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Three Great Unwinds

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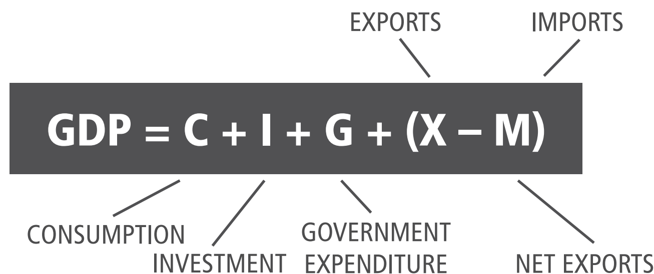
The bull market in equities has recently celebrated its seventh anniversary and many investors question its sustainability. The argument has been made that central banks have engineered the recovery by flooding global capital markets with liquidity. In reality, they claim, the global economy is in poor shape and as a result, the current bull market is unsustainable.

In reality, the global economy continues to expand, but below the long term run-rate of 3.5% Real GDP growth. It is this persistent and pervasive low growth that is the real problem plaguing global markets. Low growth has forced central banks to slash policy rates in an attempt to induce consumption and investment. Low growth has resulted in a muted inflation outlook as demand-pull and cost-push mechanisms of inflation generation have broken down. This low growth quandary must be combatted with coordinated policy responses from central banks (cut rates, inject liquidity, induce risk-taking) and governments (boost spending, induce consumption and investment) to ensure that it does not become entrenched as it has become in Japan.

At the risk of putting readers to sleep, let's revisit the basic GDP economic argument. GDP equals the sum of domestic Consumption, business Investment, Government expenditures and Net Exports (Exports minus Imports).



A material recession usually results in declining consumption as unemployment rises and confidence falls. In the face of declining demand and rising uncertainty, businesses usually respond by cutting investment. Government expenditures rise, initially due to the increased demands on the social safety net (unemployment insurance, worker retraining programs) and later as the government attempts to boost consumption ("cash for clunkers") and replace private sector investment ("shovel-ready" infrastructure projects). To aid this, the central bank usually cuts policy rates to spur borrowing (to pull economic activity forward) and this usually results in the currency depreciating, boosting the competitiveness of exports and reducing the attractiveness of imports.

Seven years after the Great Recession, governments and central banks everywhere find themselves in the same position – trying to generate meaningful economic growth. However, they both must contend with the unwinding of three large economic phenomena, which have exerted downward pressure on global growth and will continue to do so for several years to come.

Global Deleveraging

Imagine a world without credit. Purchasing a home would require most consumers to save for 15 to 20 years before they enjoyed the benefits of home ownership. Credit allows consumers to pull economic activity and growth forward to increase their standard of living. This activity happens every day and, as long as credit is underwritten in a disciplined manner, society benefits from the acceleration in economic activity. However, because human beings are fallible, credit is more cyclical than most econometric models forecast. The decade of the 2000s highlights this fact.

In the 2000s, people who should not have received credit were granted credit on increasingly favourable terms ("NINJA" loans). Credit-worthy individuals were extended credit on more favourable terms than they were entitled to (negative amortization loans, teaser rates). This has happened in the past and will surely happen again in the future. The difference in the 2000s is credit was over-extended on extremely favourable terms to consumers, companies and even countries (Opa! Greece) EVERYWHERE, AT THE SAME TIME.

A massive global credit binge took place during the first half of the 2000s. This pulled an enormous amount of growth from future periods into the early 2000s, effectively bankrupting the decade of the 2010s of growth. In the aftermath, investors are discovering that it is not possible to recover from a 10-year credit party by experiencing a one year credit hangover. As a result, global growth will remain below the long-term trend for several more years, as various components of the global economy continue to delever.

CHANGE IN DEBT-TO-GDP RATIO SINCE 2007 BY COUNTRY

(Ranked by real economy debt-to-GDP ratio, 2Q14 [1])

Advanced economy

Developing economy

Leveraging

Deleveraging

Rank	Country	Debt-to-GDP[1] ratio (%)	Real economy debt change, 2007-2014 (Percentage points)				Financial sector debt change
			Total	Government	Corporate	Household	
1	Japan	400	64	63	2	-1	6
2	Ireland	390	172	93	90	-11	-25
3	Singapore	382	129	22	92	15	23
4	Portugal	358	100	83	19	-2	38
5	Greece	317	103	70	13	20	1
6	Spain	313	72	92	-14	-6	-2
7	France	280	66	38	19	10	15
8	Italy	259	55	47	3	5	14
9	United Kingdom	252	30	50	-12	-8	2
10	United States	233	16	35	-2	-18	-24
11	South Korea	231	45	15	19	12	2
12	Malaysia	222	49	17	16	16	6
13	Canada	221	39	18	6	15	-6
14	China	217	83	13	52	18	41
15	Australia	213	33	23	-1	10	-8
16	Germany	188	8	17	-2	-6	-16
17	Thailand	187	43	11	6	26	21
18	Vietnam	146	13	10	-1	5	2
19	Chile	136	35	6	20	9	9
20	Brazil	128	27	3	15	9	13
21	India	120	0	-5	6	-1	5
22	Philippines	116	4	-3	9	-2	-5
23	Turkey	104	28	-4	22	10	11
24	Indonesia	88	17	-5	17	6	-2
25	Mexico	73	30	19	10	1	-1
26	Russia	65	19	3	9	7	-4
27	Saudi Arabia	59	-14	-15	2	-1	-8

Source: World economic outlook, IMF; BIS; Haver Analytics; national central banks; McKinsey Global Institute analysis.

[1] Includes debt of households, non-financial corporations, and government; 2Q14 data for advanced economies and China; 2013 data for other developing economies.

NOTE: Numbers may not sum due to rounding.

As the table above demonstrates, the global financial system has led the charge on deleveraging, as banks now carry more and better quality capital. However, many financial institutions still have material work to do on this front. Households in many countries have delevered significantly, in some cases dramatically so (mortgage defaults in the US, Ireland and Spain). However, in some nations households have not begun this process at all (Oh Canada!). Corporations globally have substantially deleveraged and US multinationals in particular, carry trillions of dollars in cash on their balance sheets. Bringing up the rear are sovereign nations, many of whom have continued to lever up. Some of this is structural as the social safety net continues to be accessed by elevated numbers of citizens. However, some of this is by design as budget deficits are extended to compensate for lower consumption and deferred investment.

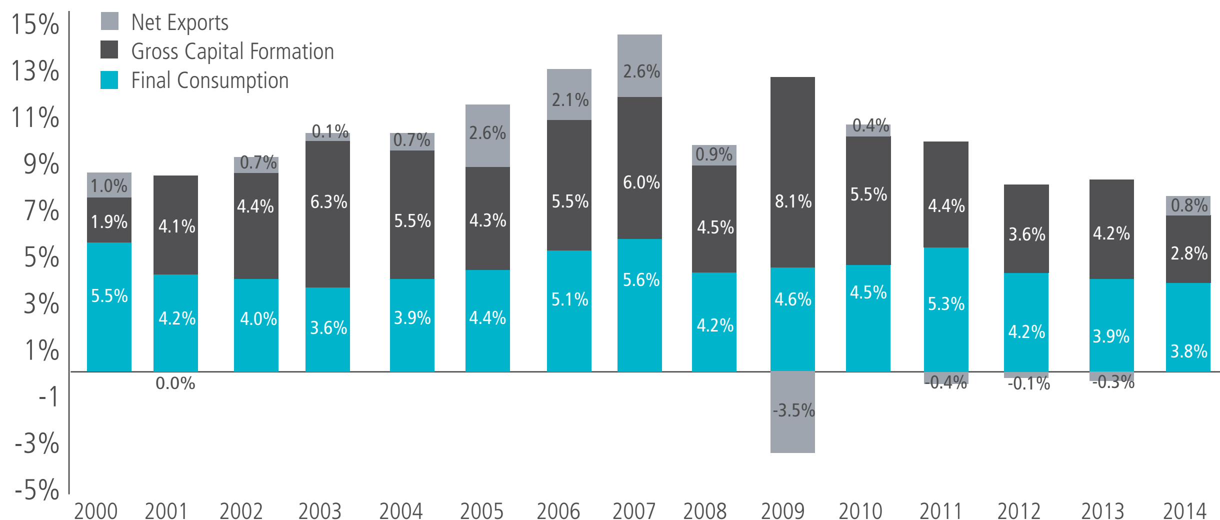
Deleveraging is inherently deflationary as households, companies and countries elect to utilize disposable income, free cash flow and/or government receipts to reduce leverage rather than for consumption or investment. This puts downward pressure on global growth and will continue to do so until the global credit cycle is renewed. That is until households and corporates achieve their desired capital structures and begin to use disposable income and free cash flow to fund consumption and investment.

China's Structural Shift

The second great unwind is China and its transition from a 10% Real GDP growth economy (driven by credit-fueled investment) to an eventual 4% Real GDP growth economy (with rising domestic consumption driven by real wage growth). This structural shift has implications for China but also for China's trade partners that have ramped up their own capacity to supply a Chinese economy growing at 10%.

In 2008/2009 when the global economy was in the depths of a deep recession, China announced an enormous stimulus plan of US $586B. The capital was utilized to drive investment primarily in housing, infrastructure, health and education and represented 16% of then-Chinese GDP. The subsequent investment resulted in dramatic capacity increases in a number of capital and labour intensive industries (including steel, coal and cement) and meaningful increases in raw material imports to feed these growth engines. The result was a surge in Chinese growth that also supported growth in a number of neighbouring nations (Indonesia, Thailand, Malaysia, Singapore, South Korea, Vietnam), commodity exporters (Chile, Canada, Australia) and exporters of finished capital goods (Germany, Japan).

CHINA'S GDP BY EXPENDITURE



Source: NBS, RHIC, 2013 data are prior to latest economic census revisions, since revised expenditure numbers are not yet available. 2014 shares are partially imputed based on official announcement.

However, this level of growth, and the manner in which it was generated, is wholly unsustainable. There are only so many airports that can be built before capacity utilization and returns fall to unacceptable levels (as represented by the black sections on the chart above). So China is now focused on reducing capacity in these same capital and labour intensive industries and shifting employment and growth into industries that generate lower but more sustainable and predictable growth (as represented by the blue bars on the chart above). This transition will see China's growth rate continue to moderate and the current real GDP target has been set at a 6.5% CAGR through 2020.

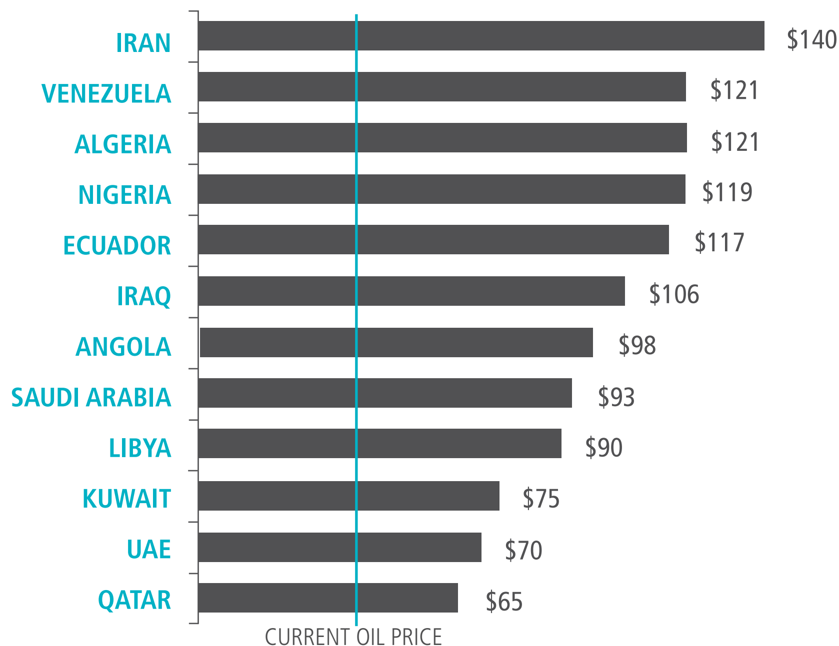
This slowdown will also force other nations to adjust their capacity to support a slower growing China. Nations that sustained themselves by supplying a Chinese economy growing at 10% will have to reduce capacity in their own capital and labour intensive industries to adjust to a Chinese economy growing at 6.5%. This will put downward pressure on business investment and domestic consumption, and growth in these countries will follow China's trajectory down. The collective restructuring will put downward pressure on global growth as China and its satellites drive the second great unwind.

Oil Price Reset

This last unwind is actually a commodity price reset but the most dramatic impact is from the decline in oil prices. Many oil-exporting nations have provided an unsustainably-high standard of living to their citizens, subsidized by high oil prices. Saudi Arabia is the largest and most important member of OPEC and the poster child for unsustainable subsidization. Saudi citizens enjoy free health care, free education, subsidized gasoline, water and electricity and generous unemployment benefits and public pensions. The 2014 Saudi national budget required US $93 oil prices to balance all of this largesse. In 2015 WTI averaged US $48.78 and finished the year at US $37.04, inducing a Saudi budget deficit of US $98B or 16% of GDP.

OPEC BREAKEVEN LEVELS

(Estimated levels of oil price needed for OPEC members to balance their government budgets in 2014)



Source: Wall Street Journal

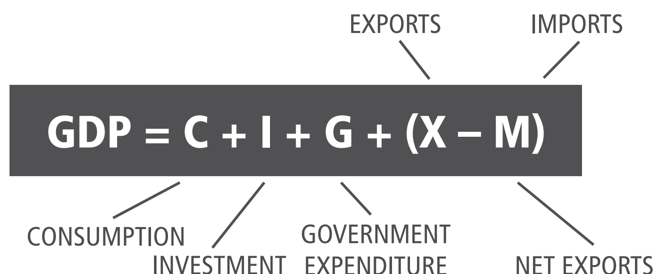
In response, the Saudi government has announced sweeping reforms to reduce this budget deficit. Subsidies on gasoline, electricity and water were all reduced (gasoline prices rose 50%). Privatizations are being studied and the government is co-ordinating regional tax increases on soft drinks and tobacco with other countries. Finally, the implementation of a Value Added Tax is planned and should come into effect over the next three years.

Clearly Saudi Arabia is making plans for a long term oil price materially below US $93. The level of subsidization in the Saudi economy is set to fall dramatically and the standard of living for Saudi citizens is about to fall as they are forced to spend disposable income on basic necessities, leaving less for luxuries. All of this will put downward pressure on growth in Saudi Arabia as government expenditures and consumption are both curtailed. Unless business investment rises to counteract this effect, growth should slow over the next few years. The rest of OPEC and other oil-exporting nations (Russia, Brazil, Canada) will face a similar growth crunch as they are forced to take similar action to reduce budget deficits. Collectively, this will put downward pressure on global growth as these nations reset expenditures based on a lower oil price.

The argument could be made that low oil prices are better for a number of nations that make up a very large portion of global growth. Indeed, the four largest economic regions/countries in the world are all net oil importers (Eurozone, United States, China and Japan), who stand to benefit from lower oil prices. However, the benefits of low oil prices often take longer to be perceived assimilated and acted upon than do the negative effects of low oil prices. So there is a natural delay in delivering the "oil price dividend" that many prognosticators talk about. In addition, the United States and China in particular, have invested heavily in building production capacity, such that low oil prices are less of a benefit to their economies than may have been the case historically. Consider all of the layoffs and deferred investment in the US shale oil industry since oil prices started their descent. Clearly this has had an immediate and negative impact on US growth despite the longer term, overall beneficial impact.

Putting it all Together

The three great unwinds have exerted downward pressure on global growth since 2010 and will continue to do so for several years to come. This decade, governments and central banks must co-ordinate to create the conditions that foster business investment, domestic consumption and overall growth. Remember how the growth math works.



The countries that will navigate the next several years best will be those that marry accommodative monetary policy from the central bank with stimulative fiscal policy from the government. The combination should yield the necessary economic environment to eventually foster higher rates of domestic growth. Ireland and Spain (two of the PIIGS from 2008) are excellent examples of the power of accommodative monetary policy married to stimulative fiscal policy. While the Eurozone is forecast to grow at 1.7% in 2016, growth in Ireland and Spain is forecast to be 4.5% and 3.5% respectively. Contrast that with France which has laboured to deliver stimulative fiscal policy and whose growth has lagged that of the Eurozone as a whole.

The global economy does NOT appear to be headed towards a synchronized global recession with a resulting equity market sell off. Regardless of how long the bull market has existed or how long it has been since our last recession, the economic data does NOT support synchronized global economic contraction. Steep yield curves, expanding PMIs, rising money velocity, lower swap and credit spreads and low energy prices all indicate low but positive global growth. Gradual deleveraging and market reforms should pave the way for more sustainable growth at historical levels in the future. The risk of recession does exist because the absolute level of global growth is low and therefore more sensitive to negative economic events. However, it would likely take several material policy errors by various central banks and/or governments to induce a material global contraction.

When Does it all End?

It ends when the deleveraging of corporations and households ends and the deleveraging of sovereign balance sheets can begin. It ends when China (and its satellite countries) successfully restructure to a more sustainable level of growth. It ends when oil prices more closely reflect fundamental supply and demand pricing and net oil exporters adjust budgetary expenditures to reflect this pricing. Collectively, this should take several more years to accomplish, assuming no material setbacks (i.e. Brexit, German elections) in the interim. However, the markets will not wait for the "all clear" signal. Markets will continue to discount future cash flows and economic data and will likely price in the expectation of improvement before the data confirms it.

In the meantime, global growth should continue to be positive, if below trend. Those calling for interest rate "normalization" (outside of some EM countries) will be disappointed as central banks should remain cautious. "Lowflation" will likely persist and yield curves should remain near historically-low levels. For equity markets, volatility should remain elevated as mixed economic data alternately supports and undermines investor confidence and sentiment. Nonetheless, equities should continue to enjoy favourable costs of capital and low opportunity costs, making them the desired investment of choice for long-term, risk-adjusted returns.

Thanks and **stay focused**,

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