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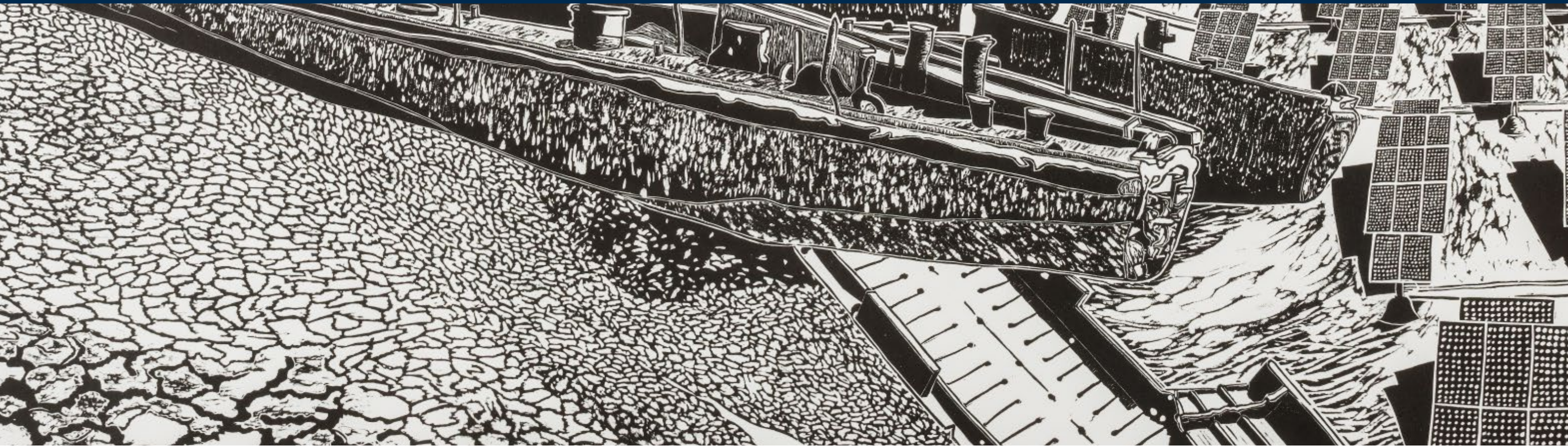

MONTHLY THINKING

NEITHER A BORROWER NOR A LENDER BE

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"Neither a borrower nor a lender be (and it's better to have a bit of cash on the balance sheet)"

WILLIAM SHAKESPEARE – HAMLET, AND WALTER SCOTT & PARTNERS

CHARLIE MACQUAKER
Executive Director – Investment

Global equities continued their upward march this month, with a number of stock markets reaching new highs. Momentum continues to be fuelled by optimism that inflation will cool further and that the Federal Reserve and the European Central Bank (ECB) will consequently loosen monetary policy against the backdrop of an anticipated mild slowdown in global growth.

Despite the collective 'phew' from equity markets over the prospect of lower rates, global sovereign bond markets (with the notable exception of China, but that's another story) have seen a rise in yields since the start of the year. To some extent this reflects lingering core inflation and delayed gratification for those that expected imminent interest rate cuts, but by and large, expectations

abound that monetary policy loosening will occur later in the year. This has not stilled the voices of a number of commentators that remain concerned about burgeoning global debt.

The International Institute of Finance estimates that total global debt rose to US$313 trillion in 2023, compared to around US$226 trillion in 2020[1]. The global debt-to-GDP ratio has continued its decades-long upward trajectory. In the early seventies, it was just over the 100% level, but hit a Covid-related peak of 258% in 2020, although it fell back to 238% in 2022[2]. In the US, the government debt load stands at over US$34 trillion compared to US$23 trillion at the beginning of 2020[3].

"The problem children lie in the weaker recesses of the corporate market"

As for company debt, according to IMF data, non-financial corporate debt, loans and debt securities rose from 99% of GDP in 1990 to 154% in 2022[4]. However, the net debt to equity ratio (ex-financial companies) for the MSCI World Index, has ranged roughly between 75% and 100% over the last twenty years, and stood at 89% as at the end of 2023, having declined since the height of the pandemic[5]. The problem children lie in the weaker recesses of the corporate market. S&P Global has noted that globally, a refinancing maturity wall is "looming higher for speculative-grade debt". Global debt maturities will rise from nearly US$2 trillion this year to a peak of US$2.8 trillion in 2026, with speculative-grade maturities rising four-fold to US$1.1 trillion between 2024 and 2028[6]. 'Higher for longer' interest rates may impair the ability of some high-risk borrowers to roll their debt, potentially leading to higher defaults.

Worries about the debt mountain are scarcely new, but necessity and expediency, aided by ultra-loose monetary policy, led to the can being kicked down the road. But as the world is weaned off its longstanding diet of cheap money, the elevated levels of sovereign debt and debt in the lower-quality rungs of the corporate sector may be brought into sharper investor focus. There is now a shift towards normalised monetary policy, bringing with it threats at a macro and, for some businesses, at a corporate level.

"Politicians are loathe to act, with little appetite for fiscal rectitude"

From a bottom-up stock-picker's perspective, and therefore interested in 'macro' events purely in terms of how they impact individual businesses, the debt deluge raises a number of questions. In the wake of the GFC and latterly the Covid-19 pandemic, the stimulus taps were turned on and government budget blowouts were deemed necessary to insulate the electorate and many businesses from adverse economic consequences. No matter the political hue, most global governments went 'big'. The adverse economic consequences of this debt accumulation are conventionally thought to be; an increased cost of servicing high levels of debt which may crimp government expenditure, the crowding out of private investment, higher long-term interest rates caused by an excess supply of government debt, and potentially more demands on the taxpayer who has already endured the corrosive effects of inflation and higher interest rates. Yet for all this, there hasn't been a debt denouement, and politicians are loathe to act, with little appetite for fiscal rectitude, certainly in this year of elections. As debt ratchets higher, markets may take more notice. The proponents of Modern Monetary Theory, which suggests that governments that operate a fiat currency system (i.e. just about everyone) need not be financially constrained on spending, would argue that all this may not matter. Ex-UK Prime Minister Liz Truss's fiscal blowout experiment was nonetheless called out in short order by bond vigilantes.

In the wake of crises and calamities, monetary largesse made money ultra-cheap for corporate borrowers. This was expedient at times of economic stress for a range of businesses, but it also created distortions. Weak businesses with bloated balance sheets can be sustained by low interest rates, but cracks start to show when the cost of servicing debt goes up. The proliferation of cheap debt can foster corporate and economic inertia, as we saw in the case of Japan, where zombie businesses that should have died years ago were able to keep going, but not growing. But it can also fund over-hyped, unsound businesses that quickly unravel as the cost of capital rises.

Geared business models can be vulnerable to macro changes of both a monetary and demand nature in the economy, as the problems of the commercial real estate market are now highlighting in the wake of the Covid-19 pandemic, with some property owners not being able to service their debts. Some banks in the US and Europe are facing the prospect of adding to their loss reserves. In the US, the non-bank and regional bank sectors have been active lenders in the commercial real estate arena, and in the latter regard the plight of New York Commercial Bank has highlighted the pitfalls of real estate exposure. None of this is a systemic risk, but in China, the unfolding demise of weaker players in the property sector demonstrates the economic consequences of over-leverage and misallocation of capital. Borrowing money should have a cost. A higher cost of capital acts as an enforcer, making companies think about how they invest in their business. It can bring about creative destruction whereby the inefficient expire, leaving room for new businesses to grow.

"We have always placed balance sheet rigour at the heart of our investment process"

We are not against the use of debt in the right circumstances. As long as capital raised from debt is allocated well (i.e. investing in the business for future growth), and the extent or rising cost of debt does not disrupt profitability, it can form a worthwhile part of a company's capital structure. However, we take a dimmer view of businesses that use leverage to conduct share buybacks. Despite the market's current preoccupation with the timing of interest rate cuts, we are now in an era of monetary policy normalisation. We have always placed balance sheet rigour at the heart of our investment process. Good cash-generation and no, or low, manageable levels of debt, endow a company with a greater control of destiny, allowing it to invest for the future and weather macroeconomic cycles.

Some Japanese companies take debt aversion to the extreme as exemplified by sensor maker Keyence, where cash and cash equivalents were 85% of shareholder equity at the end of fiscal year 2023. We have, on many occasions, asked the company why it retains so much cash. However, it acts as an economic buttress, and enables the company to invest in growth in challenging times, although it dampens return on equity. Keyence is currently experiencing some tough end markets, as evidenced by its third-quarter results. Operating profit fell 4% year on year, although revenue held up well, rising 2% over the period, with the Americas and Europe seeing growth, while small declines were seen in domestic and Asian markets. Gross margins continued to improve, thanks to favourable currency trends, and cost-of-goods sold reductions, but this was more than offset at the operating profit level by higher investment operational expenditure in the form of recruitment. Despite that, operating margins remained above 50%.

Markets appear to be in a sweet spot, supported by the promise of a turn in the monetary cycle, with global growth muddling along thanks to the diminishing impact of inflation. Macro uncertainties, whether they be over debt, 'sticky' inflation and higher-for longer interest rates, or strained political tensions across the world, have been partly sidelined by investors. But whatever the backdrop, we prod, probe, and debate, assessing how the world's leading companies are navigating the perennial ebbs and flows of economic tides and positioning themselves for long-term growth. Some are working their way through cyclical headwinds, while others have been more resilient. However, many share common attributes. Our focus is on companies that are financially strong, market-leading businesses, that thanks to their ability to adapt and innovate, and through excellent management, are tapped into durable, long-term trends that, in our view, will drive their earnings over the years to come.

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[1]IMF Blog, 15 December 2021 and Institute of International France, 21 February 2024 and https://www.iif.com/Products/Global-Debt-Monitor
[2]IMF Blog, 13 September 2023
[3]Fiscal Data Treasury, 12 March 2024
[4]IMF Datamapper, 2022
[5]Walter Scott, MSCI, Factset, December 2023
[6]S&P Global Ratings, 5 February 2024

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STOCK EXAMPLES

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