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When does a lot of debt become too much? **Article 4 of a series of articles on the global economic challenges impacting investors by Investment Strategist Peter Lucas.**

When does a lot of debt become too much? You might as well ask the length of a piece of string. What one can say is that as debt levels and interest costs rise, you eventually reach a tipping point whereby solvency worries, rising interest rates and deteriorating circumstances feed on each other, leading to total collapse. Debt levels in the developed world are now back to the higher end of their historic range, and yet there is no sense of concern. Indeed, governments felt sufficiently confident of their financial position to shutdown entire economies for several months. Low interest rates are a key part of this story. Anyone can afford free money. But could that be about to change?

When the real estate bubble popped in the United States, it took the economy to the edge of an abyss. It took some drastic action by the authorities to pull us back from the brink and 'save' the economy from a likely depression. However, life after the financial crisis has been anything but normal, with central banks having to delve ever deeper into their bag of tricks to keep the show on the road. Furthermore, what growth there has been, has been anaemic by historical standards. It certainly feels like something has fundamentally changed.

Some governments tried to trim their deficits after the financial crisis, but ultimately found that their attempts were self-defeating. In the UK, after several years of unpopular spending cuts, the government declared *mission accomplished*, even though the national debt was larger than before. And once austerity had been ditched, it was only a question of time before governments started to splash the cash. And then along came COVID-19 and blew all the fiscal arithmetic out of the water.

Before we consider the implications of the debt problem, it is important to talk about demographics. Most developed world countries have ageing populations, which means that over time there are going to be more people in retirement – requiring pensions and healthcare – and fewer workers (as a proportion of the population) to pay for it all. Debt levels are high today but are even higher on a forward-looking basis.

As debt levels have risen, central banks have found themselves walking an increasingly narrow tightrope. Stimulate too little and they risk deflation and a spike in real interest rates (inflation falling well below interest rates); too much and they risk a rise in nominal interest rates. Either outcome would be a problem for an over-leveraged economy. Thus far they have prevented the economy from careering into either ditch, but in doing so, they have facilitated another rise in debt levels. Since the financial crisis the main preoccupation has been deflation, but the risks may now be shifting in the other direction.

The money created under QE did not have inflationary consequences because it never hit the streets, but rather remained tied up in the banking system; plus, government austerity provided a constant headwind for the economy. Now we have huge amounts of government spending, funded by bonds bought by central banks. It is not helicopter money, but it is surely something close.

But what about the banks? For many years banks have been ham-tied by a combination of tighter regulation, flat yields curves and in some cases, negative interest rates. If yield curves shift higher and steeper in response to deteriorating inflationary expectations, the environment will become more conducive for banks to lend; if the credit multiplier works in tandem with central bank activity, the money supply could expand at a rate of knots, thereby compounding the inflation problem; and if central banks try to arrest any resulting rise in bond yields, it could be akin to pouring petrol on a fire. Incidentally, all this would be happening at a time when the anti-inflation discipline of globalisation is being rolled back and supply chains have been disrupted.

But wait a minute, what about Japan? Haven't they been doing something similar for years without pushing up inflation? It's a fair point and one that will be dealt with in a future article, but suffice to say that there appear to be sufficient financial and cultural reasons to think that Japan is not a good parallel for what is happening in the West.

Whatever the truth of that last statement, there are two things that we can be pretty sure of. First, the tried and tested methods used by overborrowed monarchs and governments to reduce their debts are inflation and financial repression (holding interest rates below inflation for a long period). Whatever the exact timing of it, this is almost certainly where we are heading. And second, low commodity prices, cheap value shares and low breakeven inflation rates (on inflation-linked bonds) mean that it is much cheaper to position for inflation than deflation or even the status quo. Investors should take advantage of these opportunities while the going is good.

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