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Debt sustainability: do recent yield increases matter?

Key take aways

- Long-term yields have moved up during 2021, at the same time as coronavirus-related public spending has added to debt levels. We expect many economies' debt to increase further.
- Debt levels and rates do not currently pose a threat to debt sustainability. But the case remains that relatively small increase rate increases could add substantially to debt service costs – and the current situation will not last forever.
- Investors should be prepared for a change in monetary policy stance (even if limited). Were debt sustainability worries to grow, equity investors might increasingly favour higher quality names.

01 Introduction

Since the beginning of the year long-term yields have risen in the U.S. and Europe. Debt levels are also rising, not least as a result of the Covid-19 crisis. Rising yields and higher debt raise the question again of debt sustainability.

Debt levels are rising relative to GDP. According to the IMF, public debt/GDP ratios in the advanced economies rose by 20 percentage points in 2020 to average 125% (Figure 1). The IMF forecasts that among the major economies only Germany will manage to reduce debt-to-GDP ratios significantly in coming years. The others (e.g. the U.S., France, Spain or Italy) will continue to have debt levels over 100% of GDP (Figure 2). While the increase in debt levels in emerging market and middle-income economies looks less pronounced (debt/GDP of 62% in 2020, up 10 percentage points on 2019), the trend here is also upwards. These economies also often do not have the privilege of being able to finance themselves in their own currencies, so refinancing carries exchange rate risk.

In this publication we focus on debt levels and interest rates in developed economies.

Debt levels are one part of the debt sustainability equation – interest rates are the other. As we noted, yields have risen since the beginning of the year but from a longer term perspective they are still close to historic lows, in Europe in particular. Long-term developments in interest rates, as well as the interest rate burden relative to economic output, will be important.

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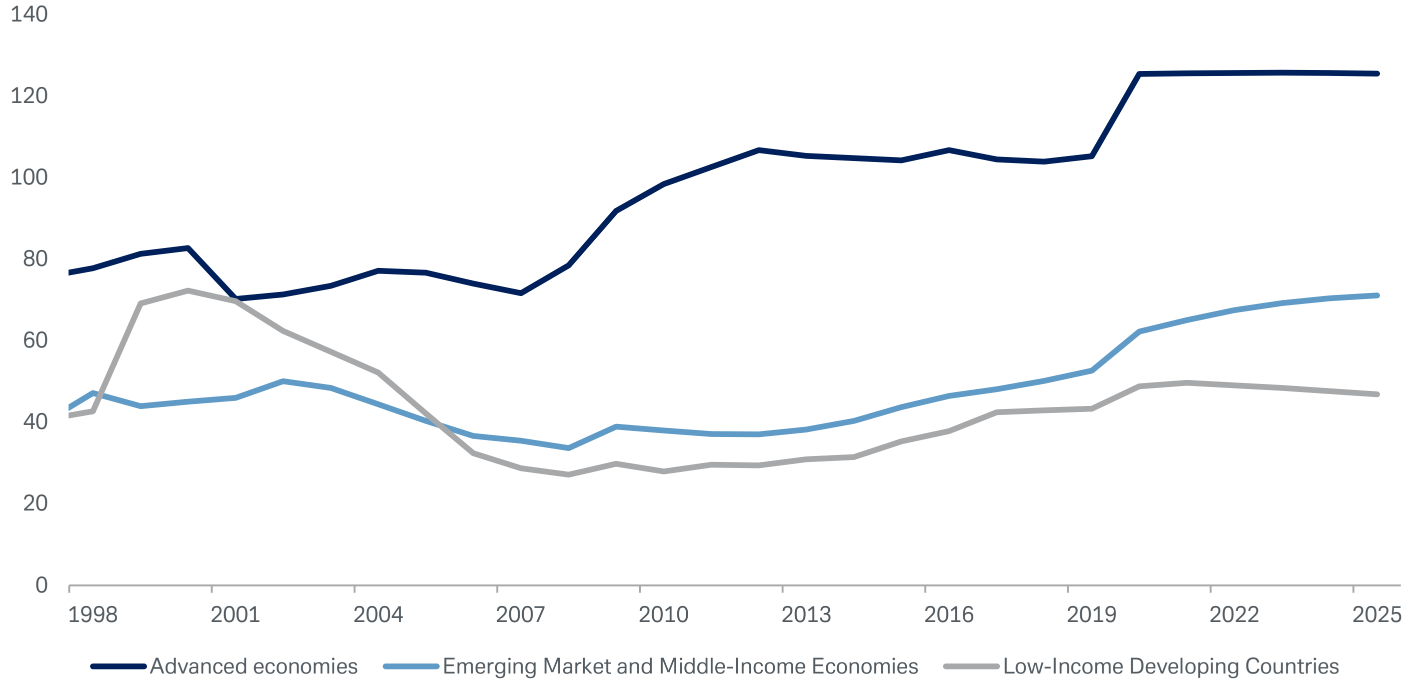
Figure 1: Debt/GDP levels for different economy groups (IMF forecasts for 2020 and beyond)



Source: IMF, Deutsche Bank AG. Data as of May 4, 2021.

02 Debt sustainability issues

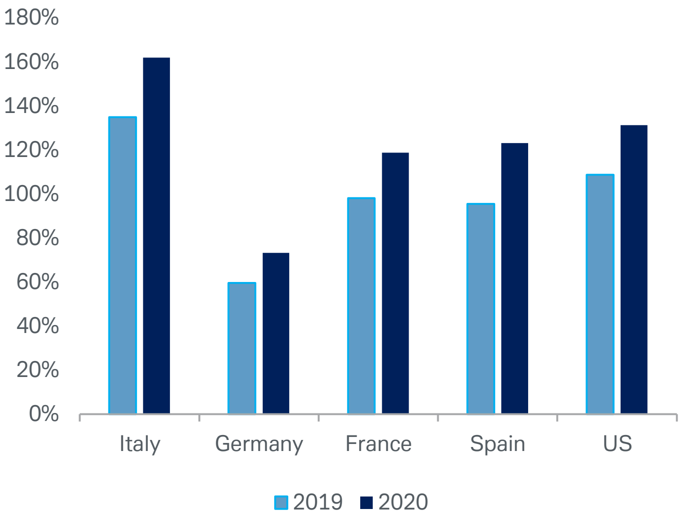
Debt levels are likely to rise further, at least in the short term. In many countries the coronavirus pandemic has led to expanded lockdowns and tightened restrictions during 2021, with governments therefore prolonging state support. Economies have also committed to longer-term debt-financed spending plans which go beyond immediate pandemic-related support (e.g. Biden's infrastructure plan or the Next Generation EU fund), despite already high debt/GDP ratios.

Economies are also proving much less willing to cut spending than after the Global Financial Crisis (starting in 2008). As the subsequent Euro Crisis (2009-2012) showed, one recession can transmit into another one, if fiscal spending is reduced too fast.

Such fears mean that debt metrics and other traditional debt criteria are now playing only a subordinated role in budget planning, as can be seen in most fiscal spending plans worldwide. The EU Maastricht criteria are suspended and the German "debt brake" (severely limiting structural budget deficits) may not be reapplied in 2022 after the upcoming federal election.

So what does this mean for debt sustainability? Low interest rates help constrain government debt burdens. In fact, looking at national governments' interest payments, the additional debt taken during the past years has in fact reduced the average interest rate paid on total debt in many countries (Figure 3). Despite the recent uptick in U.S. and core Eurozone, as well as peripheral yields, interest rates have been on a structural

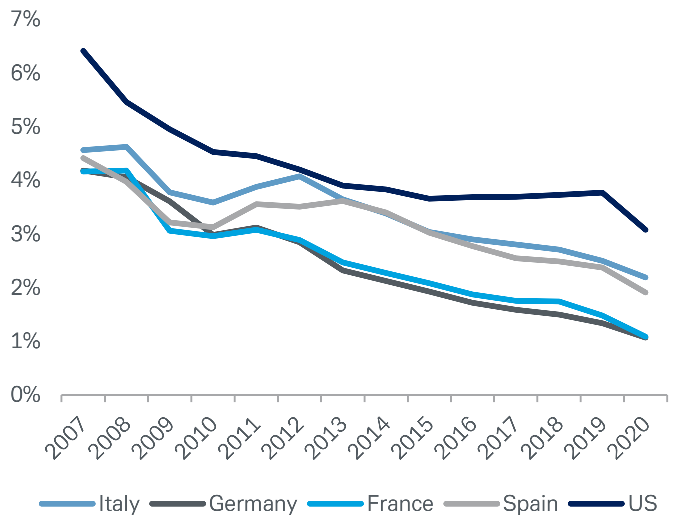
Figure 2: Debt/GDP ratios for individual economies



Source: IMF, Deutsche Bank AG. Data as of May 4, 2021.

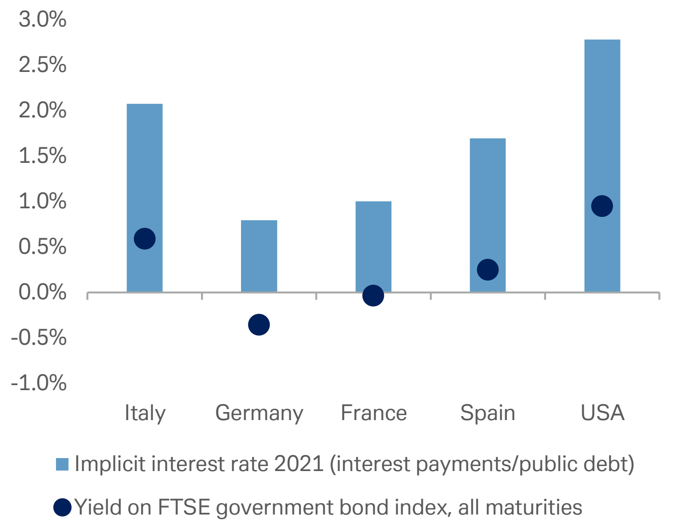
decline for decades as we explained in our previous report [CIO Special: Financial repression – still restraining real yields](). If yields are continuously grinding lower, rolling over old debt or issuing new debt will reduce the average interest rate paid on total debt as can be seen in Figure 4. In some cases, where the average interest rate on outstanding bonds is negative (e.g. Germany) the effect can even turn positive. By issuing debt, the state is actually earning money apart from the very long end of the curve.

Figure 3: Interest payments (in % of public debt) trended lower



Source: Datastream, Deutsche Bank AG. Data as of May 4, 2021.

Figure 4: Implicit interest rates and government bond yields in 2020



Source: Datastream, Deutsche Bank AG. Data as of May 4, 2021.

As a result, there is (for the moment) consensus that in the post-pandemic age, high and rising debt-to-GDP ratios are not a sufficient condition for questioning a country's debt sustainability capability.

In addition, Japan also provides a stark example of the underlying trust in core government solvency. Despite seemingly ever-rising governmental debt levels, the country has not experienced a debt crisis which has forced the government to restructure and deleverage. By contrast, examples like Argentina suggest that mounting debt levels in emerging market countries can mean a long and stony restructuring path.

In our view, a country's debt-carrying capacity is dependent on several factors:

1. Central bank support: As long as some of the circulating debt is absorbed by the issuer's central bank, governments will not be under great pressure to find buyers for their bonds. Some central banks are giving explicit (yield curve control) or implicit (providing favourable financing conditions) guarantees that they will keep yields low. However, there will be limits to this, for example in Europe where public concerns and diverse economies will ensure a debate around policy priorities.
2. Belief in governments' debt repayment intentions and capabilities: Credit ratings are one important indicator in this respect, which also help determine the interest rate level. The higher the issuer's credit rating the less likely investors start to question a country's debt carrying capacity.
3. Economic growth needs to be higher than average yields paid: As long as economic growth rates of indebted countries are higher than the average yields on their outstanding bonds, debt-to-GDP ratios will shrink in times of balanced budgets. Even in times of high fiscal spending, higher growth than interest rates have a statistical stabilizing effect on debt ratios.

More information can be found in our CIO Special – Peak Debt: sustainability and investment implications.

Small changes in interest rates can however still cause significant budget headaches. Japan provides a striking example. In Japan, if average interest rates on public debt were to rise by 50bps, the additional yearly interest expenses for Japan (where the debt/GDP ratio is over 250) would amount to more than 1.2 percent of GDP. To put it another way: adding 50bps to interest costs of USD12.2tn in debt would imply an additional fiscal spending of more than USD60bn annually.

Japan is an extreme example, but this simple mathematical calculation shows how dependent public borrowers in general are on low interest rates, and on the increasing link between public debt and central bank balance sheets. The Bank of Japan has not let interest rates move much for years and has kept them in a tight corridor even for longer maturities. Other countries may end up navigating this course as well.

In this context, a country's debt-carrying capacity is also dependent on the maturities of the outstanding bonds and how this affects refinancing needs. At the moment having most of your government bonds with a short maturity would seem advantageous for governments over longer maturities – as the very short end is still well anchored in contrast to longer-dated bonds. But at a different point in time in the business cycle the opposite could be true. Which suggests that while the current situation at the moment looks less dramatic than during the Eurozone crisis of 2009-2012, there is also an inherent fragility to the situation. Countries with higher debt-to-GDP ratios remain more susceptible to exogenous shocks and deal less well with structural problems than less indebted countries. When things worsen, some countries could come quickly under pressure. As the Eurozone crisis demonstrated, risk premiums can rise very fast when confidence in one country's credibility is challenged.

03 Investment implications

Rising yields have various consequences for investors. For bond investors, they increase the attractiveness of additional bond investments but for existing holdings the tangible result is a fall in the price of the bond. For equity investors rising yields are neither generally good or bad, but it very much depends on the reason why yields are rising. An increase in yields due to better economic prospects can be also supportive for equities. A rapid increase though may be more challenging. For more details on the effects of rising yields, see our recent CIO Special: Yields end deep hibernation.

The effects of rising yields on debt sustainability are important when it comes to the perceived risk of government bonds. As we discussed before, the recent increase in yields does not pose an immediate threat to debt sustainability. This however is only one part of the equation with debt-to-GDP levels being the other. One related concern is that the willingness of governments to cut deficit spending may be less ambitious as could be the drive for reform e.g. as part of the Next Generation EU plans. The implicit bail-out promise given by many central banks may also not apply indefinitely.

Investors therefore have to be prepared for a change in monetary policy stance, at least to some degree. In the Eurozone the ECB will likely end its net asset purchases under the pandemic emergency purchase programme (PEPP) next year. A reduction in the pace of net asset purchases will highly likely happen even earlier – perhaps as early as Q3 2021. While a short extension of the PEPP or a temporary increase of the regular Asset Purchase Program is possible, this could create a rather uncomfortable situation for some peripheral or corporate bond investors. A fast U.S. economic recovery and reflationary environment will also bring the Fed at some point in the future to reduce its net asset purchases. Once the policy normalization path is set, markets will differentiate more between economies and start to question a country's debt-carrying capacity.

Moreover, even if monetary policy remains accommodative for the time being, the stimulus effect is expected to fade as the incremental change in net asset purchases will be negative than positive in Europe as well as in the U.S. This will have implications for both economies and markets.

Hopes that many governments can simply grow their way out of debt may also be premature. While we expect the major global economies to grow further, the sharpest increases in growth rates will soon be behind us and leading indicators are currently topping out. In a future crisis, high debt levels could be an obstacle for further fiscal stimulus. However currently low yields along with fiscal stimulus are supportive for the economy. A rise in yields may not derail the general outlook as long as it reflects an improving economy.

Rising rates will also have implications for private sector debt, and not just for creditors in the capital structure of individual companies (i.e. by corporate bonds). Equity investors will be affected as well. Supportive global central bank policy has sustained the lives of many highly indebted and marginally profitable companies dependent on a low-rate, easy monetary stance to survive. These lower-quality companies can have their investment moments, usually in the earliest stages of a new market cycle when central banks remain very accommodative and prospects for companies that were priced to fail are now improving. Additionally, lower quality companies can find bids during periods of extended monetary support, which was the case during throughout most of the last market cycle.

But such lower-quality companies can start to struggle when debt sustainability again becomes a concern. Overall investor sentiment will sour and higher quality company names will be set to perform again. (We see higher quality firms as those that tend to carry less financial risk through healthier balance sheets with lower financial leverage and higher liquidity, and consistently profitable with low earnings/sales volatility and wider profit margins.) Usually these higher quality companies tend to perform better in economic downturns or times of stress (as during the Global Financial Crisis or the most recent U.S. credit rating downgrade in 2011 (Figure 5). But they may also perform well in the current environment, even with strong economic growth, if debt sustainability worries increase.

Figure 5: High vs low quality over time (recession areas are shaded)

Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of May 7, 2021.

Glossary

The ECB's pandemic emergency purchase programme (PEPP) is a temporary asset purchase programme of private and public sector securities in order to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by COVID-19 outbreak.

An emerging market (EM) is a country that has some characteristics of a developed market in terms of market efficiency, liquidity and other factors, but does not meet all developed market criteria.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The global financial crisis (GFC) is the financial crisis that started in 2007/2008 and lead to a recession in many major economies, originating from an asset bubble in the U.S. mortgage market.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The International Monetary Fund (IMF) was founded in 1994, includes 189 countries and works to promote international monetary cooperation, exchange rate stability and economic development more broadly.

The S&P 500 Quality Index is designed to track high quality stocks in the S&P 500 by quality score, which is calculated based on return on equity, accruals ratio and financial leverage ratio.

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