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"The degree of leverage now being used is staggering, and the underlying global imbalances – notably between the savers and the spenders – will require long and painful adjustment."

Sir Vince Cable
British Secretary of State for Business
Member of Parliament, 2010 - 2015

WHY LEVERAGE MATTERS

By James K. Tonrey, Jr., Chief Executive Officer

We will soon enter the ninth year of recovery from the 2008 financial meltdown. Periods after recessions, in this case a severe recession, are usually bumpy as the economy once again begins to regain its footing. Psychology plays a large role as well. People tend to remember, and are most affected by, their recent experience. It is no surprise that even today, almost nine years removed, there is still a genuinely cautious mood among the investing public.

Economic recoveries vary but generally last four to six years. Why then are we now nine years out from our last recession? Could this mean we are in for another big disruption? Can this recovery continue for a few more years? These are important questions and economists all over the world are engaged in the debate. Let's take a look under the hood as to what caused the recent recession and how that has influenced the trajectory of this particular recovery.

Read any account of the great recession of 2008 and the term leverage will dot the pages. A common misunderstanding is that all leverage is good. Isn't borrowing money to buy a house, a car, or build a business a positive force that helps create jobs while increasing the velocity of money in the system? Doesn't everyone benefit when borrowing ignites the underlying economy? The answer to these questions are complicated and debated vigorously from all angles. *But, simply stated, the answer is no, not all debt is created equal.*

The definition of financial leverage is using someone else's money to generate a profit or return that is greater than the interest payable on the borrowed money. Sally borrows money from a bank that has an interest rate of 5%. She invests those funds and receives an 8% return. She has used leverage to generate a profit of 3% annually as long as the asset has held or increased in value. This is known as positive leverage. Negative leverage occurs when Sally can only expect a return of 2% on her investment while the underlying investment has held or decreased in value.

Another key variable when evaluating the use of leverage is how much of an investment is financed. If Sally borrows 25% of the cost of her investment and puts down the other 75% with her own money, and the return is only 2%, then her total loss is smaller than if she had financed or leveraged more. Remember that the more leveraged used the greater the risk assumed.

Tim Nuding, CFA, wrote a piece in 2014 entitled *"Is Leverage Good or Bad?"* In the article he concludes that the use of borrowed funds is neither good nor bad but stresses that leverage will *exaggerate* both the good or bad effects that can change on a dime depending on the sector, the time period, and unexpected multivariable dislocations in the economy. He says *"we can see that the level of interest paid is critical to the leverage proposition. With very low interest rates, many more investments meet the expected minimum hurdle of returning the interest paid and vice versa. Some would even say that ultra-low interest rates create an unhealthy misallocation of capital resources."*

Given that basic primer, let's take a macro look at the use of leverage today.

Starting with our own *national debt*, the US has increased its debt burden from approximately $10 trillion in 2008, at the height of the recession, to almost $19 trillion today. This does not tell the whole story as economists will argue more important is the ratio of total debt to the Gross Domestic Product (GDP). Over the past seventy years this ratio has

averaged about 62%. Today it stands at 104%. The reason this is important is that it helps measure the ability of a country to repay its obligations, which affects future bond yields and borrowing costs.

Another borrowing metric is to look at total *worldwide sovereign debt*. In 2014, this debt load was estimated at $200 trillion. A striking number to be sure, but again, it is important to measure the total leverage versus the total output or GDP of all the countries included to get a more relevant perspective. What we find is the $200 trillion is almost three times the entire global economy. China's debt, a major part of this calculation, has tripled since 2009 from $10 trillion to $30 trillion, according to the firm McKinsey.

How about US *mortgage debt*? The New York Fed's quarterly report released in May showed that nationwide total mortgage debt has risen to approximately $8.4 trillion, the highest level in the past five years. The good news is that foreclosures have dropped dramatically, credit scores have improved, and home equity lines of credit are down.

Next up, let's look at *student loans*. As of today, students in the US owe nearly $1.3 trillion in debt and around 11% of the 5.2 million students that left school in 2013 have defaulted on their federal student loan obligations. Given that the labor markets have continued to strengthen, this figure is high. In 2016, the average student graduated with approximately $37,000 in debt. This is up 6% from last year.

Last, but not least, *auto loans* are hitting new highs. The average auto loan is slightly above $30,000 and the average monthly payment is $503.00, both at their highest levels ever. Probably more eye catching are the terms. The average length of an auto loan has risen sharply to sixty- eight months.

It is easy to read the last few paragraphs and be a bit cynical about the growth prospects here and abroad. It certainly begs the question…*how in the world can we grow our global economies when saddled with so much borrowing?* To answer this question we need to go back to the basics of good leverage and bad leverage. In 2008, there was unlimited greed, easy money and irresponsible corporate behavior leading to no money down borrowing. The basic tenets of using leverage were violated at every turn. Eventually, asset prices declined sharply and quickly. It is not hard to understand that having a constant loan on a depreciating asset causes borrowers angst. It rocks the foundation of a capitalist system built on trust, playing by the rules and, importantly, predictable asset valuation with some inflation.

We find ourselves in a debt super-cycle at the moment. There is no doubt the increase in leverage is due to low cost borrowing that has weakened economic growth prospects all over the world. But there are stark differences from the debt issues that plagued us nine years ago. Generally speaking, it can be argued that asset prices are somewhat reasonable and the debt carried more manageable and responsible now. Furthermore, debt loads have shifted from personal to government balance sheets (a topic for another day). Interest rates on loans are at historic lows, the credit quality higher and thus the carrying costs far better than ever before. There is also an opportunity for a new administration, on either side, to address the burdensome and outdated corporate and personal tax code that most people agree needs change. Importantly as well, the Federal Reserve Bank is on guard watching for any signs of a deflationary environment that would throw a monkey wrench into a continued recovery. What we do not need is a decline in asset prices. A pricing correction is healthy but another shock would not be welcomed. So the optimist would argue that even though growth is on the low side and the use of leverage relatively high there are positive signs wages are increasing and that finally the middle income earner is seeing some light at the end of the tunnel. The International Monetary Fund just released their three year global growth forecast for advanced economies and the estimates range from 3.1% to 3.7%, enough to continue global recoveries. Lastly, and possibly most important, consumer confidence in our economy will matter greatly as we continue our climb out from under a generational severe financial shock just nine short years ago.

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