GUARDIAN CAPITAL | PRIVATE WEALTH

PERSPECTIVES

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'Til debt do us part

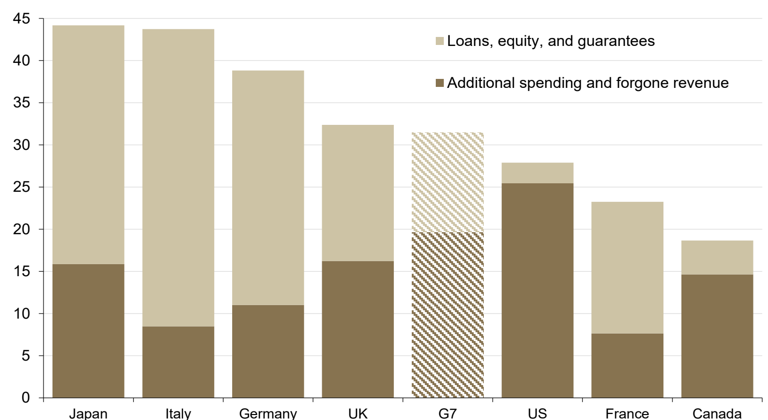
Over the past year, governments around the world have introduced significant measures to help blunt the economic impact of the pandemic on households and businesses.

The International Monetary Fund (IMF) estimates that as of March, the G7 economies (Canada, France, Germany, Italy, Japan, the UK and the US) have committed US$12 trillion, an amount nearly equivalent to one-third of the group's economic output, to COVID-19-related relief measures and other initiatives (such as private loan payment deferral programs).

Without a doubt, these initiatives have been warranted to keep economies afloat during this crisis. They have played a key role in mitigating the impact of lockdown measures and leaving households and businesses well positioned to rebound quickly once the rollback of economic restrictions arrives in earnest.

While this suggests that governments' efforts will likely help shorten the recovery time of the economy as a whole, they will carry a lasting impact on fiscal positioning for years to come.

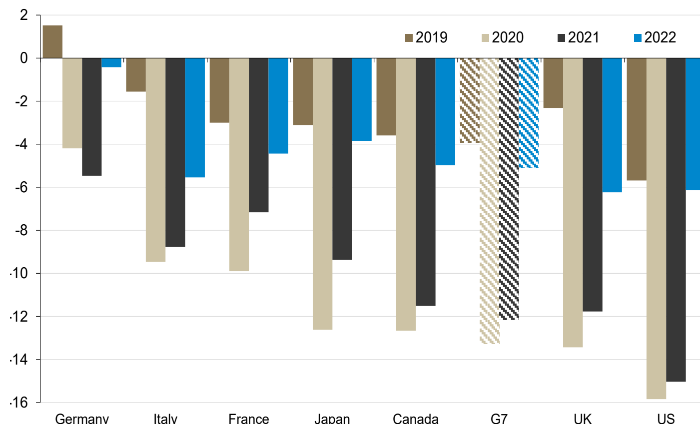
G7 COVID-19 Fiscal Response
(percent of gross domestic product)



Source: International Monetary Fund's Fiscal Monitor (April 2021), Guardian Capital

In addition to the increase in spending, the pandemic has also resulted in sharply lower government revenues — corporate and personal income tax and sales tax receipts have been constrained due to economic lockdown conditions. The net result has been gaping fiscal deficits that are expected to persist for the foreseeable future.

G7 General Government Fiscal Balance
(percent of gross domestic product, <0 denotes fiscal deficit)

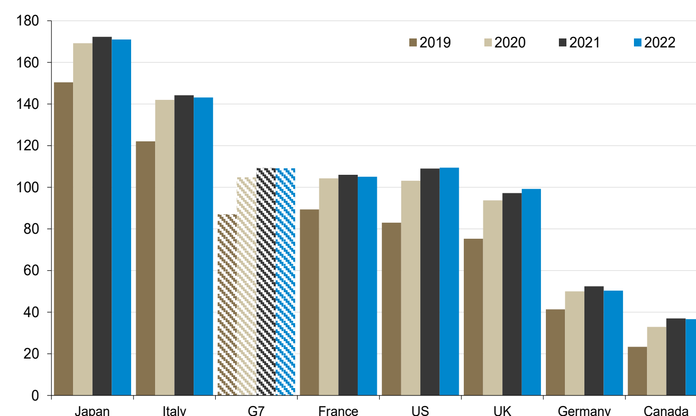


Source: International Monetary Fund's Fiscal Monitor (April 2021), Guardian Capital

To meet these fiscal shortfalls, governments are increasingly tapping into debt markets, resulting in G7 debt burdens already rising by a cumulative US$9 trillion, and further increases to that number anticipated going forward. The net debt-to-GDP ratios among the G7 have jumped by more than 10 percentage points from their pre-crisis levels and now exceed 100% for the aggregated group.

These deficits and debt burdens are not sustainable forever and will need addressing in the future. The potential options are less than ideal for the broader economy. An increase in taxes or decrease in spending and investment by governments would provide a drag to economic growth, while simply printing money to pay off obligations would erode the currency's purchasing power and raise costs of capital. The adoption of these sorts of policies will have significant implications for investors and markets more broadly.

G7 General Government Net Debt
(percent of gross domestic product)



Source: International Monetary Fund's Fiscal Monitor (April 2021), Guardian Capital

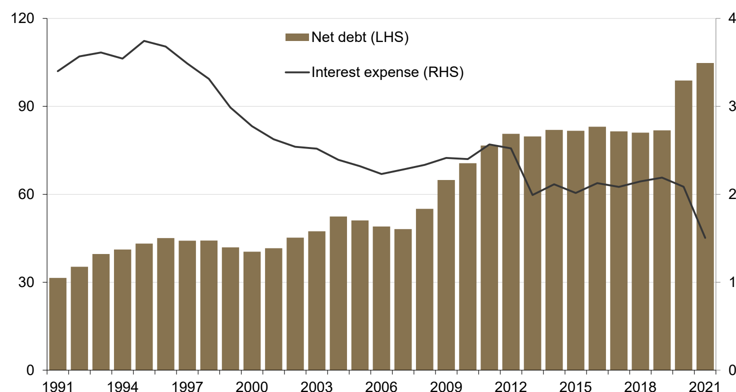
Political focus is likely to be on the taxes targeted at the upper end of the income and wealth spectrum, including higher income taxes, capital gains inclusion rates and other investment income taxes and estate/wealth transfer taxes. Such policies may get more attention as the end of this crisis becomes more visible; however, the actual implementation is unlikely to come until this crisis is well and truly over.

A big reason for the lack of immediate impetus to rein in fiscal largesse is the fact that the costs of carrying the elevated debt loads are far from onerous right now.

Debt levels themselves are not an immediate problem, although they typically come with high debt servicing costs. When more government funds are being spent on interest charges, it means that less is going toward paying for necessary services and investment, leading to a negative debt spiral and negative economic implications.

The costs of carrying debt have plunged to historic lows. The expectation is that they will remain low near term thanks to historically low interest rates worldwide (which reflect the actions by central banks amid the crisis), and efforts by government treasury departments to extend the time to maturity of the debt they hold.

G7 COVID-19 General Government Net Debt & Interest Expense
(percent of gross domestic product)



Source: Organisation for Economic Co-operation and Development Economic Outlook (March 2021), Guardian Capital

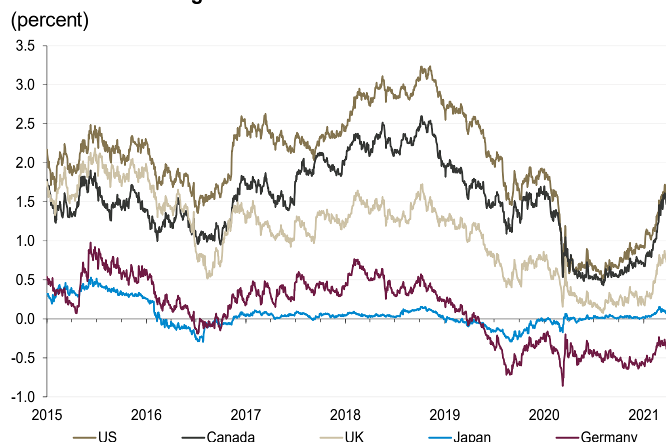
The lows in interest rates have been turned in, it would appear. Yields on government debt have increased in recent months against the improving global growth outlook. Market expectations are that higher is the path of least resistance for rates.

Market interest rates remain historically low, and the pressure on financing costs is benign. However, increasing costs of elevated debts likely means that a shift in the approach to fiscal finances is coming, and tax planning may well gain importance in the investment management process.

Efforts by governments to help their economies go from poorer in sickness to richer in health have come with commitments to have and to hold substantial financial obligations from this day forward. While governments remain focused on providing support to their economies, it is going to be a case of stimulative policies remaining 'til debt do us part.

G7 10-Year Sovereign Bond Yields

(percent)



Source: Bloomberg, Guardian Capital; data to April 27, 2021

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