How Will the Debt Bubble Be Resolved?

CALAMOS INVESTMENTS

Solutions for the next decade: Finding income and risk-managed equity opportunities in a changed world.

Transcript of a video recorded 10/14/19.

MICHAEL GRANT
Co-CIO, Head of Long/Short Strategies and Growth Strategies, and Senior Co-Portfolio Manager

The problem with most forecasts is that they tell us more about the present than the future. What causes the most harm for client portfolios is not the risks that are widely discussed, but the factors assumed to be safe but which prove nothing of the sort.

One critical assumption to examine is how the global debt cycle will be resolved, and whether some policy choices could lead to a more reflationary and thus, inflationary regime in the 2020s.

After the financial crisis of 2008, central banks pursued a policy of cheap financing. In other words, they developed policies that suppressed interest rates and credit risk to minimize the burden of excessive debt. This policy has been successful for some parts—for example, U.S. consumers have largely "grown out of" their debt burdens.

But this policy is really one of "kicking the can down the road." Not only have debt levels remained high despite a decade of policy austerity, but central bank capital subsidization has encouraged more, not less, debt. That is apparent when we look at corporate balance sheets as well as many of the emerging economies.

Debt cycles are common through history. The critical question is not if they are resolved, but how. The "how" ultimately rests on which segment of society absorbs the cost of the bad debt. This is as much a political and social debate as an economic one.

There are essentially four ways of resolving the debt bubble.

The first option is cheap refinancing, which has been the norm for the past decade. Unfortunately, it amounts to delaying the problem rather than resolving it. In some areas, these policies have worsened the debt burden. Quantitative easing (QE), for example, has perversely raised global debt levels by artificially lowering the cost of borrowing.

These policies have encouraged financial risk-taking, such as debt-funded share buybacks, instead of economic risk-taking, such as expansion of capex. Increasingly, early stage companies have been funded with debt when they would normally have been funded with equity.

This is why cheap refinancing has morphed into a multiyear distortion of capital allocation. We cannot rule out the possibility that the Fed restarts unconventional policies like QE, but we think it is loath to do so. We see such policies as short-lived and increasingly ineffective and unpopular, partly because they aggravate wealth inequalities.

Central banks have pursued the "cheap refinancing" option but reached the end of that road. What are the other options that could replace QE?

The second and third options for addressing the debt burden are a lengthy period of repayment, with less spending and rising savings rates. Alternatively, policymakers could allow a setting of default and debt liquidation.

Unfortunately, both of these are synonymous with disruption and disappointment. Both are unlikely amidst rising "populism," where the burdens have already fallen harshly on the "average consumer." These paths are not perceived as "solutions" and would be interpreted as the failure of policymaking.

Today's setting of political and social fragmentation rules out any choice where the debt problem falls back upon the consumer. After all, if the choice is between bailing out Goldman Sachs again or bailing out "the people," which will be resisted?

This leads to what is the "least bad" choice for reducing leverage: stronger nominal economic growth and thus, higher inflation.

History teaches that when real yields are negative, primarily through higher rates of inflation, leverage tends to decline. Through inflation, the debt burden is absorbed primarily by the creditors—that is, the wealthy and the savers—rather than the debtors, typically, the middle class. This contrasts with the post-2008 order where the creditors were bailed out.

Of course, the likelihood of higher inflation appears exceptionally low. Policymakers have failed to deliver their inflation targets. But this is exactly why the assumption of "low inflation for as far as the eye can see" should be examined. We think shifting demographics and the reversal of globalization imply policymakers might just succeed where they have failed in the past.

All of this is consistent with our view that equity markets have entered a period of transition. The world needs higher nominal growth to address global leverage. It needs higher inflation and it just might get it as fiscal policy dominates monetary policy. At minimum, investors should prepare for a more volatile macro setting through the 2020s. Shifting demographics and the reversal of globalization make this much more likely.

Videos recorded 10/14/19.

Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. The views and strategies described may not be suitable for all investors. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations.

Calamos Financial Services LLC, Distributor
2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | www.calamos.com | caminfo@calamos.com

© 2019 Calamos Investments LLC. All Rights Reserved.
Calamos® and Calamos Investments® are registered trademarks of Calamos Investments LLC.

801783 1019