Rising Debt and its Potential Consequences: Canada's New Normal?

Crista Caughlin, CFA, Portfolio Manager, Fixed Income
Kevin Minas, CFA, MBA, CAIA, Institutional Portfolio Manager

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Discussion Highlights

- Increasing debt can stimulate the economy in the short term but can have negative longer-term consequences if the debt isn't put to productive use;
- Human psychology tends to cause us collectively to extrapolate good times as going to last longer than they will, and this builds large excesses into the system;
- Eventually, those excesses have to be addressed and deleveraging can be a painful process;
- Canada has become particularly indebted by global standards at a time where the cost of servicing debt is sharply rising; and
- We share some potential economic and investment implications in a highly indebted world that has returned to a real cost of capital.

We continue to live in a world with too much debt. Although this is not a new phenomenon and is likely to continue, we need to understand how changes in debt impact both the economic and financial market outlook. In essence, we need to understand where we are in the debt super cycle to inform our investment decision making.

Debt matters because all else equal, it pulls forward future spending. How? Well, borrowing today means spending less than you make in the future so you can repay the debt. When households, corporations, and governments are increasing leverage (taking on more debt), economic growth is better than it would be otherwise because spending levels are boosted. By the same token, if households and corporations are attempting to deleverage (paying off their debt), spending is cut, which slows down growth. Therefore, changes in debt levels matter for expected changes in future growth, which is an important input to understanding changes in inflation, interest rates, currency movements, and company revenues and valuations.

Given the knock-on effects changing debt levels have on asset prices, it's a critical topic investors need to consider when constructing resilient investment portfolios. In this paper, we will focus primarily on Canada to highlight the current concerning debt and credit backdrop, but it's worth noting that elevated and fast-growing debt levels are also a global phenomenon.

Global Debt Overhang

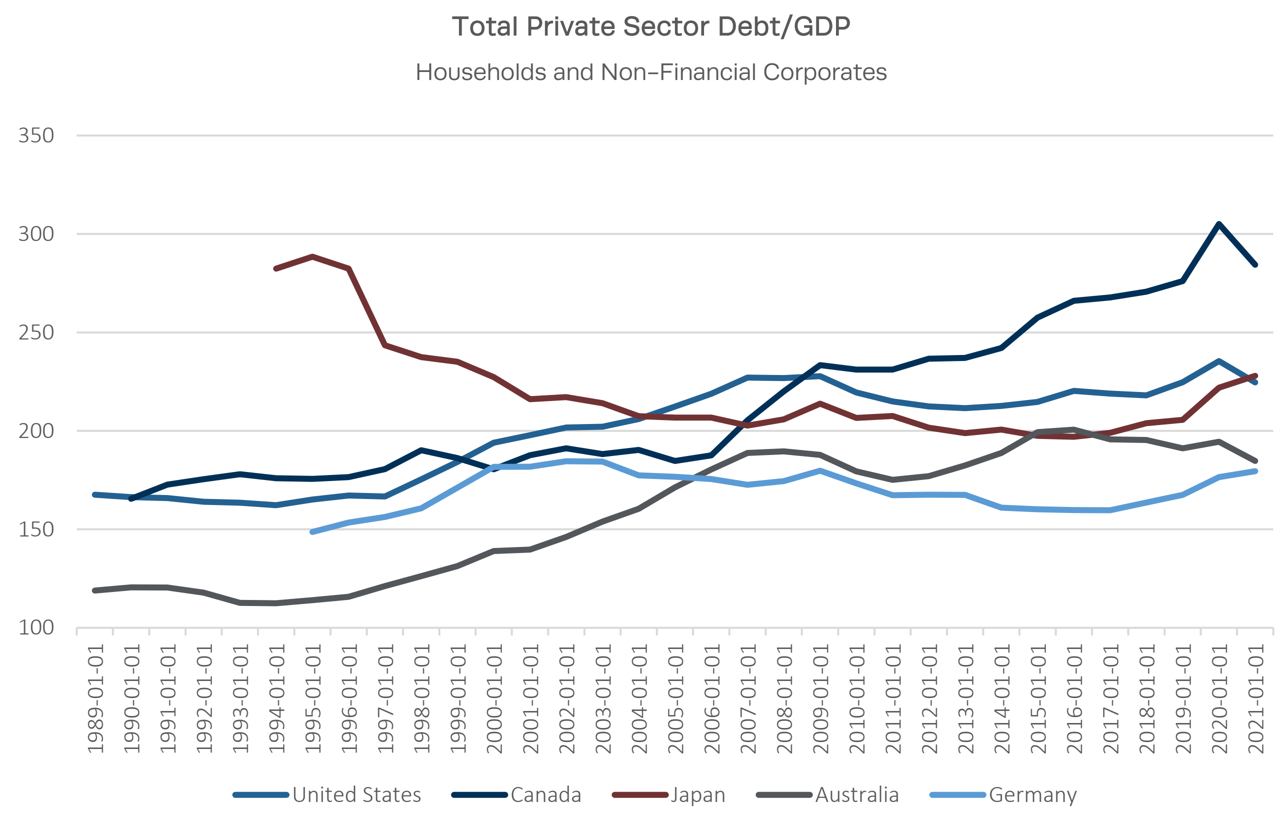
We should start by saying, debt (borrowed funds) and the related concept of credit (the lending of those borrowed funds) are not inherently bad. In fact, lenders extending credit to borrowers is a normal and healthy part of a well-functioning economy. Consider the case of a small business owner who needs a loan to set up their operations. Provided the firm can generate income over time sufficiently high enough to cover the cost of the debt and pay down the principal, the extension of credit can have a positive net effect on society through creating employment, a source of tax revenue, value customers derive from consuming the services of the business, and so on. What's key is the proceeds of the loan be put to productive use (at least in aggregate across many loans).

Central banks play a key role in the credit creation process through two primary transmission mechanisms. The first is through adjusting the overnight interest rate (the price of debt). Raising interest rates makes debt more expensive, and like any other "product," higher prices lowers demand. The second mechanism is buying and selling financial assets to remove or add money from the financial system (the quantity of debt). For example, if a central bank buys assets it will do so by printing new money to pay for the asset. That newly printed money will make its way into the financial system, and banks and other lending institutions will use the capital to issue loans to earn a rate of return on the capital, thus increasing the supply of debt/credit. Conversely, credit contracts through the reversal of these processes when interest rates are raised, or assets are sold by the central bank.

Policy makers collectively tend to err on the side of being too loose with credit (lower interest rates, buying financial assets) because of the short-term benefits of faster growth. Low or falling interest rates stimulate the economy by 1) raising asset prices and people's feeling of wealth (lower discount rates increase the present value of future cashflows); 2) increasing consumption -financed debt; and c) reducing debt-service burdens (which improves cash flows and the ability to spend).

In the long run, there isn't necessarily a maximum level of debt for a country, provided it manages its own currency. In theory, countries/households/corporations can continue increasing their debt levels if there is accommodative monetary policy (money printing by the central bank which is used to pay off maturing debt). However, there is a level where debt is no longer sustainable—that is, where the negative consequences of debt growth overwhelm the benefits. This level is a function of the size of the debt outstanding and interest rate paid on the debt. All else equal, more debt and/or higher interest rates make increasing the total level of debt less sustainable.

Having provided the technical details of a debt cycle, what has been the trend in debt levels globally? As shown below, in a nutshell: up and to the right!



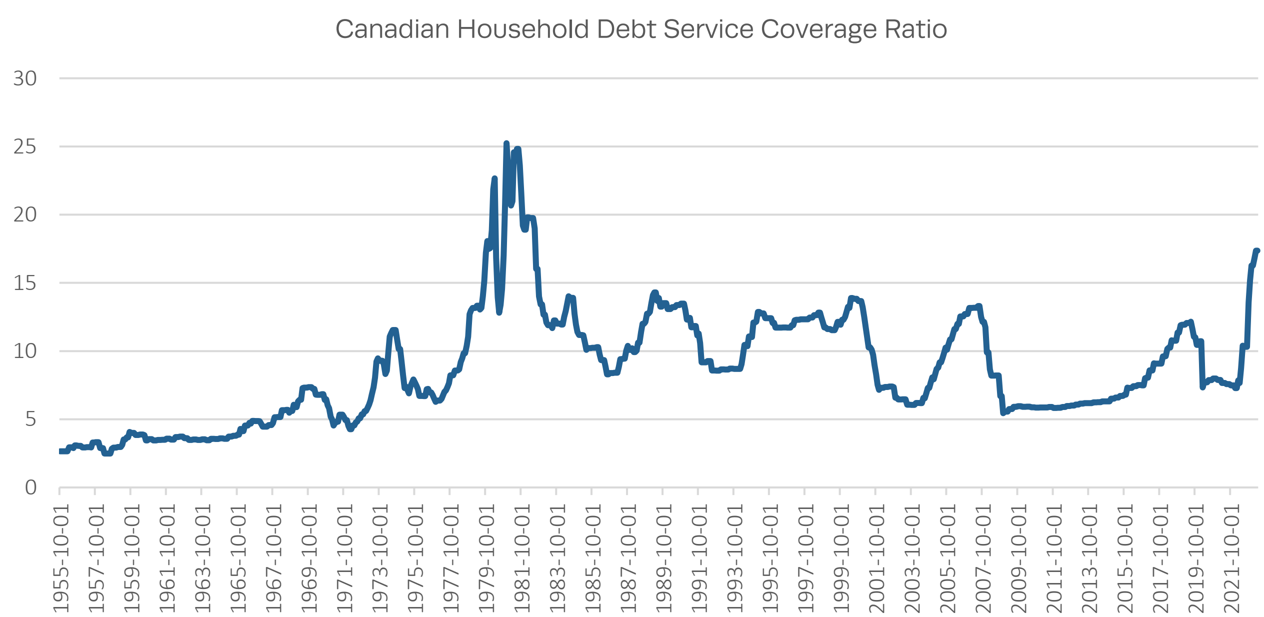
Source: MACROBOND

The Canadian Debt Situation

Post the 2007–2008 financial crisis, the Bank of Canada kept interest rates around 1% for a decade, consistent with many central bank peers globally. Despite this low cost of debt—or perhaps, in part, because of it—Canada saw no deleveraging after 2008. In fact, it saw an increase in leverage, particularly in the private sector (both household and non-financial corporations) to the point where we now have some of the highest levels of indebtedness in the developed world. One could argue taking on debt was prudent against a global backdrop of cheap financing costs (under the big assumption that the proceeds of the debt were being put to productive uses, more on this shortly) but what would happen if the cost of the debt materially and rapidly increased?

Well, we don't have to imagine the situation as we're now living through it. Over the last year and a half, we have seen the largest tightening of financial conditions since the 1980s—from the rapid and outsized increase in interest rates coupled with the highest debt levels ever.

At the current level of interest rates, the household debt service ratio (the ratio of total required household debt payments to total disposable income) has hit a level not seen since peak levels in the early 1980s when interest rates were close to 20%. In other words, despite interest rates being several times less than in the 1980s, the average Canadian household is already financially stretched to a near-record degree. Canada has reached a level of private sector debt historically associated with "financial crisis" type outcomes. Imagine if rates continue an upward path from here because inflation remains stubbornly sticky!



Source: MACROBOND, Mawer Investment Management, assumes all debt has to be refinanced at current levels

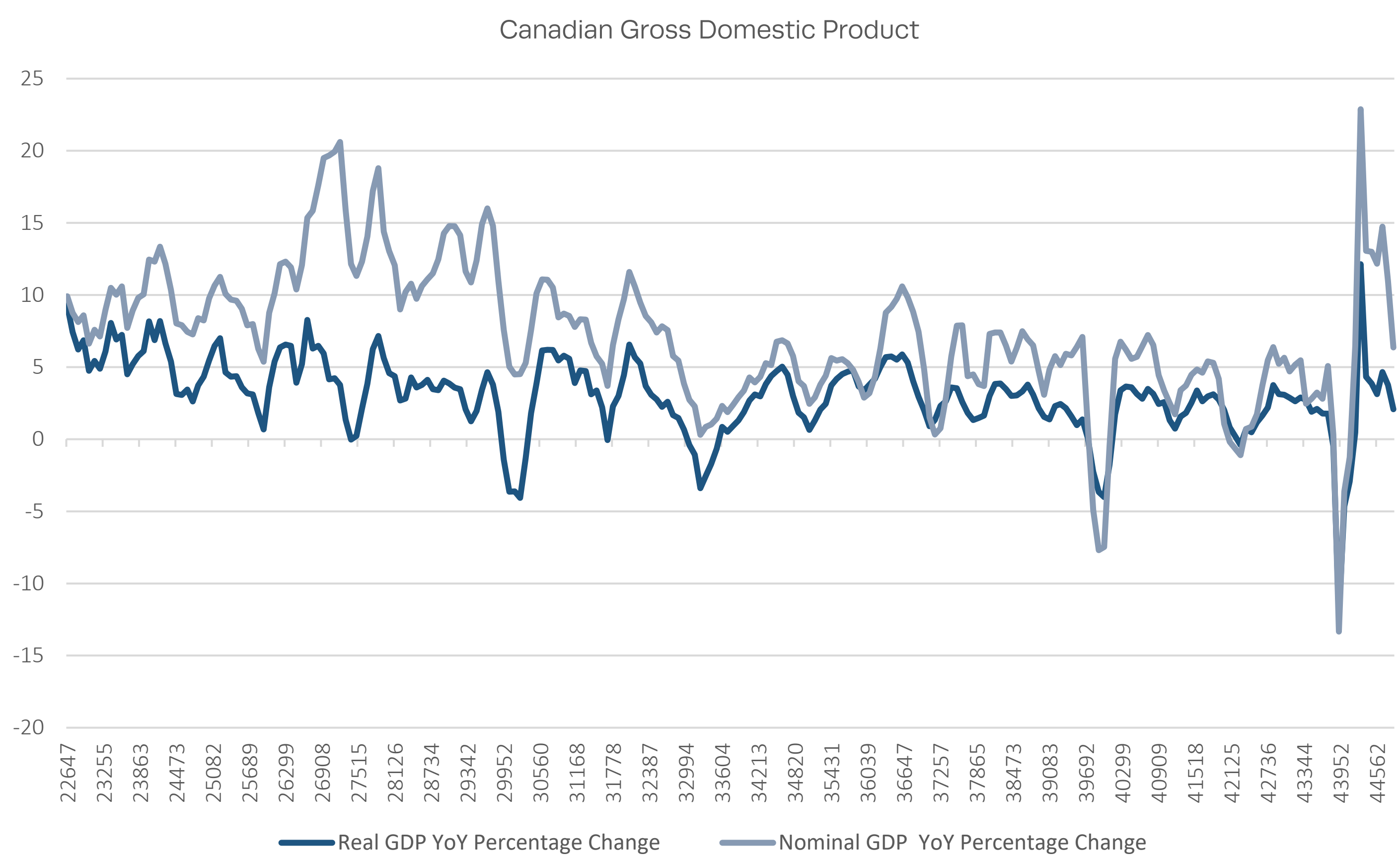
One implication is we are likely getting to a debt saturation point where households and corporations will grow increasingly uncomfortable adding more debt unless interest costs moderate. If the change in debt levels is a driver of growth, then (all else equal) it would mean less growth going forward. Another implication is when existing debt must be refinanced, higher interest rates can change the economics of a lot of balance sheets and the amount of debt lenders are willing to extend. In other words, borrowers' ability to refinance their debt could be impaired. These vulnerabilities will weigh on central banks as they consider future monetary policy.

Where Does Canada Go From Here?

As we mentioned earlier, there isn't necessarily an upper limit to the total amount of debt a country can accrue if it controls its own currency. What gets a country into trouble is a growing cost of servicing its debt relative to income levels. At a country level, this equates to interest expense versus gross domestic product (GDP) growth.

We've talked a lot about the interest expense side of things, so what about GDP growth? A primary way of solving the debt overhang problem is growing your way out of it, which would mean seeing consistent increases in wages and nominal growth (nominal growth includes the effects of inflation whereas "real growth" considers GDP growth with constant prices). Over the last two years, we did see a boost in nominal growth in Canada, which made the increased debt more palatable in the near term. However, as the stimulative and inflationary effects of outsized monetary measures and government support of the economy subsided in 2022 into 2023, we're seeing nominal growth move back closer to the long term as shown in the chart below (the light blue line). Also note that the long-term trend in growth rates (both nominal and real growth which is the dark blue line) have been trending downward in Canada for many decades despite ballooning debt levels. In other words, the marginal benefit of debt has been falling, which suggests we're not getting a lot of bang for the marginal debt-fuelled buck.

Canada GDP Breakdown



Source: MACROBOND

Worse still, what might happen if Canada enters a recession? GDP growth would go negative; inflation, which is already trending down, would continue falling; and government deficits would increase, meaning more debt financing. The net effect of all this would be an even tougher economic backdrop for digging ourselves out of trouble than the past few years, where economic growth was decent. At least, on a nominal basis.

In summary, to make existing debt levels more manageable, there needs to be economic growth to boost income and the ability to pay down debt, or a lower debt cost to decrease the servicing costs and have more income go to debt repayment. It would also help for inflation to moderate and then remain stable so that central banks aren't forced to maintain an aggressive stance on interest rates to fight elevated and unpredictable inflation levels while also inflating away the value of existing debt.

This type of goldilocks environment where growth is meaningful but without spurring rampant inflation is known as "beautiful deleveraging." In other words, debt levels would be reduced over time in a minimally economically disruptive manner. Beautiful deleveraging is hard to engineer though, and counting on outsized economic growth in Canada (which hasn't happened in decades), would likely require some significant technological breakthroughs to boost productivity. That's certainly possible, but hard to predict or bank on.

Economic Implications

If our thesis that Canada is approaching concerning levels of debt in a world that's returned to a real cost of capital resonates, then several, related economic implications also follow:

Interest Rates: All else equal, increased debt levels require interest rates to be lower to keep debt servicing costs manageable.

Monetary Policy: The larger the debt builds, the more asymmetrical monetary policy becomes. Policy must be much easier (lower rates) to boost growth and entice people to borrow, whereas it needs to tighten less to slow growth. The result is lower interest rates than there would have been otherwise in both scenarios.

Growth: By definition, debt pulls growth forward. Where we are at in the debt cycle will determine the growth implication. If we continue down the path of (attempted) deleveraging post COVID, we should expect to see lower growth levels.

Volatility: We should expect increased pockets of volatility as high debt levels mean any downward shock can be greatly magnified. We saw this recently in the banking sector with the spectacular collapse of several regional banks in the U.S. and the central-bank-orchestrated rescue of Credit Suisse. The higher rates go, the more vulnerabilities get exposed and the more central banks must intervene to stem issues caused by their own aggressive monetary policy.

Investment Implications

There's a phrase you'll often hear repeated amongst our Research team: "prepare, don't predict." What we mean by this refrain is, that while being aware of the overall macroeconomic backdrop is important, consistently predicting and correctly positioning for every market gyration is a very difficult, if not impossible, task. Instead, the unifying, guiding themes of our investment approach are to ensure balance, discipline, and long-term thinking to create and maintain resilient portfolios that will do well over time—regardless how macroeconomic concerns play out.

To that end, the main investment implications we see associated with current Canadian and global debt levels and how we are managing for them, include:

> **Future long-term return expectations:** Less tailwinds than in the past and a potential moderation in return potential broadly across asset classes. For much of the period post Global Financial Crisis, markets were flooded with central bank liquidity. Much of this liquidity made its way into the financial markets, elevating risk asset prices and thereby investment returns. If we see a moderation in liquidity levels, this previously positive catalyst for risk assets recedes.
>
> At the same time, the long-term secular decline in interest rates which started in the 1980s and persisted until 2022 boosted fixed income returns through capital appreciation. A return to a more normal cost of capital diminishes some of the capital appreciation potential for fixed income—though higher interest rates improve income potential, which acts as a partial offset and restores some of fixed income's diversifying properties.
>
> **International diversification:** Hedge idiosyncratic risk in one region, country, sector, and company with broad diversification, preferably on a global basis to have the widest opportunity set possible. Diversification is the one free lunch in investing.
>
> **Equities:** Focus on wealth-creating businesses with defensible competitive advantages and rational capital allocation and balance sheet policies. In other words: invest in companies that are positioned to have higher odds of coping with and succeeding in a variety of future states.
>
> **Credit:** Avoid reaching for yield. Meaning, don't take on incremental risk without incremental return potential. For example, we have been avoiding the debt of companies with negative free cashflow and those that are borrowing to pay dividends as we don't feel the credit risk premium is high enough to compensate for the risk.
>
> **Alternatives:** Consider expanding the investable universe to include alternative asset classes like private equity and private credit. These and other alternatives can add capital appreciation, income, inflation protection, and diversification benefits to portfolios—though often with greater complexity, higher fees, and less liquidity.

Conclusion

Incentives drive behaviour, and though debt serves a useful function in society, Canada and many other countries around the world are reaching alarming levels of indebtedness thanks in large part to years of easy monetary policy. While very little can be done at an individual level to change where we are in the debt super cycle, as investors, we can make better-informed decisions and intentional adjustments at the holding and portfolio level through careful observation of this powerful cycle. As we like to say, put the investment odds in our favour by focusing on the things we can control: building diversified, resilient portfolios that can withstand any "new normal."

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