Debt Rises to Pre-Great Recession Levels
Positive Economic Factors Preserve Optimism for Now

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The current economic landscape, punctuated by global growth, low inflation and historically low interest rates, also features a significant rise in debt. The rate of increase is likely unsustainable over the long term and therefore bears close monitoring; however, at present, individuals, corporations and governments are financially able to service their debt provided steps are taken to moderate the growth of future debt levels.

Rise of Global Debt

Following the worst financial crisis since the Great Depression more than a decade ago, many households and companies took steps to reduce their debt levels. Governments, on the other hand, ramped up spending to offset the impact from the financial crisis, resulting in rising public sector debt. Where are we today in terms of debt levels around the world?

According to research by the Institute of International Finance, global debt rose to more than $230 trillion in the third quarter of 2017, $16 trillion higher than it was at the end of 2016.[1] Additionally, private sector debt reached new highs in Canada, France, Hong Kong, South Korea, Switzerland and Turkey.[2]

According to the Bank for International Settlements (BIS), debt-to-Gross Domestic Product (GDP) for all countries where data is available has increased from 190% in 2001 to 245% in September 2017, as illustrated in Exhibit 1.[3] While Western economies have greatly contributed to higher borrowing levels, all major regions are adding to burgeoning debt. As demonstrated in Exhibit 2, emerging

Exhibit 1: Debt-to-GDP for All Reporting Countries

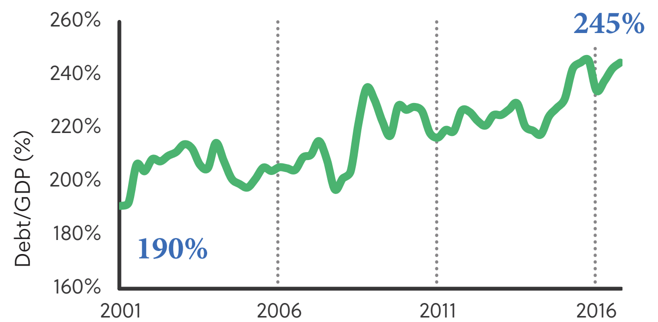


Exhibit 2: Debt-to-GDP for Emerging Markets

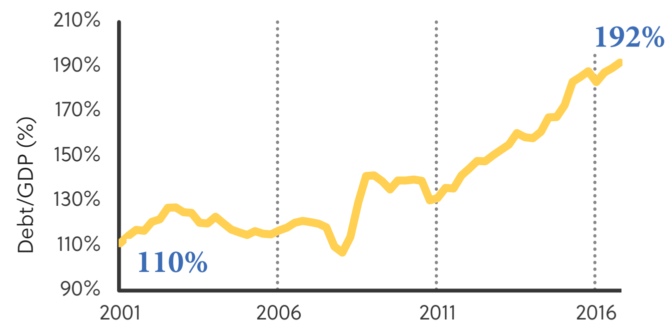
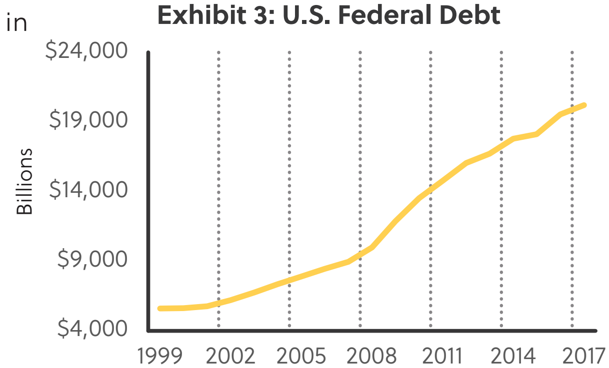


Exhibit 3: U.S. Federal Debt

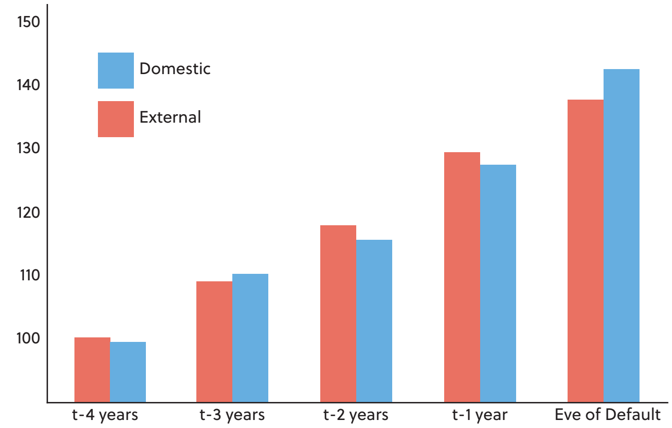


1 "Global Debt Monitor," Institute of International Finance, January 2018, https://www.iif.com/publication/global-debt-monitor/global-debt-monitor-january-2018.
2 Enda Curran, "Global Debt Hits Record $233 Trillion," Bloomberg, January 4, 2018, https://www.bloomberg.com/news/articles/2018-01-05/global-debt-hits-record-233-trillion-but-debt-to-gdp-is-falling.
3 "Credit to the Non-Financial Sector," Bank for International Settlements, March 11, 2018, https://www.bis.org/statistics/totcredit.htm.

market countries saw their debt-to-GDP rise from 110% in 2001 to 192% at the end of September 2017.[4] For advanced economies, debt-to-GDP grew from 205% to almost 280% during the same period.[5] Even regions that pursued austerity policies, such as the Eurozone, saw their debt to GDP grow.

The U.S. has not escaped rising debt levels. According to the BIS, U.S. debt-to-GDP has increased significantly, largely due to rising budget deficits. As shown in Exhibit 3, the gross national debt has risen from $5.6 trillion at the end of 1999 to more than $20 trillion in 2017.[6]

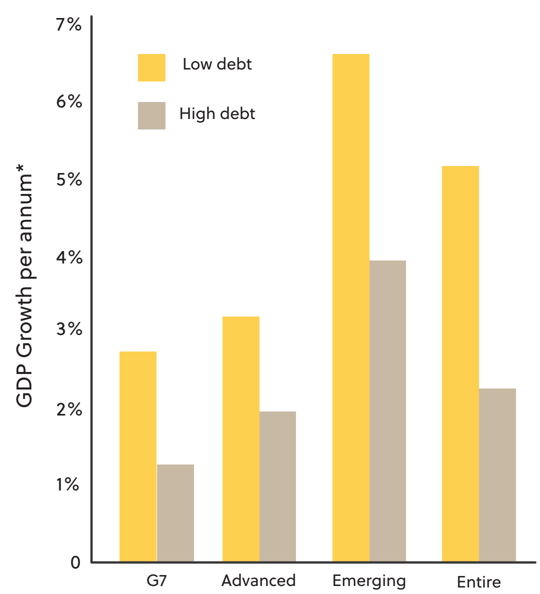
Exhibit 4: The Runup in Domestic and External Debt on the Eve of Default, Average Default Episode 1800-2006



What Does this Mean for Global Economies?

Economists have long studied the role that debt has played in contributing to global financial and banking crises. The BIS has created a financial cycle indicator based on credit growth, credit-to-GDP and house prices, and concluded that the rising debt-to-GDP ratio is an early warning indicator of crises.[7] Historically, dislocation in the business cycle, a characteristic of recessions and downturns, tended to coincide with elevations in the financial cycle indicator. Carmen Reinhart and Kenneth Rogoff studied financial and debt crises since 1800 and found that, on average, domestic and external debt rise significantly during the four years prior to the crisis, shown in Exhibit 4.[8] Another study by economists at the International Monetary Fund (IMF) found that for every increase of 10 percentage points in debt-to-GDP, subsequent economic growth slows by 0.2%.[9] What is more concerning is that the relationship they found was nonlinear: as debt increases, the impact on economic growth becomes larger.

Exhibit 5: IMF Study on Debt and GDP Growth



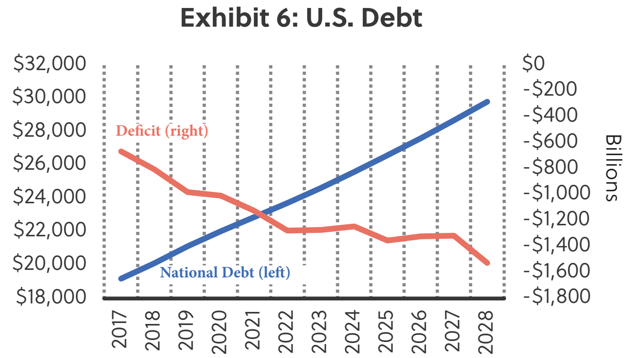
*Average for subsequent five years

What Does this Mean for the U.S.?

In the U.S., corporate and household debt have also accelerated recently. Rising household debt was one of the contributors to the financial crisis, and in its aftermath, debt declined as consumers defaulted on their mortgages, paid down debt and improved their balance sheets. Household debt dipped to its lowest level of the past decade in 2013, reaching $11 trillion.[10] However, the past several years have witnessed an increase in

4 Ibid.
5 Ibid.
6 "Gross Federal Debt," Federal Reserve Bank of St. Louis, March 27, 2018, https://fred.stlouisfed.org/series/FYGFD.
7 Inaki Aldasoro, Claudio Borio, and Mathias Drehmann, "Early Warning indicators of banking crises: expanding the family," Bank for International Settlements, March 11, 2018.
8 Carmen M. Reinhart and Kenneth S. Rogoff, "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises," the National Bureau of Economic Research, March 2008, http://www.nber.org/papers/w13882.
9 Manmohan S. Kumar and Jaejoon Woo, "Public Debt and Growth," International Monetary Fund, July 2010, https://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf.
10 "Quarterly Report on Household Debt and Credit," Center for Microeconomic Data, Federal Reserve Bank of New York, August 2013, https://www.newyorkfed.org/medialibrary/media/research/national_economy/householdcredit/DistrictReport_Q22013.pdf.

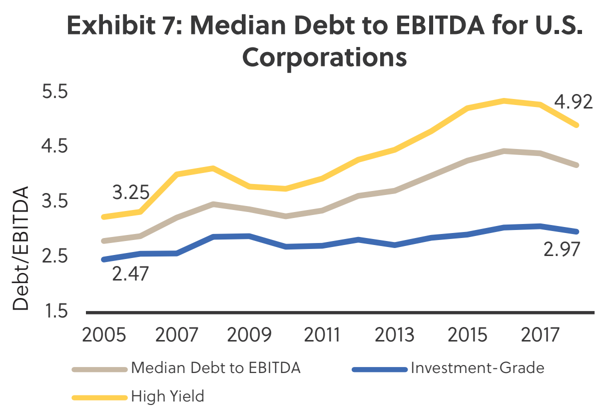
household debt, and it is now higher than it was before the financial crisis at more than $13 trillion.[11] Likewise, U.S. corporate debt declined following the financial crisis as companies became more cautious, but it has recently been on the rise as companies take advantage of low interest rates. Corporate credit has risen to more than $14 trillion, up from 2010 levels of around $10 trillion.



As previously mentioned, U.S. total debt-to-GDP has increased from 120% in 1952 to 250% at the end of 2017. During this period, economic growth has slowed. Debt levels both in absolute terms and as a percentage of the economy are expected to keep rising, which concerns many investors. According to the latest projection from the Congressional Budget Office, federal government budget deficits are expected to rise to almost a trillion dollars in 2019 and keep rising.[12] This situation will continue to drive national debt higher, which will result in its having a higher interest expense (expected to rise from $263 billion in 2017 to about $1 trillion by 2028).[13] This will crowd out other spending priorities.

Conclusion

While we recognize the risk of rising debt and the negative impact on economic growth ahead, PFM remains fairly positive on economic growth and the returns that investors can expect from capital markets going forward. The rise in debt seems as much a function of entities taking advantage of the current favorable interest rate environment and not an indication of spending at a level that makes financial distress likely or imminent. At current low interest levels, moderate inflation, low and declining unemployment and improving wage growth, U.S. households are financially able to service their current debt levels. Our conclusion is not that households are in financial straits, but rather, points out that the U.S. consumer cannot continue to be the sole driver of global economic growth. Likewise, U.S. corporations are well-positioned to pay down the debt they have accumulated in recent years. As demonstrated by Exhibit 7, in the investment-grade universe, corporate debt levels relative to profitability are not stretched.[14] In the high-yield universe, debt levels are more worrisome and we expect default rates to trend higher over the next several years. Two-thirds of corporate debt will roll over in the next five years, providing companies with the ability to refinance or pay down debt. In the context of continuing economic growth, corporations are generating cash flow to be able to service their current debt.



11 "Household Debt and Credit Report" Center for Microeconomic Data, Federal Reserve Bank of New York, May 2018, https://www.newyorkfed.org/microeconomics/hhdc.html.
12 "The Budget and Economic Outlook: 2018-2028," Congressional Budget Office, https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf.
13 "Updating the U.S. Budget Outlook," Committee for a Responsible Federal Budget, March 2, 2018, http://www.crfb.org/papers/updating-us-budget-outlook.
14 Bloomberg, accessed May 1, 2018.

Rising public debt may be more challenging. In the U.S., we will carefully watch the combination of $1 trillion annual deficits on top of today's debt and increases in interest costs as interest rates are driven higher in response to positive indicators. The majority of the federal budget is directed at entitlement spending and interest on the national debt, while discretionary spending makes up a relatively modest percentage of federal government spending. Controlling rising budget deficit and national debt will require national and political consensus, which may be difficult in the current political environment.

The purpose of this InvestEd is to point to risks that we see that have the possibility to disrupt our views. Debt has been rising, albeit along with economic and wage growth. Both households and companies need to turn their attention to their higher debt loads while the economy is doing well. Failure to adequately deal with rising debt levels represents a risk and could possibly add to the severity of the next economic downturn.