When incorporating the above considerations into our equity assumptions, we have to take into account the varying scale of the debt issue among regions. The U.S. equity universe has clearly led the charge in raising corporate leverage (**EXHIBITS 10A and 10B**).¹¹

¹⁰ As capital gains are commonly more lightly taxed than dividends.

¹¹ Aggregate fundamental corporate data can be substantially distorted by sector differences and anomalies. Most prominently, the cash-rich U.S. technology sector dilutes the extent of the rise in leverage in the rest of the U.S. market, while the U.S. and European auto sectors' finance arms cause distortions in the opposite direction. Calculating median debt levels allows us to largely avoid these issues.

Debt has risen the most in the U.S. and the UK while trending downward in Japan - trends that can be obscured in aggregate (10A) by sectoral distortions but are clear in median data (10B)

EXHIBIT 10A: AGGREGATE NET DEBT TO EQUITY, NONFINANCIALS

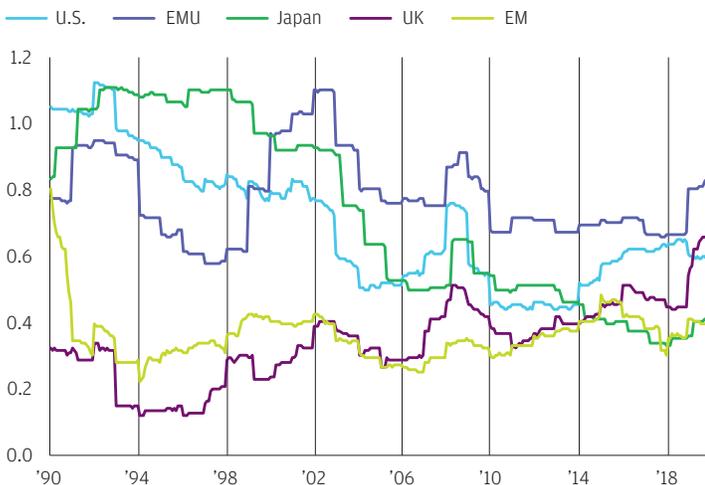
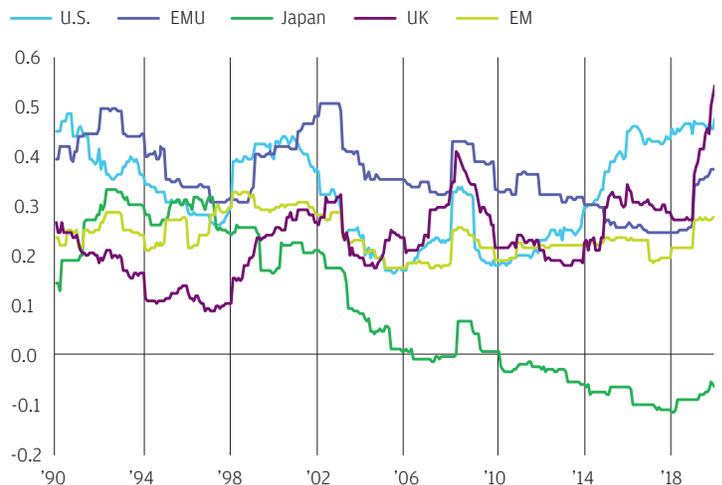


EXHIBIT 10B: MEDIAN NET DEBT TO EQUITY, NONFINANCIALS



Source: Datastream, J.P. Morgan Asset Management; data as of October 5, 2020.

The only other major market to show a clear upward trajectory is the UK, albeit from a much lower starting level. In contrast, the Japanese corporate sector until recently remained in a multi-decade deleveraging mode. Trends in other regions look less interesting, although long-run average/neutral levels differ, likely owing to differences in sector composition, accounting and corporate culture.

In sum, the return implications for equity markets of the new high debt reality are clearest for the two extreme cases: The U.S. sees the clearest negative impact on margins but also benefits from a relatively large boost to RoE and valuations. At the other end of the spectrum, Japan's low level of corporate debt supports our long-standing view that there is ample scope for corporates to increase leverage and reach a higher level of payouts, which we think will be a major driver of returns. European and EM debt levels are more or less in line with history, leading us to expect only a modest drag on margins - but here too we anticipate a positive impact on P/Es and RoE.

CONCLUSION

We expect higher indebtedness to be sustained across both sovereigns and corporates due to increased market tolerance for debt. High debt loads are expected to amplify market volatility in times of recession.

In bond markets, this new cycle is shaping up to be very different from the post-financial crisis cycle. The most striking difference is the signal that monetary and fiscal policy will be used in tandem well into the recovery. That increases the risk premia we attach for inflation risk over the next 10 to 15 years across DM and EM sovereign bond markets. The active use of fiscal policy should lead to greater differentiation among bond markets, manifesting most clearly in emerging markets.

In credit, we expect this anomalous leverage cycle to lead to tighter spreads per turn of leverage, but this does not change our aggregate corporate spread assumptions. In the U.S., in particular, we expect eventual deleveraging to reduce the support for buybacks.

For equities, the most evident impacts of high debt loads will likely be enabling the continuation of high shareholder payouts while dragging on net margins. That this would occur against a low interest rate backdrop also implies equilibrium valuation levels well above history. However, the factor most likely to determine whether a high debt world has a positive or negative impact on equity returns is revenue growth. Here the jury is still out, although we do see upside risks. Given the differences in the rise of corporate debt across economies in recent years, these effects should be most pronounced in the U.S. market, with Japan relatively unaffected at the other end of the spectrum.

Overall, investors will have to become accustomed to living in a high debt world. In this environment, DM equities increasingly become a vehicle for income rather than capital appreciation. Investors may have to turn to EM equities and alternatives for return on capital. We also expect high indebtedness to exacerbate market volatility in future recessions.

CHINA: UNIQUE LATITUDE TO INCREASE LEVERAGE, BUT NOT WITHOUT SOME CONSEQUENCES

After remaining broadly stable for the past three years, China’s economy will likely see a notable releveraging in 2020, mainly driven by the government’s pandemic fiscal support, a package likely totaling 5%–6% of GDP in 2020. The implications are less severe than they might be for other emerging economies because of China’s unique characteristics, but the consequences are still important.

Unlike other EM economies, China can meaningfully ramp up government borrowing without a significant increase in interest rates. That reflects two key factors. First, China does not rely on foreign investors to finance its government debt, almost all of which is domestic debt. As of the end of 2019, only 3.5% of government debt was held by foreign investors vs. 38.8%, on average, in emerging markets and 21.3%, on average, in emerging Asia.*

Second, China’s large domestic banking sector offers a strong domestic bid for its government debt and serves as the main source of financing, holding 86% of total government debt. Fiscal stimulus in China is usually accompanied by monetary easing, which positions these banks well for when public sector borrowing needs rise. In addition, China’s domestic banking sector is funded predominantly by retail deposits, making it less exposed to potential interbank liquidity shortages during an economic crisis.

The government’s strong control over both the asset and the liability sides of the public debt equation also gives China a range of policy options unavailable to most other economies. So we see limited risks of any liquidity-driven debt crisis, including at the local government level, where the repayment burden is higher; any debt restructuring is likely to take place gradually.

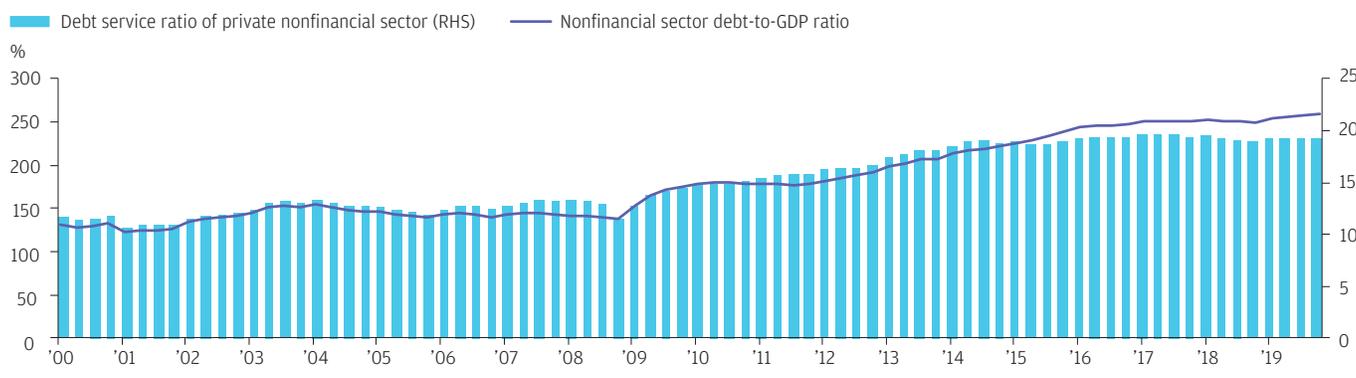
Still, even if higher government leverage is unlikely to trigger a debt crisis, it reduces Chinese policymakers’ future capacity to stimulate the economy. Policy easing this time around is more measured and targeted than the aggressive stimulus package rolled out during the 2008–09 global financial crisis. Chinese policymakers are facing some constraints because government leverage has doubled since 2008. (The 2020 package does surpass the government’s stimulus effort during its 2015–16 easing cycle.)

What are the implications for rates and debt service of the significant increase in leverage levels in 2020? In our view, real policy rates should remain low to keep the debt service burden manageable. This introduces a range of possible consequences for economic efficiency and even, potentially, productivity growth. China’s private nonfinancial sector debt service ratio (DSR) is already relatively high at 19.2%, compared with 17.5% in Brazil, 7.5% in Russia and 7.1% in India.** We estimate, to take a hypothetical example, that if the private nonfinancial sector debt-to-GDP ratio increased by 10 percentage points (ppt), it would raise China’s DSR by 1ppt. Meanwhile, a 100 basis point reduction in the average lending rate would lower the DSR by 1.2ppt (EXHIBIT A).

However, keeping policy rates low to manage debt service concerns would create financial distortions. Policy rates kept well below the natural rate of interest† would persist for longer, which would likely lead to a further deterioration in the efficiency of credit allocation to different sectors. It would also weigh on long-term productivity growth in the absence of structural reforms, especially of the state-owned enterprise sector.

China’s private nonfinancial sector debt service ratio, the highest of the BRIC countries, will rise further

EXHIBIT A: CHINA’S OVERALL LEVERAGE VS. DEBT SERVICE RATIO (DSR)



Source: Bank for International Settlements, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 31, 2019.

* All data and estimates on China’s government debt in this sidebar are as of December 31, 2019. According to the International Monetary Fund’s International Financial Statistics database, the percentage of China’s debt held by foreign investors is the lowest of all EM economies.

** The debt service ratio is defined as the ratio of interest payments plus amortization to income.

† The natural interest rate is defined as the real interest rate consistent with output at its potential level and constant inflation. For more information, see Hannah Anderson and Leon Goldfeld, “The cost of capital in China’s changing markets,” 2018 Long-Term Capital Market Assumptions, J.P. Morgan Asset Management, November 2017.

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