Why the concern over a world full of debt?

By Adriaan Pask

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Levels of global government debt have steadily increased over the past decade, jumping substantially during the Covid-19 pandemic. The latest data shows that South Africa currently has a 67.4% debt-to-GDP ratio, compared to the United States debt ratio at 130%, the European Union at almost 90%, China around 80%, and Japan at 300% of GDP. By those standards, South Africa is still in quite a reasonable position from a debt-to-GDP perspective.

Adriaan Pask, CIO, PSG Wealth

Against this backdrop, central banks all over the world are raising rates to combat higher inflation, meaning that debt-servicing costs are rising rapidly, making it increasingly difficult to see where governments will get enough revenue to pay off these debts and invest for future growth.

In the national budget speech in February, it was disclosed that South Africa's debt-to-GDP is expected to rise above 71% over the next three years. The related debt-servicing cost is approximately R400bn annually. This means that the interest payments on our debt is one of the country's fastest growing expense lines.

While South Africa has entered into debt-consolidation agreements with the World Bank and the IMF (International Monetary Fund), consolidating our debt at lower rates is a key concern, and the fact remains that our growth is muted.

In investing, we consider the global debt burden and rising debt-servicing costs when we structure portfolios. It impacts us through three avenues: households, corporates and business and government.

Household perspective

From a South African household perspective, although bond and other debt repayments are going up with rising interest rates, generally, we are still in better shape compared to global markets. However, the lower levels of consumer disposable income will ultimately hit the top line of businesses, whether they be small or listed entities. Rising debt-service costs will also damage businesses' profit margins.

Business perspective

Globally, we have already started seeing the fallout from rising rates as businesses start to focus aggressively on curbing expenses, with many of the international tech companies such as Google, Amazon, Microsoft, Yahoo and Zoom announcing large-scale layoffs to manage expenses.

Companies are also increasingly paying down debt as interest rates rise from near zero. Capital is no longer for free. In fact, it’s quite expensive. For example, businesses are therefore choosing to pay off some of the debt on the balance sheet rather than embarking on share-repurchase programmes.

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Government perspective

Things get particularly complicated from a governments' perspective as ‘modern monetary theory’ dictates that you can take on as much debt as you like if you ultimately grow yourself out of your situation and repay the debt. The risk is, however, that growth does not manifest. Then you essentially just pile on more and more debt onto your balance sheet. This has resulted in some nations now being over-indebted, and we've become concerned that their growth will be insufficient to repay these debts in some cases.

The US, for example, has already reached its debt ceiling, so it's not allowed to incur any more debt, unless that debt ceiling is raised by Congress in June 2023. Which in turn means that the US will incur even more debt, some of which will be used to pay off maturing debt. This effectively means that the US will use more expensive debt to pay off cheaper debt, and the interest rate bill will just keep rising.

Relatively speaking, South Africa’s fiscal position looks far less strained compared to some of its global peers.

SA showing fiscal discipline

What is also heartening from a South African perspective is finance minister Enoch Godongwana's comments in the budget speech where he specifically mentioned that we need to use the proceeds that we receive out of our tax collections for investing into the future. We have a good portion of our taxes going to welfare, but we need to balance that against investment for future economic growth.

Managing non-interest expenditure and the stabilisation of debt levels are also key areas of focus for government. This speaks to good fiscal discipline.

Looking ahead, I think it's going to be really important to understand how the debt markets function and also to evaluate businesses and governments on their spending patterns.

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High funding bills

Given the existing high levels of debt governments have, coupled with higher interest rates, governments will face funding or interest rate bills that they haven't previously encountered in the years ahead.

In Japan, for example (debt to GDP is 300%), there is speculation that government will significantly increase corporate taxes to try and offset some of the additional expenses on their debt. This will have a material impact on corporate earnings and the Japanese equity market.

The impact on government bonds will also be material, because the reality is that after a 40-year bull market, US treasuries are no longer considered a risk-free asset class. The resultant repricing of this asset class is starting to have far-reaching, unintended consequences.

For example, the recent failure of Silicon Valley Bank (SVB), the second largest bank failure in the US on record, is in part as a result of the fact that they invested heavily in US treasuries at record-low interest rates. As rates started to rise, they had to sell some of their bond exposure at a loss, which triggered concerns about its liquidity.

Investors will, therefore, have to consider the impact of rising rates on both companies and governments when structuring their portfolios. In this uncertain time, a trusted financial advisor has never been more important.

ABOUT THE AUTHOR

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