SCS FINANCIAL
Strategic Capital Solutions

INVESTMENT PERSPECTIVES

MAY 2016

SOLVING FOR THE GLOBAL DEBT OVERHANG

BY STEVE ORISTAGLIO, PRESIDENT & CO-CHIEF INVESTMENT OFFICER

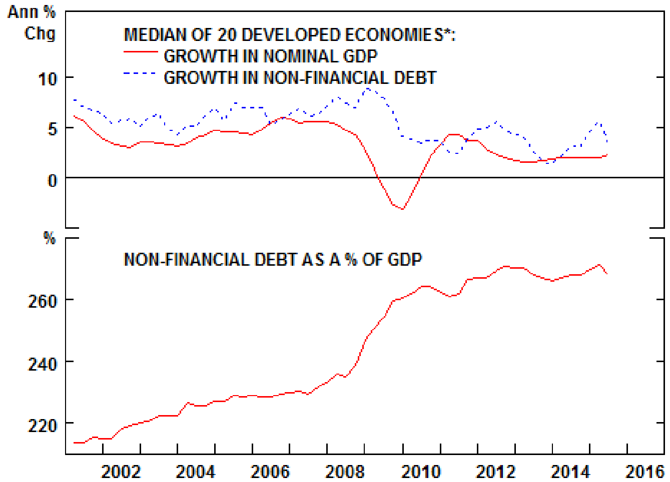
Overview: Global debt has been an important catalyst for economic growth and wealth creation for hundreds of years. Ample credit flow in the early stages of the debt cycle fuels consumption and investment that allows an economy to expand, typically at high growth rates. But there are limits to debt's use as a lever to propel an economy forward, as we have seen periodically over the past 50 years and culminating in the 2008 financial crisis. Debt levels reach a point where they are no longer sustainable and an economic contraction becomes inevitable, leading to steep asset price losses. Steps must then be taken by all parties to reduce debt loads in an orderly deleveraging so equity and credit market returns can normalize. Today, we are in the late stages of the debt cycle and levels have come down only modestly. According to BCA Research and outlined in Exhibit 1, progress in reducing debt in developed countries has been minimal, with total debt-to-GDP ratios holding at record levels or rising further.[1] The growth of debt has slowed but remains at a secular high of 270% of GDP, BCA found. The global debt overhang remains a critical problem to solve, and one that remains the single greatest challenge to economic growth and asset class returns for the next five to 10 years.

We believe there is a path forward to reduce global debt levels that reduces many of the negative impacts of deleveraging. It heeds the painful lessons of history by eschewing the extremes of severe austerity or excessive debt monetization, which can lead to depression on the one hand or hyperinflation on the other. Instead it takes a balanced approach that encompasses a variety of sensible monetary and fiscal policies discussed in this paper to help maintain economic growth while avoiding recession. This prudent mix of strategies helps avoid a downward spiral in risk assets and growth, and alleviates other adverse investment implications. However, investors must accept that deleveraging periods take place over many years, along with lower economic growth rates and equity and credit returns that are below their long-term averages.

This piece will explore four phases of the debt cycle and their investment implications; how we can successfully navigate forward from where we are today; and SCS's views on how to optimize asset allocation.

Growth Period–When Debt is a Catalyst: Alexander Hamilton once said that national debt, as long as it is not excessive, is a national blessing. Debt is an important catalyst in economic expansions because one person's debt is another person's income. It allows consumers to buy homes, companies to expand their business lines and governments to build highways. More consumption and investment helps create more jobs and raise income levels, all of which are key to GDP growth. Prudent use of debt by companies and other entities creates an ideal capital structure between debt and equity that allows them to efficiently grow and reach their optimal potential. The ability to borrow is emblematic in economies that are growing the fastest. But debt must grow in an equilibrium where incomes are rising faster than the

Exhibit 1: Global Debt Levels Remain High and Have Only Recently Begun to Come Down



Source: BCA Research, data as of 6/30/15.

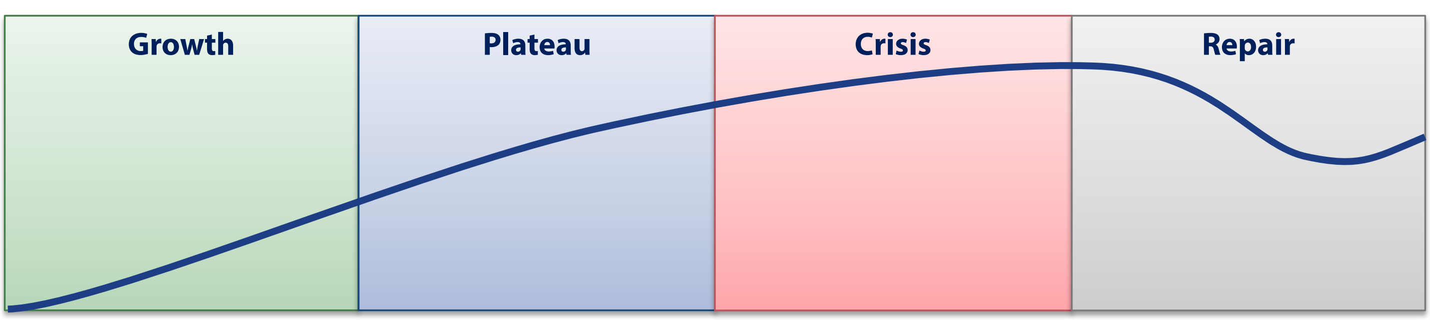
costs to service the debt. Capacity (the output of goods and services) must remain at the right levels, not too loose or too tight, to prevent weak demand or painful inflation pressures. As long as incomes are rising faster than debt, economic expansion can continue, often transforming a society.

There are many notable instances throughout history of countries experiencing profound growth due to credit creation, in both emerging and developed economies. China over the past decade went from a virtually nonexistent bond market to the third largest in the world, with over $7 trillion in public and private assets and annual GDP growth that has averaged around 10%. In another example, the GI Bill in the US after World War II provided returning veterans with low-interest mortgages and business loans that promoted years of healthy debt creation and dramatic expansion of the middle class. Investors during such growth spurts benefit from a favorable backdrop for all asset classes, with strong performance in both equity and credit markets. High growth rates during these periods are a catalyst for risk assets, with return on equity (ROE) growth that is well above debt costs.

Plateau Period–Debt Keeps Growing While the Economy Slows: But the good times cannot go on forever. The cycle hits a turning point when economic growth inevitably slows but debt levels keep rising as greed takes over and spending becomes inefficient. Consumers buy the second homes they can't really afford and load up their credit card balances. Companies stretch too far with loans to build new facilities and move into new markets, hurting their cash flows. Banks loosen their lending standards and keep creating more credit products as borrowers use increasing amounts of leverage. Incomes level off in the slowing economy and they eventually get to the point where they are no longer sufficient to cover the ever-rising debt costs. Consumers and companies feel the squeeze so they cut their spending and start saving more. Economic challenge becomes inevitable as ROEs fall short of debt costs and demand for goods and services and financial assets (e.g., stocks, bonds, commodities, real estate) starts weakening. GDP growth and asset prices plateau at the same time as debt-to-income ratios creep higher. Investing becomes more challenging as slowing growth becomes an insurmountable drag and markets become increasingly inefficient. Equity prices peak and become increasingly volatile, and credit spreads widen meaningfully.

Crisis–When the Bubble Bursts: The debt cycle is self-reinforcing on the way up and the way down. Crisis periods happen when asset bubbles burst and cause extreme pain for the financial system. Bankruptcies and defaults hit hard, stoking negative sentiment for borrowers, lenders and investors. Uncertainty feeds on itself and liquidity dries up. A notable recent example of this was during the 2008 crisis, when global equities lost half their value and credit spreads reached their widest levels in history. Banks were forced to write down billions in bad loans from mortgage delinquencies and hundreds of banks collapsed or went into bankruptcy. Millions of consumers lost their homes or their jobs, or both. Over $34 trillion in wealth was destroyed, representing more than the 2008 combined annual GDPs of the US, the European Union and Japan.[2]

The Global Debt Super Cycle



When Debt is a Catalyst

Debt fuels consumption and investment, helping to create jobs and raise income, which are key to GDP growth.

Debt Keeps Growing While Economy Slows

Growth slows as spending becomes inefficient. ROEs and incomes fall short of debt costs and demand weakens.

When the Bubble Bursts

Asset prices fall sharply as liquidity dries up, with extreme pain for the overall financial system.

Deleveraging Phase

Debt is a headwind to growth but an orderly deleveraging can be achieved through balanced fiscal and monetary programs.

These stages of dramatic upheaval are usually short-lived because governments and central banks quickly step in, although not always successfully. For example, severe austerity may seem a logical step since it attacks the root cause of the bubble bursting – excessive borrowing and spending. But steep government spending cuts can backfire, as we've seen in Greece: unemployment rises as spending and incomes fall sharply, causing corporate and government revenues to drop sharply. Deficits actually move higher, not lower, resulting in worsening debt-to-income ratios, and ultimately, depression. Extreme debt monetization has also been used by various countries over the years but it tends to lead to very high inflation or even hyperinflation, as seen in the flawed policies of Germany's Weimar Republic in the 1920s and numerous Latin American countries in the 1980s and 1990s, including Brazil and Argentina. Investing in crisis periods remains challenging as equity and credit markets experience extreme dislocations and investors seek safety in Treasury bonds in an environment of fear and volatility.

Repair Phase–How an Orderly Deleveraging Happens: History has shown there is an ideal way for an economy to restore growth above debt obligations, with the ultimate goal of generating wealth. In our view, an orderly deleveraging encompasses five key areas of fiscal and monetary programs, as seen in how the US navigated out of the 2008 crisis. First, accommodative central bank policies, including a reduction in interest rates and asset purchases, help to reduce debt levels and lower the exchange rate. Lower interest rates help lower the costs of debt, while a weaker currency helps to spur trade, which all helps offset the deflationary forces of sluggish growth, flat spending and below-target inflation. Second, there must be some austerity via reduction of wasteful spending by households, companies and governments to repair balance sheets and restore healthier debt-to-income levels. Third, there must be some prudent fiscal spending, typically on infrastructure or other projects, to provide an important infusion to the economy. It may seem counterintuitive to suggest more spending at a time when debt levels and budget deficits are cresting, but productive initiatives help to boost employment and incomes and contribute to higher government revenue levels at a time when they are desperately needed.

Exhibit 2: Investors Should Expect Muted Growth and Inflation During Late Deleveraging

	Historical Averages	Late Deleveraging Forecast
Inflation	2%-4%	0%-2%
Cash	3%-4%	0%-1%
Bonds	4%-5%	2%-3%
Credit	6%-8%	4%-6%
Real Assets	7%-8%	0%-4%
Public Equities	8%-10%	5%-7%
Private Equities	13%-15%	10%-12%

Fourth, there must be some debt restructuring and defaults that allow overleveraged entities to return to more optimal capital structures or to be wound down, and cleanse the system of the worst offenders of irresponsible borrowing. Finally, there must be some moderate transfer of wealth through selective tax increases that help support government budgets. Philosophically this puts us in the camp of economist John Maynard Keynes, who espoused low rates and fiscal spending in these periods as the best way to counterbalance a deflationary spiral, versus his counterpart Friedrich von Hayek, who criticized credit expansion in favor of higher saving rates and other austerity methods. Taken together and in the right combination, we believe these strategies allow various constituents to methodically get their balance sheets in order so the cycle can reset and begin again, which brings us to where we are today.

Investment Implications of Deleveraging: The early years of an orderly deleveraging usher in a period of rapid asset price growth where equity and credit markets rise sharply. For example, between 2009 and 2014, the S&P 500 Index returned 17%, with real earnings growth of 11%, on an annualized basis. Credit markets also roared back as liquidity returned, with spreads narrowing (improving) and strong returns across mortgage-backed securities, high yield and investment grade corporates. In the tense days following Lehman Brother's collapse in September 2008, governments and central banks did their job in igniting a wealth effect in a matter of years that allowed risk assets to recover from levels we had not seen since the Great Depression. Yet deleveraging is not a quick solution. Given the historic levels of debt today, it could take years to offset deflationary forces and allow income levels to rise back up above debt servicing costs for a long enough period to restore debt-to-income ratios. Research by economists Carmen Reinhart and Kenneth Rogoff backs this idea. They looked at instances of high debt levels between 1946 and 2009 and found that mean growth rates were about 4% lower for countries with debt-to-GDP ratios above 90%.[3] They found the trend evident over long periods as well: over 200 years countries with high debt saw mean growth rates of 1.7%, versus about 3.7% for countries with debt levels under 30% of GDP. We thus expect that deleveraging will continue to be a consistent drag on growth and asset prices, with more muted equity and credit returns for the next five to 10 years. As outlined in Exhibit 2, on page 3, inflation and asset returns are expected to be below their historical averages.

While our asset allocation and investment programs reflect these parameters on asset returns, we are also closely assessing the risks that come along with deleveraging. In the US, if the Fed were to raise rates too quickly it could send the global economy into another recession. With rates already at historic lows and growth and returns very muted, central banks in general will have a severely weakened ability to stimulate economies, which is a significant tail risk. China's robust housing and credit markets (discussed below) could develop into bubbles that could also trigger global recession. However, as long as the world pursues these deleveraging policies in a balanced way, with healthy participation by all stakeholders, returns can remain positive, albeit at lower levels than historical averages. We also believe skilled active managers may be able to do meaningfully better than these expected results given their ability to generate alpha. We have remained focused on balanced asset allocation without any major shifts given return forecasts are still reflecting the scaled risk premiums in which cash returns are projected to be less than Treasuries, which are less than credit, which are less than equities. Tactical moves within asset classes will continue to be very important to manage opportunity and risk in a more volatile environment.

Where the Major Economies are in the Debt Cycle: We have only just begun to see debt levels come down in select areas of the global economy, and much more needs to be done. Households in the countries that were hit hardest in the crisis have done the most to lower their debt burdens, as have banks and financial services companies. Governments who stepped in to come to the rescue are now deeply in the red due to bailouts and falling tax revenues: between 2007 and 2014 global government debt increased by over 40%, to $58 trillion, according to research from McKinsey.[4] Below is a quick snapshot of where the major economies of the US, Japan, Europe and China are in the debt cycle.

US – In Good Shape

- The US has made the most progress in deleveraging post-crisis through successful quantitative easing
- Incomes have risen and U.S. households have seen the greatest reduction in debt-to-income ratios
- However, corporate leverage has been rising at a moderate but unsustainable rate and the energy fallout could lead to higher default rates

China – Still in the Early Innings

- China has initiated significant policies to fuel credit expansion and economic growth over the past decade
- China's growth potential is still high despite government debt levels equivalent to those of developed markets
- While there are many excesses in China, the country has the economic potential, the tools, the reserves and the will to execute a balanced deleveraging

Japan – Needs to Keep Going

- Japan has faced deflationary forces for more than 20 years and continues to have a massive debt overhang
- A strengthening yen has stalled the recovery process and the recent BoJ move to negative interest rates has been met with mixed reviews
- Policymakers must continue fiscal stimulus, monetary easing and structural reforms

Europe – Must Avoid Japan's Mistakes

- Debt levels have continued to rise as countries have not received enough stimulus and inflation is stuck near zero
- Like Japan, the rally in the euro has stalled the recovery and efforts by the ECB have fallen short
- The region should pursue reflationary policies more aggressively, including much-needed fiscal spending

Conclusion: The global debt overhang is one of the key challenges facing investors today, with significant implications for markets and economies. We have seen only selective deleveraging and much more needs to be done. We advocate a balanced approach with a mix of sensible fiscal and monetary policies, including productive activities from not just central banks, but governments, companies and households. While an orderly deleveraging will take years, with slower growth and muted returns in the later years, a sound understanding of risks and opportunities in this natural progression of the cycle can help investors to reach their long-term objectives and wealth goals.

Next: *A closer look at the global economy's major players – the US, Japan, Europe and China. SCS explores the other top issues each faces. Visit scsfinancial.com to follow this series and read more Investment Perspectives pieces published by our investment team.*

SERIES OVERVIEW

Investors today are facing challenging market and macroeconomic conditions that could tip the global economy into recession or allow it to maintain a positive, healthy uptrend. In this new series, SCS explores what it considers to be some of the essential questions facing world capital markets today.

- *The global debt super cycle*
- *Top challenges facing the global economy's major players*
- *Geopolitical considerations*
- *Global equity and fixed income valuations*
- *Investment and asset class considerations*

REFERENCES

[1] *BCA Research, Jan. 4, 2016. "The Debt Overhang: Where are We Now?"*
[2] *Roosevelt Institute, "The Crisis of Wealth Destruction." April 7, 2010.*
[3] *Carmen Reinhart & Kenneth Rogoff, "Growth in a Time of Debt," Jan 2010.*
[4] *McKinsey Global institute, "Debt and Not Much Deleveraging," Feb 2015.*

IMPORTANT DISCLOSURES