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Global CIO Outlook
Storm Clouds Over Davos

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A certain pall hangs over Davos on these gray Swiss mornings. The clouds that have gathered over the Alps betray the mood among policymakers here that all is not well with the world.

Indeed, all is not right in the global economy. Issues related to China loom large as concerns mount over the sizeable accumulated debts used to stimulate their economy in the wake of the financial crisis, and to prop up zombie companies and State Owned Enterprises that desperately need to be restructured or closed.

According to McKinsey Global Institute, the total debt of China has risen from approximately 160 percent of GDP at the beginning of the financial crisis to over 280 percent today. As the Chinese economy continues to slow, a large portion of this debt will become impossible to service.

China is not alone. According to U.K. newspaper *The Telegraph*, total public and private debt in emerging market (EM) nations has risen from around 150 percent of gross domestic product (GDP) at the peak of the last credit cycle to approximately 185 percent today. Disturbingly, a large portion of the private sector debt is denominated in U.S. dollars. As EM currencies continue to decline versus the greenback, the debt burden in local currency terms continues to mount as EM domestic economies continue to slow. In some cases like Brazil, the contraction is accelerating.

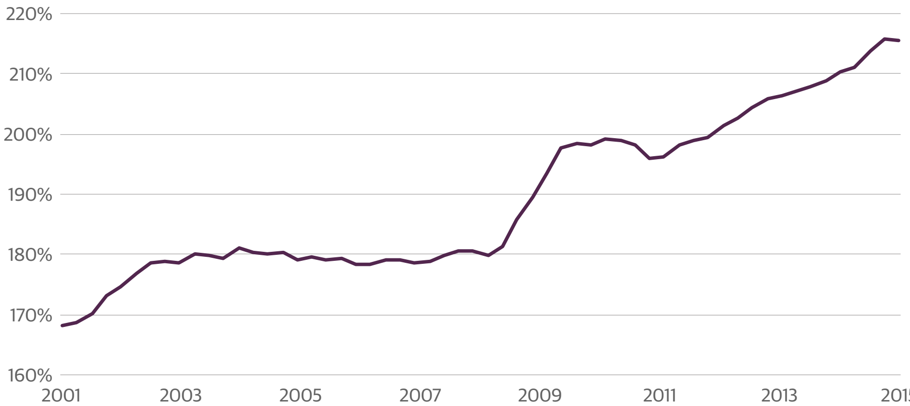
The hopes that the U.S. and European economies will be the locomotive engines to pull the global economy out of the debt mire might prove to be a grave miscalculation. According to *The Telegraph*, a debt boom of a similar scale has occurred across the 34 Organization for Economic Cooperation and Development (OECD) nations, with total debt to GDP for the group rising to approximately 265 percent.

While speaking to *The Telegraph* here in Davos, William White, chairman of the OECD's review committee and former chief economist of the Bank for International Settlements, suggested the stresses on the financial system mean that it is now "worse than it was in 2007."

The period since the financial crisis has seen a rise in leverage on a global basis, an uncomfortable position for an economy to be in during a slowdown. Policymakers must find a way bring this debt boom to an orderly end, or risk further destabilizing an already fragile global economy.

Global Debt Boom Signals Trouble Ahead

Global Nonfinancial Crediit, % of GDP



Source: BIS, IMF. Countries included: Austria, Australia, Belgium, Canada, Switzerland, Czech Republic, Germany, Denmark, Spain, Finland, France, U.K., Greece, Ireland, Italy, Japan, Korea, Netherlands, Norway, Portugal, Sweden, U.S., Argentina, Brazil, China, Hong Kong, Indonesia, India, Mexico, Malaysia, Russia, Saudi Arabia, Singapore, Thailand, Turkey, South Africa, Hungary, Poland. Data as of 1.20.2016.

According to White, "It will become obvious in the next recession that many of these debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something."

Therein lies the rub. When is the next recession, and can policymakers identify a means to find an orderly way to restructure debts to avoid financial collapse and turmoil? I would argue that they have precious little time to address the issue and bring this current debt episode to an orderly end. Certainly, historical evidence of success in resolving these types of issues is sparse.

Quite simply, the world is in trouble and the leaders at Davos know it. Adjustments must be made quickly to address the issues associated with global imbalances before the ominous gathering clouds unleash a global storm that could prove challenging to navigate.

For now, we can only hope that policymakers act quickly to buy time. The ongoing market turmoil puts further rate hikes by the Federal Reserve on hold and increases pressure on China to make radical adjustments, such as a rapid devaluation of the renminbi to spur growth in domestic export industries.

While these policy moves are likely to cause violent swings in prices for risk assets, it could accelerate global rebalancing, allowing growth to stabilize while buying more time for an orderly restructuring of global debts. If policymakers can seize this opportunity for fiscal restructuring and international coordination, the pall can be lifted and we can realize a sustained solution to end the economic malaise gripping the global economy.

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