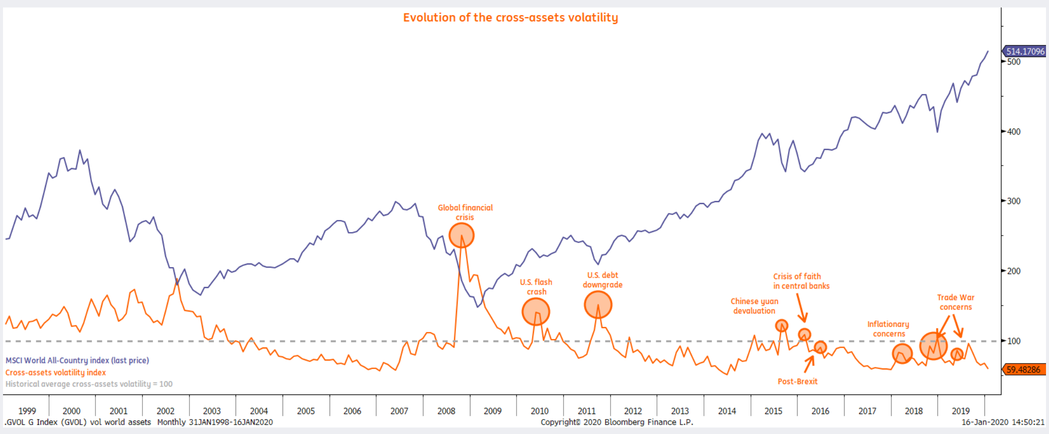
JANUARY 2020

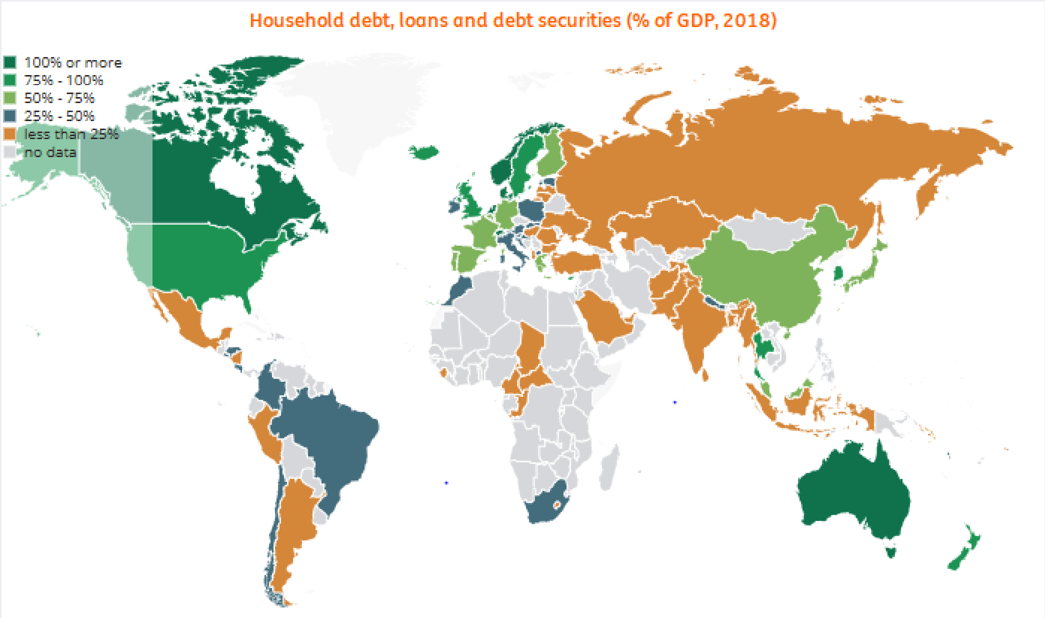
IN THE NEWS

High consumption, asset prices and debt combination is unsustainable

- The world's advanced economies are trying to keep their balance on an **unstable platform of high consumption, asset prices and household debt** as we enter the 2020s. Any significant shock and increase in volatility, which is kept artificially low as central banks hold down interest rates - the cross-assets volatility index has averaged 100 since 1999 and is now (below 60) lower than that level for a four straight year, the longest streak ever! -, could trigger "doom loops" that compromise the economic and financial systems.



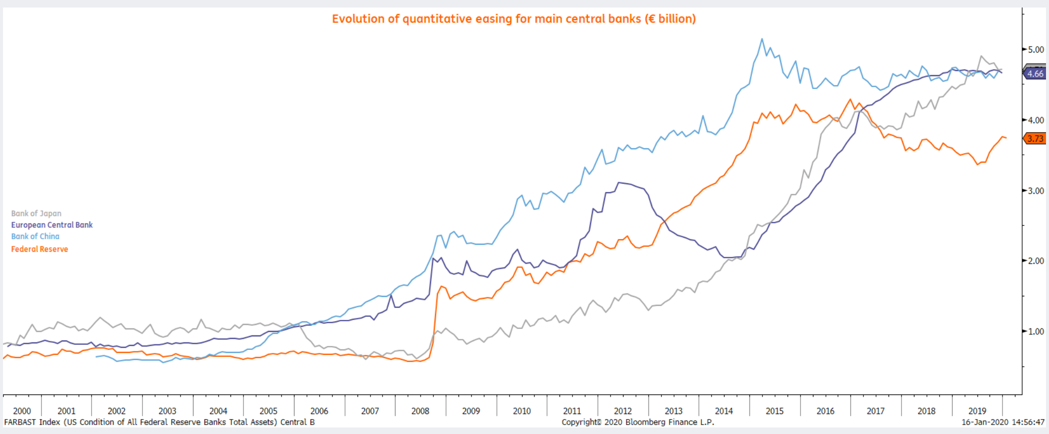
- **In recent years**, personal consumption, rising employment, government deficit spending, higher housing and assets prices have underpinned growth. But with wage growth low, **borrowing was a major factor in consumption** as central bank, that engineered high asset prices, allowed scope for additional borrowing. **Global household debt has reached around 75% of gross domestic product, with especially high levels in some advanced economies.** The comparable figure was around 57% in 2007 and 42% in 1997! Global debt (household, business and government) is seen expanding to $255 trillion, at a lofty 320% of global GDP or almost three times global economic output and about $32,500 for every man, woman and child on earth. Even with very low interest rates, household debt service ratios, which measure aggregate principal and interest repayments to income, remain high, ranging from 8% to 16%.



Source: IMF

- The combination between high debt, consumption, and asset price - equities have appreciated by nearly 405% (in euro and reinvested dividends) since 9 March 2009 - is unsustainable and can lead to self-reinforcing feedback loops. Initially, increases in asset prices facilitate an expansion in credit and consumption that leads to further asset prices rises. But slower growth, unemployment, or falling income or asset values can quickly send the cycle into reverse as **negative shocks ripple through the structure of household finances.**
  - Looked at from a balance sheet perspective, assets such as houses and financial investments are financed by mortgages and other debt. On a cash flow view, employment and investment income must cover consumption and debt repayments. **Any income shock** — unemployment, lower earnings, declines in interest or dividend income — **must be offset by reduced consumption**. Higher debt repayments or inability to refinance pressures the ability to consume. Falling housing prices or values of financial investments weaken the household balance sheet, forcing reduced consumption or accelerated debt reduction.
  - **These first-order effects spread through successive disturbances, which rapidly amplify the stress.**
    - **One area of contagion is the financial sector.** Major negative shocks expose excessive risk-taking by borrowers and lenders. If employment markets worsen, vulnerable households can't service borrowings. Non-performing loans increase. Banks tighten credit, making it less available, harder to get and more expensive. Maturing debt becomes difficult for borrowers to refinance, worsening cash flow pressures. Forced sales, defaults and repossessions set off a spiral of falling prices across asset classes. Shrinking household net wealth force even less consumption. Postponed home purchases and upgrades impact construction. This has a material impact on the U.S. and Euro-Area, where housing accounts for about one sixth of the economies.
    - Where banks are a major part of the stock market, such as in the U.S., U.K. and Australia, **further contagion comes from reduced bank profits pressuring share prices and dividends.** The loss of net worth and income further hits consumption by investors who rely on this cash flow.
    - **Then there are government finances.** General tax collections decline. Direct revenue derived from property and financial transactions falls. If the government has to support financial institutions — a persistent feature of asset price busts — the funds required to recapitalize banks and guarantee deposits stress government balance sheets. These are already weaker after 2008. Capital flight or reduced inflows as foreign investors exit squeeze the current account and currency.
    - The cycle continues through successive phases until a new balance is achieved.

- **Recent central bank actions around the world reflect the realization that policy must prop up asset prices to safeguard consumption, which constitutes around 50% to 60% of GDP in advanced economies.** As of October, the collective balance-sheet assets of the Federal Reserve, European Central Bank, Bank of Japan and Bank of England stood at 35.7% of their countries' total GDP, up from about 10% before the financial crisis of 2008.



- **The problem is that these policies perpetuate and increase debt, prevent normal asset-price cycles and increase the vulnerability of households.** The ability to maintain this inherently unstable equilibrium remains the key to the prospects of advanced economies. The social strains that it is coming under, for example, in terms of purchasing power and affordability of housing, are increasingly expressed in mass protests across the globe.

- Debt accumulation can be appropriate in economic downturns as a way to stabilize economic activity. However, **the three previous waves of debt accumulation have ended badly** – sovereign defaults in the early 1980s; financial crises in the late 1990s; the need for major debt relief in the 2000s; and the global financial crisis in 2008-2009. And while currently low interest rates mitigate some of the risks, high debt carries significant risks. It can leave countries vulnerable to external shocks; it can limit the ability of governments to counter downturns with fiscal stimulus; and it can dampen longer-term growth by crowding out productivity-enhancing private investment.

- That is the reason why we consider it is better to continue to give priority in the portfolio to **"high-quality" stocks** which have been the big winners in 2019, with a gain of 34% in euro **(more comments in the equity section)**. Companies posting revenue growth, stable profits and an above average return on equity **remain the best equipped to deal with the prevailing uncertainty in a low-growth environment!**