IIF Weekly Insight
Elephant in the room

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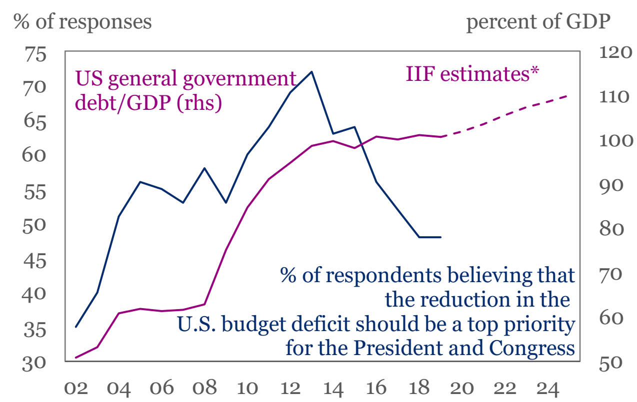
- Elephant in the room: the U.S. accounts for fully a third of all global government debt
- Fewer countries likely to see above-trend growth in 2020
- Our new "green flows" tracker shows a sharp pickup for Q1
- H1 2019 IIF Survey of Long-term Investors: fewer concerns about trade tensions, China slowdown

Spring meetings focus on debt: Among the many concerns highlighted at last week's World Bank/IMF Spring Meetings and IIF events—including the Washington Policy Summit, Global Debt and Financial Stability Roundtable, and Sustainable Finance Roundtable—are growing risks for low-income countries and the specter of a new wave of sovereign debt crises over the next several years. As our latest Global Debt Monitor Insights illustrates, both total external and government debt in low income countries have hit their highest levels since 2005. Moreover, private creditors—lending at commercial rates—now account for 20% of the creditor base (vs. 8% in 2010). This has fed into higher debt servicing costs. All of this underscores the need for more transparency in sovereign debt markets, a policy issue we will be addressing with a forthcoming set of voluntary Principles for Debt Transparency.

In contrast, high and rising levels of government debt in many mature markets—notably the U.S.—elicits few concerns in the current low-rate, low-inflation environment. In fact, a recent poll suggests that reducing the U.S. budget deficit has declined in importance for the general public, in recent years, even as pro-cyclical tax cuts feed into higher projected debt levels (Chart 1). As our latest Global Debt Monitor data indicate, out of some $65 trillion in global general government debt, the U.S. government accounts for nearly a third ($21 trillion). Yet even the IMF argues that U.S. growth momentum remains "robust," indicating that the "denominator effect" of growth prospects has been allaying potential investor concerns. While global financial stability risks may be limited as low/negative rates persist, rising leverage presents an array of medium- and long-term risks, including maturity and liquidity mismatches for corporate and EM sovereign borrowers with FX exposure.

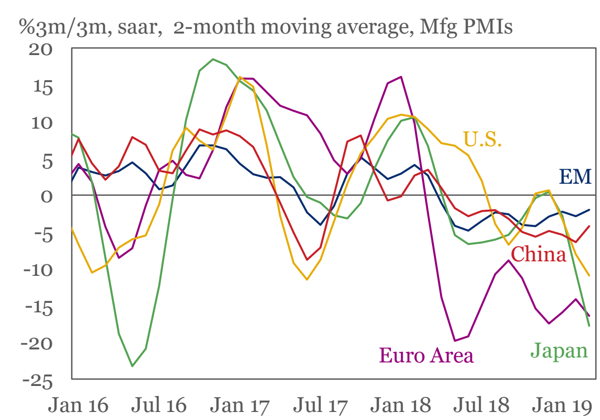
Fewer countries likely to see above-trend growth in 2020: With global growth moderating to 3.2% in H2 2018 after peaking at 4% in 2017, business sentiment indices reflect rising concerns about a slowdown, in both mature and emerging economies (Chart 2). Yet the proportion of countries experiencing above-potential growth remains above

Chart 1: Public concern about rising U.S. deficits is limited



*Source: IIF Global Debt Monitor, Pew Research Center, DB; *based on CBO budget projections. State and local government debt-to-GDP ratios are assumed to remain fixed during the projection horizon.*

Chart 2: Weaker global growth—if it materializes—would make it harder to keep government debt/GDP levels in check



Source: IIF, Haver

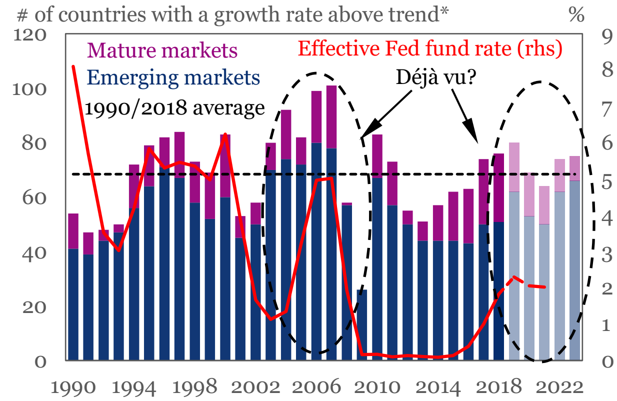
the 1990-2018 average, with some 80% still above potential (Chart 3). While this year's dovish turn by mature market central banks has brightened the short-term outlook, IMF projections suggest that an increasing number of countries will face difficulties to sustain above-trend growth as soon as 2020-21—implying more challenges for a world awash in leverage.

Spotlight on climate-related risks: Last week's Spring Meetings in D.C. also put a spotlight on climate change and its adverse implications for financial stability—echoed across the Atlantic by a new report from the Central Banks and Supervisors Network for Greening the Financial System (NGFS). While the IMF highlights climate change as a key risk to potential global growth, the long time horizon for these risks leads many to underestimate them. Low-income countries are particularly exposed to environmental and social risks, and even if addressed now, still-strong population growth in Africa suggests that climate factors will likely accelerate migrant flows to Europe and beyond, with significant implications for the global economy and financial markets. However, willingness to invest in mitigation of ESG risks has been growing: estimates from the Global Sustainable Investment Alliance suggest sustainable assets across major mature markets have grown by some 35% since early 2016, exceeding $30 trillion in early 2018. Green debt markets too have expanded rapidly since 2016, with total outstanding green bonds surpassing $430 billion in Q1 2019. Our new Green Flows Tracker suggests that retail investor appetite for green bonds has hit a record high, with $300 million of inflows in Q1 2019 (Chart 4).

New Survey of Long-term Investors—top takeaways: While concerns about trade conflicts and a potential China slowdown have eased in recent months, they still top long-term investors' global risk rankings. The political and economic backdrop in Europe is increasingly weighing on investor sentiment, while regulatory uncertainty (notably around liquidity and capital rules) is also a concern. The majority of respondents expect the Fed policy rate to reach 2.75% during this tightening cycle, implying one more rate hike. Given client demand, ESG criteria are an increasingly important factor for institutional investors' asset allocations. Survey participants also reported that development of an effective taxonomy should facilitate integration of ESG factors.

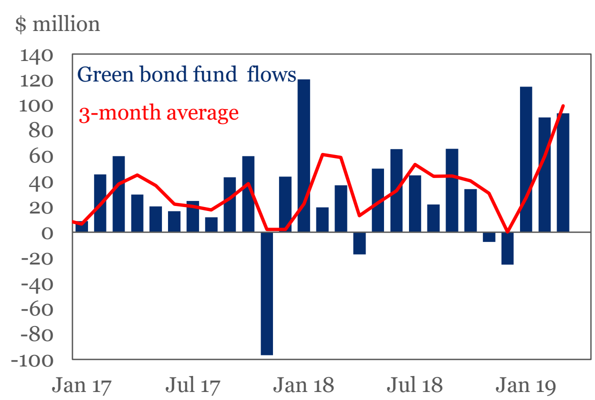
Respondents expect their clients to reduce allocations to mature market stocks and corporate bonds given growing concern about credit quality and still-stretched asset valuations. Appetite for mature market sovereign bonds is expected to remain broadly stable. Despite the current low-inflation environment, participants expect a slight increase in exposure to inflation-linked bonds, reflecting expectations of future central bank policy easing. Finally, long-term investors expect stronger client demand for emerging market assets this year, with particular appetite for EM hard-currency bonds (Chart 5).

Chart 3: Fewer countries expected to enjoy above-trend growth in 2020



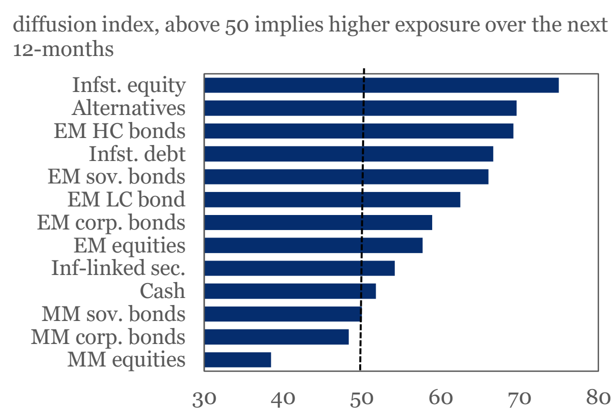
*Source: IIF, IMF, *trend growth is defined as the average growth of preceding 10-years, covers 140 countries*

Chart 4: New *Green Flows Tracker* shows big Q1 pickup



Source: Bloomberg, IIF

Chart 5: Institutional investors look to increase exposure to alternatives and emerging market assets



Source: IIF Survey of Long-Term Investors

