Beware the debt knell for bull markets

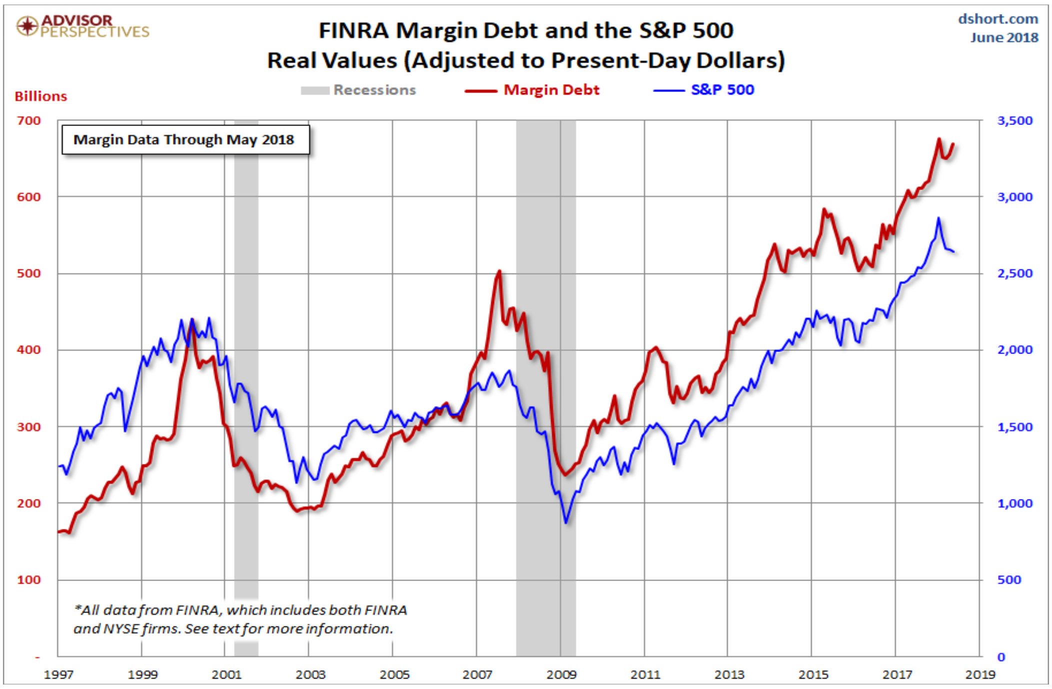
By Terry Farrow, lead manager of *HC Charteris Global Macro Fund*

London, 10th July 2018: The stock markets in the USA seem to go up on any news, Bad or Good. Despite threat of a global trade war, equities have continued to brush aside the latest geopolitical fears just as it has done with many other risks in recent years, However, there are now increasing signs that a significant correction is overdue as some of the major drivers behind the nine-year bull market begin to give way to bearish factors.

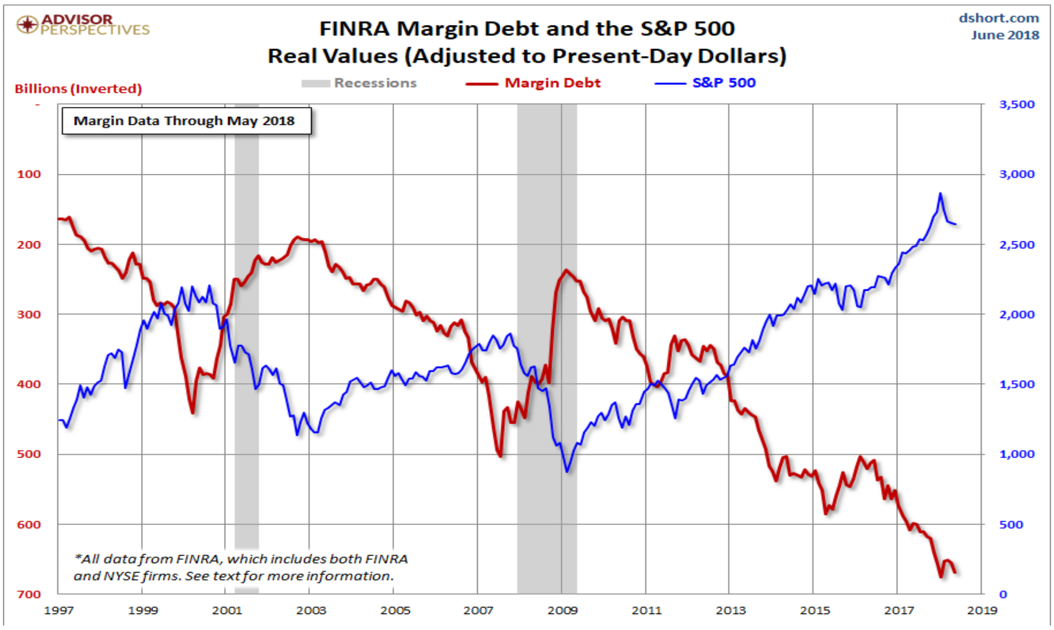
An important warning sign is the mountain of debt being piled up by all sectors of the economy, which history shows tends to precede major turning points in financial markets.

Since 2008, share buy-backs amounting to an estimated $4 trillion have been a key reason for driving US shares higher. This trend was given a further boost as one -off tax cuts last year led many cash-rich companies to retire equity, sending indexes to record levels. The flipside of this phenomenon is that corporate debt levels are also on the rise. It seems that not only is cash held by companies being used for share buy-backs (and not investment); some companies are buying their own shares with borrowed money. Yahoo Finance estimates that 39% of buybacks in the US were funded by debt in 2016.

Rising markets have also fuelled a worrying level of margin debt among households as illustrated by the graph below. *(Source dshort.com)*



Inverting the graph gives an even starker picture of how soaring margin debt levels have pumped up valuations to unsustainable levels.



Rising Debt Levels:

Student debt in the US now exceeds $1 trillion dollars and higher levels of default to match. Auto loans account for in excess of $1.1 trillion with default levels also seeing an increase as rising interest rates and inflation eat into consumers’ ability to service loans.

Not to be outdone, the US government debt stands at $21.1 trillion, translating to debt per taxpayer of $174,249.00.

Beyond the US, a rising level of debt is also of growing concern. In the UK 1 in 5 mortgages is interest-only, which together with other household debt, has become a cause for further concern.

Interestingly, many economists look at government debt as a proportion of gross domestic product (on which the government has no claim) but a more relevant metric would be to look at the UK’s annual tax revenue, estimated to be £680 billion. Thus, with UK debt close to £2 trillion UK’s debt-to-income is around three times.

In Europe the situation is no better and may even be considered worse with overall debt of approximately Euro 12.3 trillion which equates to approximately debt to GDP of 88.1%, though individual states are a lot worse - Greece at 180%, Italy at 131.2%, Portugal at 127.7%, Cypress and Belgium just over 104% with France and Spain at around 96%.

If borrowing to consume is bringing future consumption forward to today at what point does this get to such a position that it becomes unsustainable? If interest rates rise, servicing the debt becomes more onerous. Surely if we can no longer afford to borrow to consume then demand will fall and so will GDP.

It therefore appears that the central banks in the USA, UK, Europe and Japan are caught between a rock and a hard place as if they raise rates in a slowing economy a recession is certain. With the exception of the USA there is no room to lower rates further – other than to go negative and even the USA has very little room for manoeuvre. The US yield curve is flat and looking to invert - a sure sign of recession. What options will be open to the central banks -print more money- monetise the debt or default. On top of this with trade wars looming, more tariffs will increase inflation ultimately adding to the problems.

To date investors have ignored trade wars and the huge amounts of debt to continue investing in the stock market. In the USA it is tech-stocks mainly the FAANNG stocks – that have led the index. The market cap of the S&P 500 consumer discretionary index has gained $318bn so far this year, of which Amazon and Netflix on their own account for $375bn. But strip these two leaders out and the index is down by $57bn.

Currently investors have used either Index trackers or ETFs as an investment tool because of their low cost. Index trackers either replicate the index by matching weightings to the index as close as they can but this means they will always have a negative tracking error (if not they are not proper tracker funds) or use derivatives to track the index which exposes them to a higher risk as the derivative has no asset value and a third-party default risk.

With ETFs it is important to understand their underlying strategy and their associated risks. Overall it would appear that a large number of ETFs are overweight in FAANNG stocks, notably Amazon, Google, Facebook, Netflix and Nvidia. Bearing in mind that these shares have made most of the gains in the index, owners of these funds may lose more money than they anticipate in any sharp downturn due to both the overvaluation of these stocks and their over-weighted position within the funds.

The message for investors is to tread gently because all the signs point to a sharp drop ahead.

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Please visit www.charteris.co.uk/funds/global-macro.html