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On the Edge of a Precipice: Costlier, Less Available Funds Adding to Global Worries

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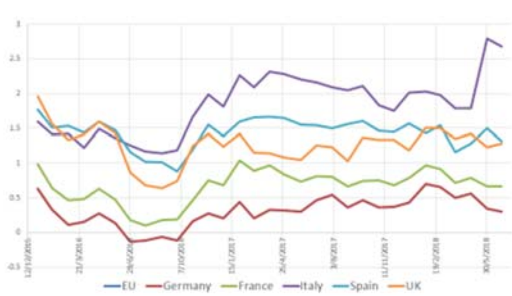
Interest Rates are increasing globally

Interest rates are rising in most corners of the world and they will increase further in the next few years. The inevitability of rising interest rates over the next several quarters stems from three sources: (1) the removal of excessive monetary accommodation and the gradual imposition of tighter monetary policy by the major central banks of the world; (2) the rise in inflation stemming from a world close to, or at full employment; and, (3) the inescapable result of higher prices resulting from imposing stiffer tariffs on global trade.

EU Gov't bond rates inching higher



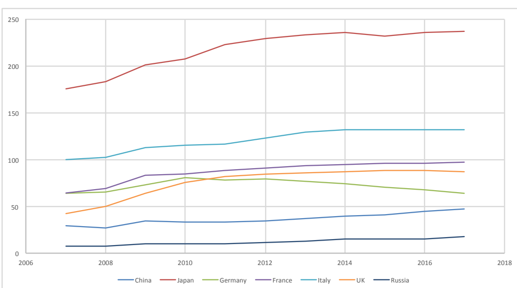
Higher interest rates will have their most debilitating effects upon the economies of the world with the largest degree of indebtedness. This interest cost constraint will bear heaviest and multiplies on economies when their countries borrow in dollars to finance domestic, non-dollar denominated projects. The cost of servicing and repayment of dollar denominated debt climbs substantially during periods of heightened global risk, such as at present, when fears of trade wars and their consequent impact upon motivating investor demands for safety appreciate the value of the dollar.

National debt exceeds sustainable standards

Asia

A glance at the following chart reveals that Japan has the most extensive amount of debt relative to its GDP and it is far beyond the sustainable standard. The traditional threshold for a sustainable amount of outstanding national debt relative to a country's GDP has long been estimated to be 60%. Nevertheless, Japan's debt burden is less threatening because it is all denominated in Yen, the home currency, and nearly all of it is owned by the Bank of Japan or by Japanese citizens.

National Debt (% GDP)



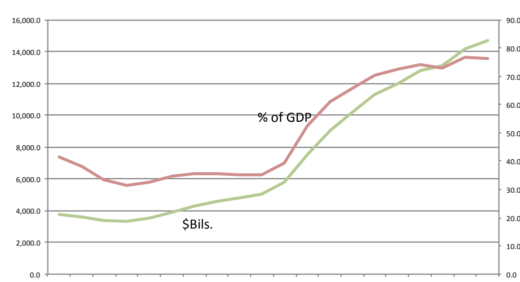
China's sovereign debt burden is not as large as those in the EU, however, China's debt problem is concentrated in their state-run banking system and in the provincial governments, which periodically have engaged in massive debt expansions to finance questionable economic projects, usually at the direction of the central government. Thus, China's credit exposure is not well captured by traditional sovereign debt to GDP ratios, and the scope of China's total debt burden is therefore not easily evaluated. Of course, China's extensive asset buildup of official dollar denominated reserves can be debited to support any domestic debt crisis.

EU

A more dangerous credit situation is present in the EU. The average debt ratio of the EU is 81.5%. Moreover, all of the key countries presently in the EU (including Britain) have debt to GDP ratios in excess of 60% of their GDP, while four countries' debt to GDP exceed 100%. Of course, Greece continues to have the most perilous credit problem and remains dependent upon EU support for its debt service. Italy has now attracted global investor's most critical attention because its debt ratio hovers above 133%, and its new coalition government seems incapable of survival. Academics in the EU have stressed that debt ratios above 60% are unsustainable in the long run and have imposed it as a constraint on member fiscal policies.

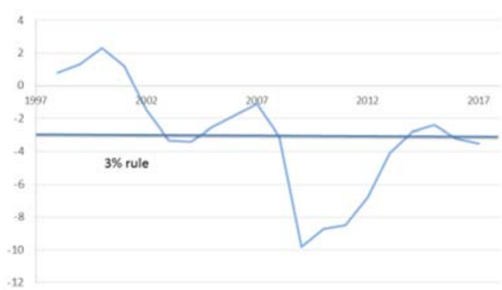
U.S.

US Public debt held by Public



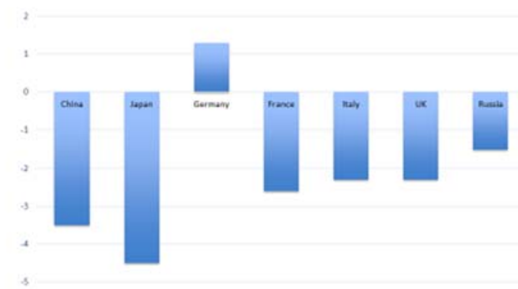
In comparison, the US has a national debt ratio of 76% when calculated from the perspective of debt held by the public. It rises to 85% when all Treasury liabilities are included. Public Indebtedness swelled substantially after the great recession when the US budget sank into a huge deficit (9.8% of GDP), as the US government tried to moderate the decline in economic activity caused by the domestic debt crisis. One of the tactics used by the Government was to substitute national debt for private credit. The Treasury and Federal Reserve bought outstanding private credit, predominantly mortgage backed securities. Subsequently, 8 consecutive years of economic expansion have contributed to the stabilization of the national debt ratio.

US Federal Budget % of GDP



Presently, the US does not have a significant problem financing its relatively large (above the 3% standard) budget deficit because other countries accept US dollar denominated obligations as reserves to support their own currencies, and because most commodities and products traded on global markets are valued in dollars. At the middle of 2017 (the latest Treasury survey undertaken) 37% of the US$14.7 trillion outstanding, US publicly-held, national debt was owned externally, mainly by China and Japan as well as other central Banks and sovereign wealth funds.

Budget Positions by Country(% GDP)



EU budget challenges will soon multiply

Recently budget deficits in the EU have subsided along with the improved economic growth in the region. As the chart above shows, Germany is the only country within the EU that has maintained a budget surplus. Besides being the largest and most powerful economy in the EU, it is also the only economy to have an external current account surplus. The two positive surpluses (fiscal and external) reinforce one another. Germany's desirable export-oriented economy has enabled it to maintain a positive current account position. Consequently, they have not needed to boost domestic demand through fiscal stimulus.

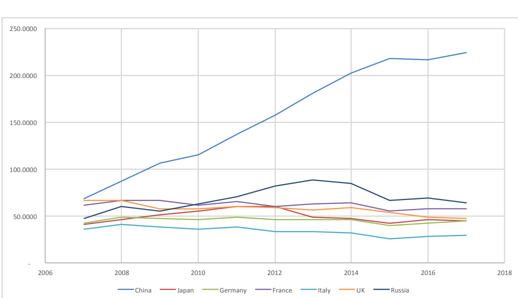
However, the rest of the members of the EU have not been that fortunate. All other countries have used fiscal policy to expand their domestic demand, and many EU economies have incurred a current account deficit in their external positions. External deficits must be financed in international capital markets which increases their typically dollar-denominated indebtedness.

Russia, China and Japan have external surpluses

Russia, China and Japan also enjoy current account surpluses. Russia supplies the EU with energy resources to maintain its external surpluses and with energy prices rising on global markets their surplus seems assured and may expand. China and Japan have huge trade surpluses with the US, and given the present strength of US domestic demand, their surpluses should continue.

Because of its global economic leadership, the US has the largest current account deficit. US external deficits have persisted annually since 1998, 20 years ago. The external deficits are driven by growth in domestic demand for imports, which create economic growth abroad. They too must be financed in global capital markets. This international bargain of trade for finance keeps the global economy percolating. If the finance stops, the US demand for foreign trade will disappear.

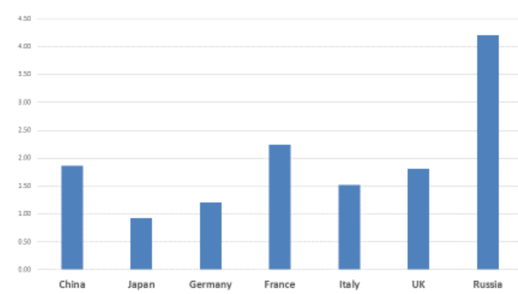
Defense Expenditure by Country ($bil)



EU Budget positions face a new challenge

After US President Trump threatened to minimize the US role within NATO and demanded that the EU raise its defense expenditures at the latest NATO meeting in Brussels, EU counties had to wrestle with the daunting prospect of increasing their defense expenditures when nearly all EU members already had budget deficits. Moreover, fiscal deficits are about to expand from the effects of diminished economic growth.

Defense expenditure (% GDP)



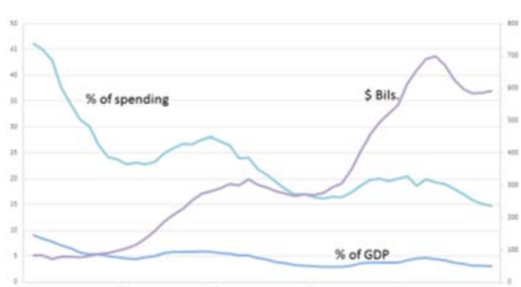
The challenge for the EU is much more demanding than making difficult fiscal spending choices. As seen in the past two charts, China is spending much more on defense than all of the EU countries combined. Moreover, a more pressing closer comparison is from Russia; Russia's defense spending relative to GDP is more than twice that of any of the biggest EU members.

Consequently, EU members must step up their allocation for defense to be more independent of the US and to meet the challenge organized by their neighbor

Russia. For most EU members faced with a declining economic growth environment, this means adding to the budget deficit rather than making critical priority decisions to cut back on other spending priorities. Therefore, the EU demands on the capital markets for new capital will increase. These greater financing demands will come as the ECB shrinks its purchases of sovereign obligations. Naturally, greater demand for funds and less official supply of funds will raise interest rates on sovereign EU debt.

In comparison, the US spends nearly $600 billion per year on defense, far more than any other country and more than all countries combined. Defense expenditure amounted to 3.1% of US GDP in 2017 almost down to its pre-2001 ratio. Defense expenditure absorbs approximately 15% of US budget expenditures annually, funds that could be diverted to finance pressing domestic social needs.

US Defense spending (% of GDP and total budget)



US deficits continue to be partially financed externally by the many allies of the US and China. It is the second international bargain between the US and its bankers: defense against aggressors for the option of using domestic funds for domestic purposes instead of armaments. US President Trump seems to want to amend this bargain.

Conclusion: The seeds of a global economic slowdown have been planted

Risks to global economic growth are multiplying.

- Political malfunctioning: democracies giving way to authoritarian regimes (Hungary, Turkey, US); regional separations from nation states (Spain); Brexit; populism replacing social democracies. All of these government transformations raise political risks, which will diminish investor risk-taking in financial markets.
- The global tariff war is not finished despite some new efforts toward negotiation. Tariffs and trade restrictions will ruin efficient supply chains, increase inflation, restrict trade, and heighten uncertainty, which shrinks long-term investment.
- Rising inflation is inescapable as global economies stretch toward their cyclical peaks, and function with higher tariffs.
- Higher inflation, tighter monetary policy, greater political risks propel interest rates upward, raising financing costs and reducing profitable investment opportunities.

- Credit worries will surface in light of the many untested public and private projects that were financed in the low, or no interest cost era. Refinancing in a higher interest rate environment with greater credit scrutiny caused by heightened political risk will become problematic.
- Greater political and economic risks always fall heaviest upon emerging market economies. They bear the biggest costs to their currency, trade, and debt availability.
- The post WW2 global order is in flux: the institutions created over the past 70 years, which launched mechanisms for negotiated settlements for trade disputes, merged economies into tariff-free zones, promoted thoughtful compromises for global environmental standards, and raised the welfare for most of the world's populations are being attacked, forced into change, or simply disregarded.

In the aftermath of these expected changes, economies will suffer before they recover. We are on the brink of an economic precipice and heading into the former soon.

For more information, please contact *camri@nus.edu.sg*

	KEY INDICATORS TABLE (AS OF 31 JULY 2018)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2816.29	3.72%	3.72%	16.23%	16.23%	3MO LIBOR	2.35	79.20
FTSE	7748.76	1.52%	1.00%	9.39%	8.87%	10YR UST	2.96	29.01
NIKKEI	22553.72	1.12%	0.20%	15.38%	13.94%	10YR BUND	0.44	-18.32
HANG SENG	28583.01	-0.46%	-0.50%	8.54%	8.01%	10YR SPG	1.40	-6.66
STI	3319.85	2.02%	2.19%	3.46%	3.14%	10YR SGS	2.46	17.35
EUR	1.17	0.06%		-1.28%		US ISM	58.10	2.83
YEN	111.86	0.99%		1.45%		EU PMI	55.10	-2.65
CMCI	1255.59	-2.53%		7.89%		JP TANKAN	16.00	33.33
Oil	68.76	-7.27%		37.05%		CHINA IP	6.00	-6.25

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency