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Independent Thinking

Recession Watch: leverage spotting

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Andrea Zazzarelli

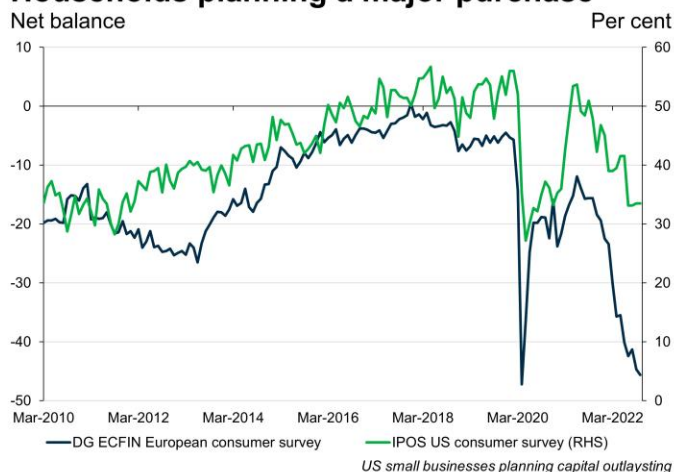
Headlines

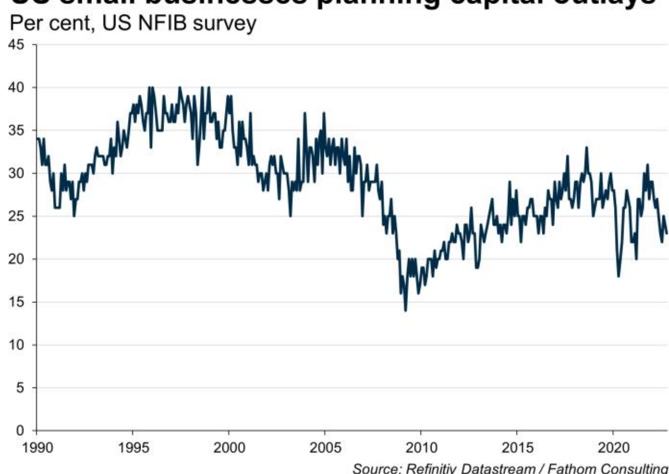
- A recession usually follows periods of high inflation and higher rates due to a slowing credit cycle
- Both the demand for and supply of credit are showing signs of weakening, particularly the former
- It is leverage that determines the vulnerability of an economy to a shock, and leverage can increase because of high debt or falling asset values, or both
- High inflation and higher rates pose a significant risk to asset values, and thus could trigger sudden and aggressive episodes of deleveraging
- QT poses the highest risk, due to its untested nature and its potential to reverse a decade and a half of market-friendly 'portfolio rebalancing' effects

I remember a former colleague telling me that it is a lot easier to sound smart by peddling a negative view than a positive one. There is some truth to this, though I have always disagreed with the premise that sounding smart ought to be the primary objective of a research note. My previous Recession Watch piece (on the potential triggers for contraction in Europe – you can read it here) was quite gloomy, so to balance it out I shall try to strike a more positive note here.

A good place to start would be to clarify that, in principle, taming inflation through higher rates does not necessarily have to mean causing a recession. The observation that higher inflationary periods have been followed by recessions almost as night follows day misses some important economic dynamics. The credit cycle is key in this regard. Higher rates reduce inflation by slowing down the demand for and supply of credit, which, in turn, weakens consumption and investment.

Higher rates discourage new borrowing and make existing debt more expensive, displacing resources away from consumption and investment. Recent surveys point to weaker household intentions of making large purchases, and fewer US corporates say they plan significant capital expenditures over the next three to six months.





Higher rates also curtail the supply of credit by increasing the constraints on bank balance sheets, which in turn lead to a slowdown in the credit multiplier. Signs of tightening credit supply are less obvious than those of weakening demand. Growth in lending so far remains robust, although the monthly survey by the US's largest small business trade federation, NFIB, points to an increasing share of businesses finding it harder to access credit. Also, the spread on banks' contingent debt (which converts into common equity if banks' capital adequacy ratios drop too low) has started to rise in 2022, a proxy for a more constrained operating environment for banks.

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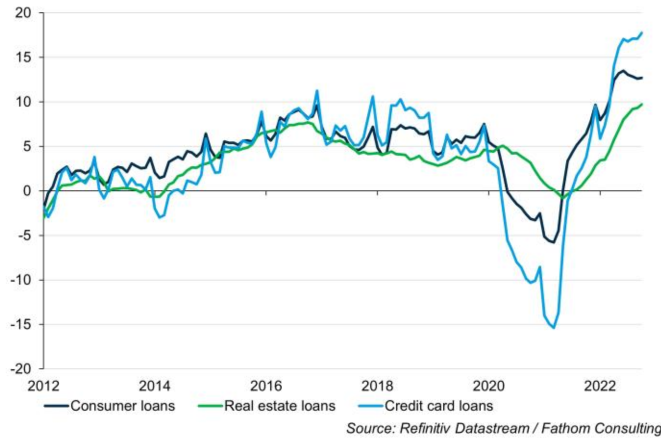
US bank lending remains healthy

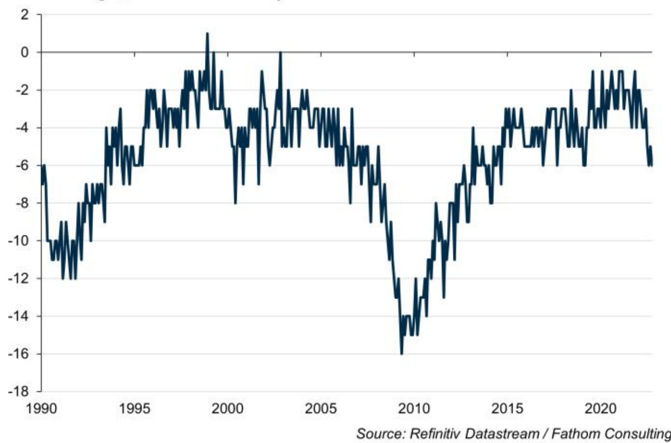
Twelve-month percentage changes



Source: Refinitiv Datastream / Fathom Consulting

Availability of loans to small businesses

Percentage, US NFIB survey



Source: Refinitiv Datastream / Fathom Consulting

Banks contingent capital bond index

Spread, basis points

Source: Refinitiv Datastream / Fathom Consulting

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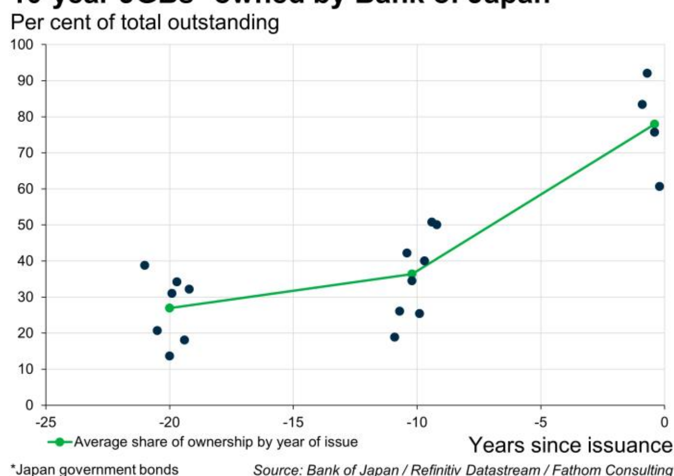
A key monetary policy-transmission channel through which the credit cycle operates is leverage. The total leverage in an economy can be thought of as the total amount of borrowing or debt relative to the total amount of income or capital appreciation that can be generated through the assets in the economy. Looking for pockets of excessive leverage is a useful exercise to identify potential triggers for economy-wide deleveraging trends.

No prizes for guessing that the most excessive leverage currently exists in the government sector. In the US (see chart above) and other developed markets, GDP growth has been increasingly supported by higher and higher levels of debt, thanks to central banks turning from buyers of last resort to almost the only buyers in town. Japan is the obvious example: the Bank of Japan bought between 60% and over 90% of recently issued debt with a ten year maturity (see chart below).



In principle, the stock of debt does not need to be repaid and could be indefinitely rolled over provided certain conditions are met — credibility being one of them, as a recent UK government learnt the hard way. However, governments have the luxury relative to private debt issuers of relying on transfers to support their debt (taxes, QE and even inflation are all cashflows

accruing to governments from transfers, rather than assets owned directly by the debt issuer). This luxury comes with costs. For example, Fathom has long argued that too much government debt is detrimental to productivity. Current high levels of government leverage almost certainly mean that we have already consumed a significant portion of future growth, and that the potential economic capacity of developed economies has been severely reduced. Moreover, excessive public debt makes policy-making harder, by rendering a recession more likely at any point in time (through lower potential output and increased vulnerability to changes in risk premia).

Outside the government sector, trends in leverage appear relatively benign. The cynical take would be that public debt has crowded out private debt to some extent. As a more neutral view, there has been some clear redistribution of leverage across economic sectors and onto the public balance sheet since the GFC. For example, US households have significantly lowered their debt ratios since 2008. Also, across developed markets, timely and necessary COVID policies have boosted savings and lowered private debt ratios.

Nor does leverage in the corporate sector scream 'danger!' on the whole. Net debt-to-equity measures of publicly traded companies, for example, seem in line with historical averages.

However, it is important to remember that debt is only half the story when looking at leverage trends. There is a real possibility that leverage in the corporate and household sectors appears relatively favourable due to discounting effects from 15 years of low rates. In other words, the risk from leverage this time around may not come from the absolute level of debt (i.e., the numerator of leverage ratios), but rather from the inflated value of the assets that are supporting that debt (i.e., the denominator of leverage ratios). These inflated fundamentals are, in turn, the result of the so called 'portfolio effects' created by the unconventional monetary measures of central banks globally, that were meant to be temporary after the GFC but which are somehow still with us today. The current prospect of high inflation and higher rates has raised the spectre that portfolio effects may go into reverse for the first time since the GFC. This observation alone should raise the probability of a significant market drawdown, and the risk that a repricing of the collateral supporting the level of debt may trigger a messy deleveraging event.

When looking at leverage in the current context, the better questions ought to be, first: since the GFC have households lowered their debt ratios enough relative to a potential 25% drop in house prices? And second, can current corporate debt levels be sustained after another 25% drop in equity prices without triggering mass defaults? On the latter question, the chart below shows how a 25% drop in equity prices would be enough to push US net-debt-to-market value to historical highs (the red dot in the chart), comparable to the GFC. Answering the first question requires a deeper analysis, as the ramifications spill over into geopolitics as much as markets.

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I promised I would limit the negativity in this note. Let me spell out, then, that an unravelling of the credit cycle through higher rates and asset devaluations is not the central case scenario for now. Reversing years of 'portfolio rebalancing' effects would probably require central banks to announce and deliver significant QT programmes, something that they have been so far reluctant to do.

Nor in my view do they need to do so, as short-term rates remain the policy tool of choice for central banks. They are better understood by the public as a method of credibly dealing with inflation. Also, the impact of higher short-term rates on markets is less uncertain than unwinding QE, as central banks have hopefully learnt from the past taper tantrum sell-off. If this view is correct, there are a few portfolio implications that we will discuss with clients more fully in our *Global Outlook, Winter 2022*. Let me finish with neither a positive nor a negative statement, but with a teaser: beware of extrapolating too much information from yield curves about the odds of entering a recession.

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https://www.coindesk.com/business/2022/11/10/jpmorgan-sees-wave-of-crypto-deleveraging-from-ftxs-woes/

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https://www.bloomberg.com/news/articles/2022-10-13/boj-tightens-grip-on-market-as-10-year-bond-ownership-nears-70

Even a modest QT programme has already started to raise issues with bond illiquidity in the US
Analysis: Nagging U.S. Treasury liquidity problems raise Fed balance sheet predicament | Reuters

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Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
andrea.zazzarelli@fathom-consulting.com
www.fathom-consulting.com

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