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Investment Insight

Friday, 15 May 2015

Mounting debt: *Remember the "Global Financial Crisis", the 2007/08 meltdown of a debt-fuelled investment binge? Perhaps describing the remedial actions of central banks as pouring petrol on the flames is unfair, but it is certainly the case that the amount of debt in the global financial system has grown, not shrunk, since then. Indeed, according to a recent analysis by the McKinsey Global Institute, government debt has grown by $25 trillion since 2007. For the most highly indebted countries, implausibly large increases in real GDP growth or extremely deep reductions in fiscal deficits would be required to start deleveraging.*

Therefore, some novel solutions are going to be needed if the world is to be weaned off its debt addiction. In this week's ***Inside Track*** *we summarise some of the options identified by McKinsey, including asset sales, one-time taxes, and more efficient debt restructuring programs.*

New frontiers: *As demographic trends present increasing challenges to long term economic growth in developed economies, some investors are tempted to bet on "the next China" or "the next India", where risk is high, but rewards can be commensurately enormous. In this week's* ***Pic of the Week*** *we look at some of the candidates.*

The Inside Track

According to the recent report by the McKinsey Global Institute, policy makers will need to consider a broader range of actions to stabilise or reduce government debt from its current all-time high levels. The following are extracts from the four strategies they posit. None make attractive reading for politicians.

1. Making fiscal adjustments to repay debt

This approach requires a government to maintain fiscal surpluses that are at least large enough to cover debt service for long periods of time…Achieving these adjustments would require tough choices about taxes and spending…A wider range of options for raising government revenue need to be considered. These include sales of public sector assets, partial or full privatization of state-owned companies, land sales, and one-time taxes, for instance on the super wealthy. All of these actions require considerable political will.

2. Increasing real GDP growth through productivity improvements

Boosting GDP growth will require dramatic productivity gains in the future, and the structural reforms necessary for productivity gains have proven difficult to enact in many countries. Even if productivity efforts are successful, they are not likely to deliver all the additional growth needed for deleveraging.

3. Raising inflation to boost nominal GDP growth

Raising inflation rates is another way to increase nominal GDP growth in the denominator in our equation. This is a viable option only for advanced economies where debt is held in the local currency.

4. Restructuring sovereign debt

With the levels of government debt today, the lack of political will for prolonged austerity in many countries, and the inability to restart economic growth, some countries may have no option but to consider new mechanisms for restructuring sovereign debt. The IMF has proposed reforms to enable sovereign debt restructuring to proceed more efficiently.

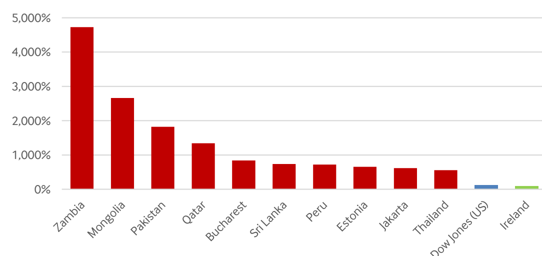
Another conceptually benign but practically radical option raised by McKinsey is to look at government debt holdings in net rather than gross terms. Focusing on net debt can provide a very different picture of government leverage. McKinsey suggest that in assessing the risk and sustainability of government debt, it is the size of net public debt (excluding holdings by government agencies) rather than the gross debt figures that really matters. If bonds owned by central banks are excluded, the government debt-to-GDP ratio in the US declines from a gross level of 89% to 67%, from 92% to 63% in the UK and from 234% to 94% in Japan. So, write off reciprocal holdings and greatly improve the global debt problem at the stroke of an accountant's pen! A ludicrous proposition one might say, until of course the alternatives are considered.

Pic of the Week

Frontier market investors try to identify those countries that have the potential to improve living standards from subsistence to something approaching consumerism. However, there are numerous obstacles facing such investors including political instability, uncertain (or unenforceable) property rights, war, religious oppression, to name just a few. So where might one have invested at the start of the new millennium in order to maximise returns? The chart reveals all, together with some developed market comparisons!

Stock Market Performance (USD)

1 January 2000 to date



Week ahead: Key events

18/05 UK House Prices
19/05 UK CPI & PPI
19/05 EU CPI & Germany ZEW Survey Expectations
20/05 Japan GDP & EU Construction Output
21/05 EU Manufacturing PMI & UK Retail Sales
21/05 US Initial Jobless Claims, Existing Home Sales
22/05 Germany Retail Sales & GDP
22/05 US CPI

Market View

	Last 7 days	YTD	5Y Ann.
Global equities	+1.2%	+6.4%	+9.7%
US equities	+1.6%	+3.0%	+13.3%
European equities	-0.6%	+15.8%	+9.4%
Emerging market equities	+0.1%	+8.3%	+1.5%
Irish equities	+1.1%	+17.9%	+14.8%
Commodities	+1.3%	+1.1%	-3.8%
Hedge funds	+0.2%	+2.0%	+1.1%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+1.3%	-0.7%	+4.1%
Germany	+0.7%	+0.5%	+1.0%
USA	+2.2%	-0.1%	+3.0%
China	+3.3%	+1.5%	+7.0%

Currencies	*Current*	*YTD Δ*
EUR:USD	1.14	-5.9%
EUR:GBP	0.72	-7.0%
EUR:CNY	7.06	-6.4%
GBP:USD	1.58	+1.2%
Bitcoin	237.41	-25.2%

Commodities	*Current*	*YTD Δ*
Gold	1,218.00	+2.8%
Copper	6,406.25	+0.6%
Oil	66.64	+7.3%
Wheat	515.00	-13.8%

Central Bank rates	*Current*
Eurozone	0.05%
USA	0.25%
UK	0.50%

Aria Capital Limited
Suite 3, The Cubes 3
Beacon South Quarter
Sandyford
Dublin 18, Ireland

T: (+353 1) 685 4100
E: research@aria-capital.ie
W: www.aria-capital.ie

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