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Dissecting the Global Debt Cycle

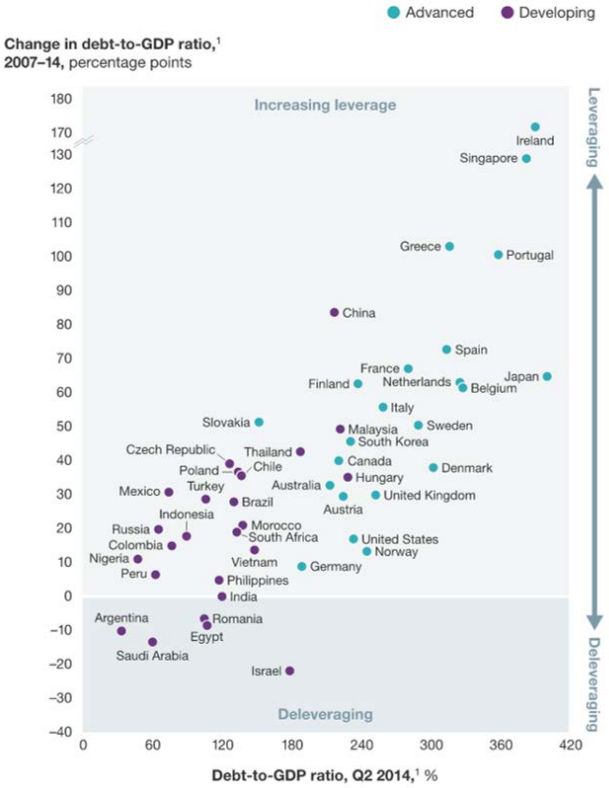
Since the advent of mankind, debt has been part of the bedrock of civilization. The Amorite kings of ancient Babylon, including Hammurabi (1792-1750 B.C.), utilized a "special tool" to confront difficult social and economic conditions created by excessive debt. They simply declared a "Debt Jubilee." This action instantly wiped out the borrowers' loans, stiffed the lenders, and the economic system began anew.

As of 2015, total global debt-to-GDP was in the range of 280-300%, according to different reports.[1] Standing at an estimated and incomprehensible $230 trillion, this is three times the size of the global economy. Since 2007, global debt has risen by $57 trillion. Of that amount, $25 trillion was government debt, the McKinsey Global Institute reported.[2]

Unsustainably high debt was one of the contributors to the 2008 Great Recession. In a March 2016 report, the Bank for International Settlements stated: "the most worrying development has been the steep rise in *private sector debt…..especially in several emerging-market economies*." "The problem is what you created with the debt," according to Steven Ricchiuto, Chief U.S. Economist for Mizuho Securities. "The fundamental issue is that we have excess supply." Additionally, the total government debt now exceeds $59 trillion.[3]

The chart on the right demonstrates the change of debt-to-GDP from 2007 to 2013/14 in advanced as well as developing countries. China's total debt-to-GDP increased from $7 trillion to $28 trillion by mid-2014, and it is larger than that of the U.S. or Germany. Economic stagnation often occurs when the total-debt-to-GDP gets too high. The 2016 U.S. personal debt balance composition was approximately $12 trillion. Greece is a classic example of a country with a high debt burden. Its economy is stagnating because Greece's debt service requires cash that is needed for economic growth and expansion. This overleverage creates a vicious cycle resulting in economic decline.

Understanding the business and debt cycles is critical to investors and their decision-making process. TCW (Trust Company of the West), a $185-billion asset manager, recently published a report that I found informative.[4] The following is the excerpt of that:



[1]Debt owed by households, nonfinancial corporations, and governments; Q2 2014 data for advanced economies and China; Q4 2013 data for other developing countries.

Source: Haver Analytics; national sources; McKinsey Global Institute analysis

[1] http://on.wsj.com/1U94qRA and http://bit.ly/2dE60x4
[2] http://bit.ly/2e8yOPY
[3] http://fw.to/qrtI6dC
[4] http://bit.ly/2egKGPW

As obvious as this truth is to investors, when the sad end to the credit cycle comes, it always comes as a big surprise to many, including the central bankers who, reliant on their models, confidently tell you that no recession is (ever) in the forecast.

Consider the chart below which plots the trajectory of cumulative asset prices (stocks, bonds, real-estate) against that of aggregate income (GDP): The chart reveals something rather extraordinary: over the course of the past 25 years, the traditional business cycle has been replaced with an asset price cycle. Rather than let recessions run their painful but necessary course, central bankers move forthwith to dispense the monetary morphing.

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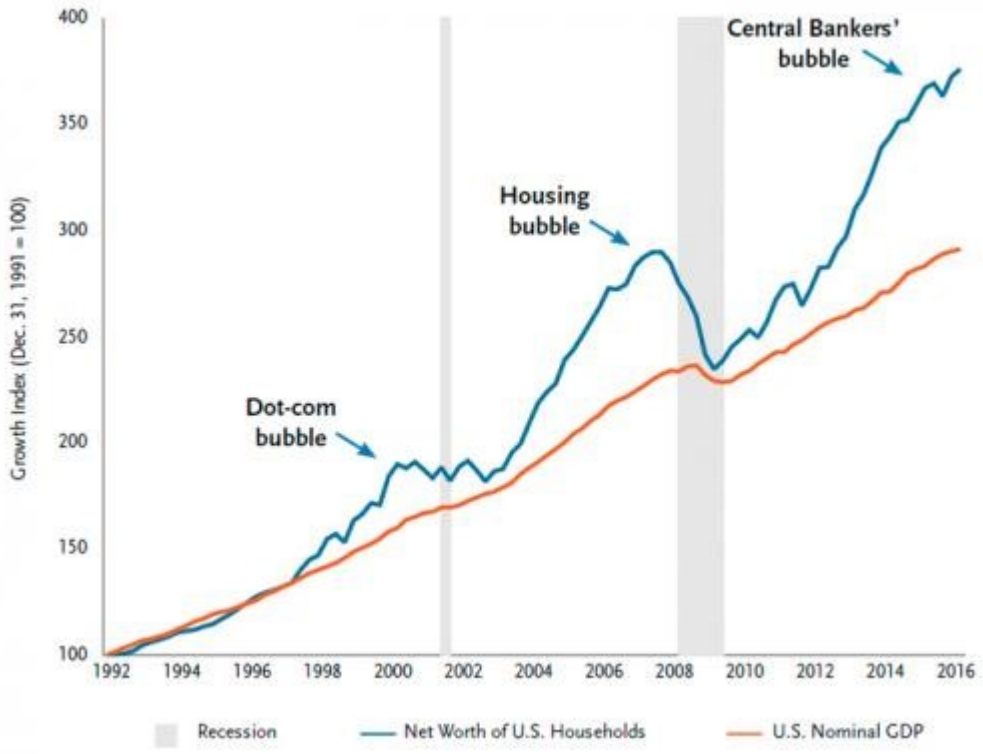

The Fed's playbook on this is well worn: First, policy rates are lowered. This triggers a daisy-chain of events: low or zero rates promote a reach for yield; the reach for yield lowers capitalization rates across a variety of asset classes which, in turn, spurs a rise in asset prices. Rising asset prices – the so called wealth effect – "rescues" the economy by rebuilding balance sheets and restoring the animal spirits. And voila! Aggregate demand rises, business invest and a virtuous growth process is launched.

But buying growth today with credit that needs to be repaid tomorrow is not a free lunch! Artificially "stimulated" credit creation means marginal or even unprofitable enterprises are being fed when they should actually be starved. Leverage goes up faster than the income available to serve it. As such, the credit fueled expansion inevitably comes to a bad end.

The Amorite kings of ancient Babylon utilized the "Debt Jubilee" to deal with the curse of excessive and stifling debt. In the 21st century, monetary leaders will ultimately confront the curse of stifling total global debt-to-GDP now existing in the global world economies. As the TCW report concludes: "While every price cycle is different, they all end the same way: in tears.

