PRIVATE WEALTH MANAGEMENT

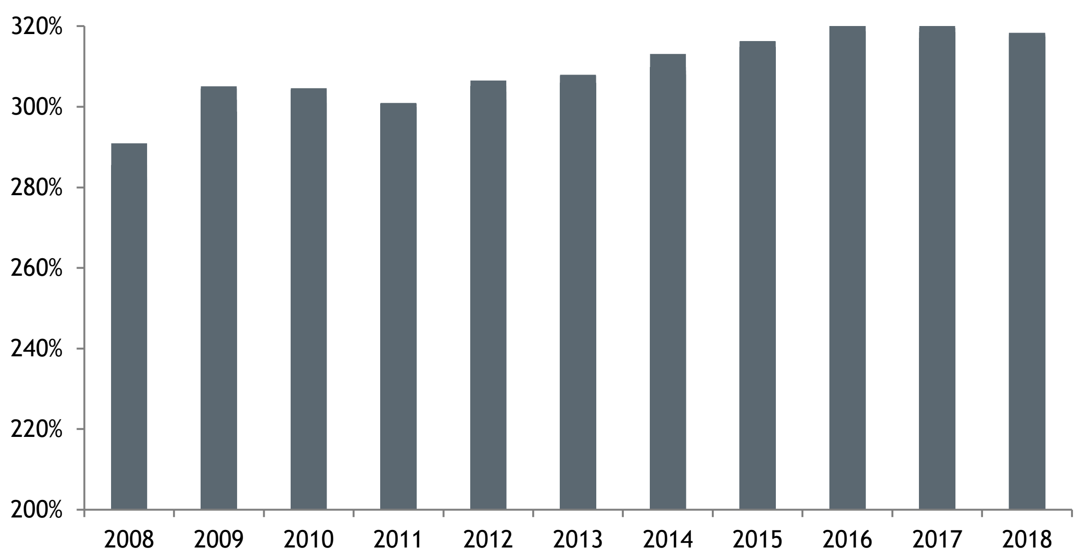
FINANCIAL MARKETS

Is a Global Sovereign Debt Crisis Imminent?

Since the financial crisis in 2008, total global debt levels have swollen to new heights.

According to *The Institute of International Finance*, global debt has grown from $172 trillion in December of 2008 to $243 trillion in December of 2018. However, these trillions of dollars only tell part of the story. The chart below provides a more useful context—global debt as a percentage of global gross domestic product (GDP). This graphic is quite telling in that global debt has not materially outpaced global economic growth, limiting reason for concern to the shock-inducing "hundreds of trillions of dollars of debt" often quoted.

Total Global Debt as a Percentage of Global GDP

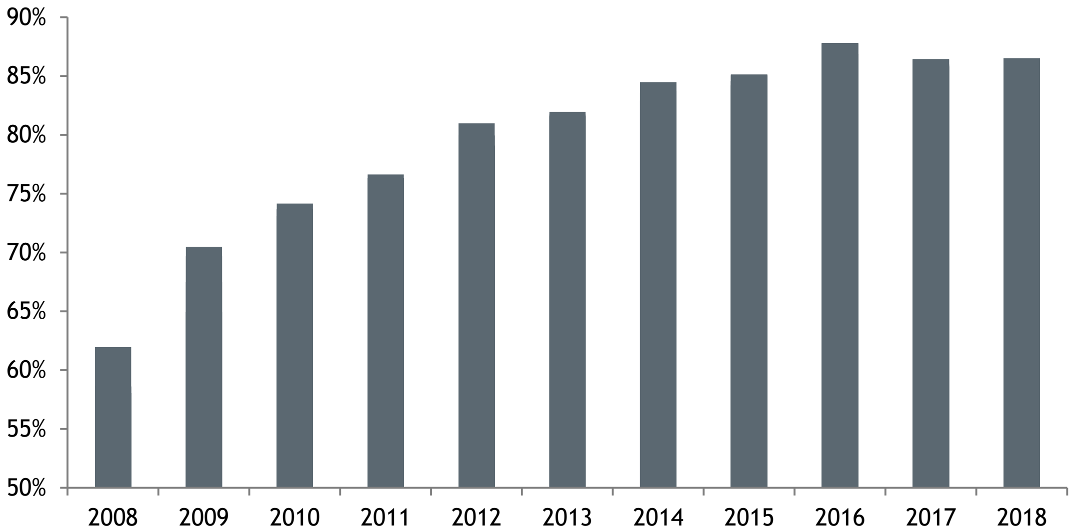


Source: The Institute of International Finance.

While global debt to GDP has only increased marginally, there have been material shifts in the underlying borrowers. Typically, the borrowers are broken out by governments, financial firms, non-financial corporations and households. It is worth taking a closer look at the portion borrowed by governments, also known as sovereign debt.

According to the chart below, sovereign debt was 62% of global GDP in December 2008. Ten years later, that number has grown to 86%—a 39% increase in the level of global sovereign debt to GDP, compared to only a 9% increase in aggregate global debt to GDP.

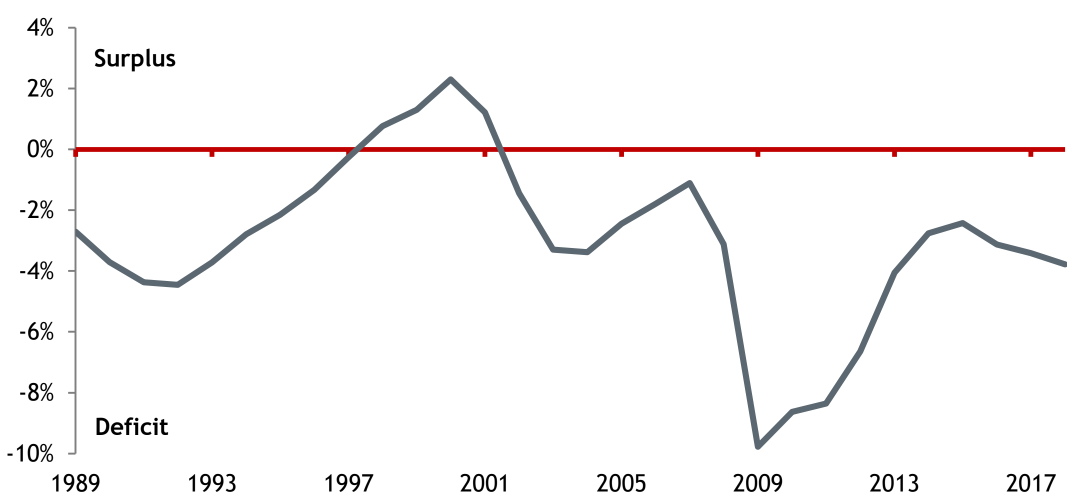
Total Sovereign Debt as a Percentage of Global GDP



Source: The Institute of International Finance.

The growth in sovereign debt over the last ten years began as a fiscal response to stimulate the economy out of the 2008 global recession. In the U.S., the government deficit grew to -10% of GDP ten years ago. It remains around -4% of GDP and growing again, as seen in the chart below.

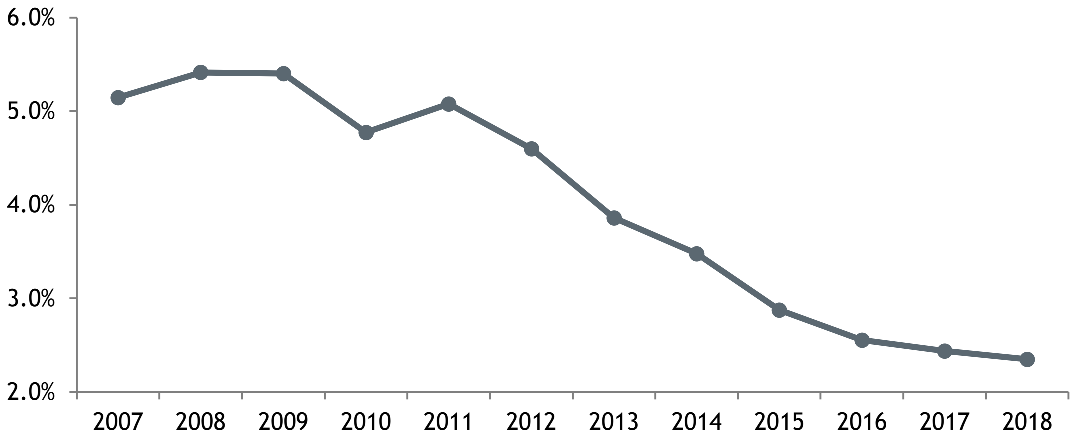
U.S. Government Surplus/Deficit as a Percentage of Global GDP



Source: The Federal Reserve Bank of St. Louis, as of January, 2018.

As deflation became a major concern between 2007 and 2009, central bankers around the world introduced quantitative easing (QE) and extraordinarily low—even negative—interest rates. While global sovereign debt levels may have grown, the cost of borrowing, as seen in the chart below, has reached new lows.

Global Average Interest Rate on 10-Year Government Bonds



Source: The Organization for Economic Co-operation and Development, as of December 2018.

Given the current low cost to borrow, governments in developed economies are unlikely to default on their sovereign debt any time soon. However, in the long run, high levels of debt have the potential to become problematic. If inflation returns, a negative feedback loop could be triggered. Interest rates would rise, leading to higher borrowing costs and slower economic growth, ultimately increasing the debt burden. If this trend also triggers currency depreciation, then potential runaway inflation could exacerbate the problem further.

For the time being, inflation seems to be nowhere in sight, considering most major economies are still battling disinflation. Emerging economies can be less stable at times, especially if large amounts of foreign-currency-denominated debt were issued and currency depreciation starts to accelerate. However, this practice does not seem problematic, since recent debt issuance has mostly been local-currency denominated and/or domestically owned. There are always a few exceptions, such as Argentina and Venezuela, which we consider immaterial on a global scale due to their relatively small economies.

The major near-term risk of investing in sovereign bonds today may not actually be default, but rather the lack of yield. As of August 15, 2019, approximately $17 trillion of outstanding sovereign bonds provided negative yields[1]. The remaining sovereign bond yields have also dropped to levels so low they have been nicknamed “return-free risk.”

While we do not see signs of a global sovereign debt crisis any time soon, the bond market has created a near-crisis for investors seeking yield. ■

1 Bloomberg.

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