

# Viewpoint

## Margin Debt and Market Fragility



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- Volatility has shifted to a lower post Covid range as VIX has stabilised sub 20%
- Margin Debt is making new record highs and M2 is reaching the stratosphere...
- ....all great ingredients for some good old fashioned market fragility!

The alignment of low volatility, record margin debt and ample liquidity are factors we need to be aware of and monitor closely.

For example, during the previous peaks of market exuberance ahead of the dot-com bubble and GFC, Margin Debt to GDP for the US was at 3% (see Figure 1). We are now way above those levels..

*We are way above the levels seen during the dot-com and GFC bubbles*

Figure 1 - US Margin Debt to US GDP (%)



Source: <https://www.finra.org/investors/learn-to-invest/advanced-investing/margin-statistics> <https://fred.stlouisfed.org/series/GDP>

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Money is cheap, so elevated levels of gearing and margin should not be a surprise. However, the magnitude of the policy induced stimulus alongside retail investor involvement and strong momentum (given the lower volatility) have taken this to an all new level.

As Figure 1 depicts in the previous page, the years preceding both crises saw margin debt more than double from 1.25% of GDP to 3%, which until recently represented the peak of gearing in the system. More recently, however, the lower interest rates since the GFC, the intervention by central banks purchasing assets and the broad market stability until end of 2019 maintained levels of margin at or near the previous peaks of 3%. Following a short correction during the depths of the Covid-19 crisis the margin debt to GDP broke 3% last June and has reached 3.8% for both February and March 2021.

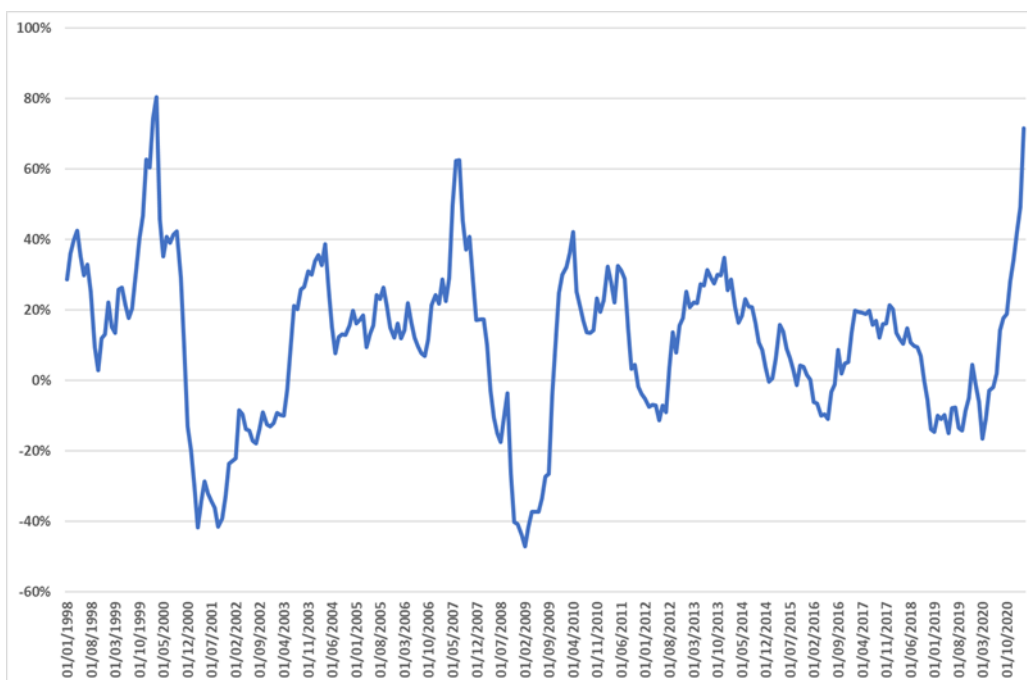
*Money is cheap, so elevated levels of gearing and margin should not be a surprise.*

As well as the level of margin debt to GDP let's also have a look at the year on year change in the level of margin debt. Figure 2 below identifies the current peak of 71.6% (as of March 2021) to be broadly in line with the recent two financial crises - 62.6% in July 2007 and 80.5% in March 2000. Also note the trajectory!

*Margin Debt is up 72% y/y since last March; compared to 81% prior to the dot-com bubble and 63% prior to the GFC crisis*

Furthermore, it is of equal interest to note that the significant and unprecedented level of stimulus across both fiscal and monetary avenues last year contained the drop in margin debt to -16.5% y/y in March 2020, as opposed to previous corrections of -41.7% in March 2001, -41.6% in September 2001 and -46.9% in February 2009. Hence, policy support prevented a squeeze in margin debt.

Figure 2 - US Margin Debt (% Change Y/Y)



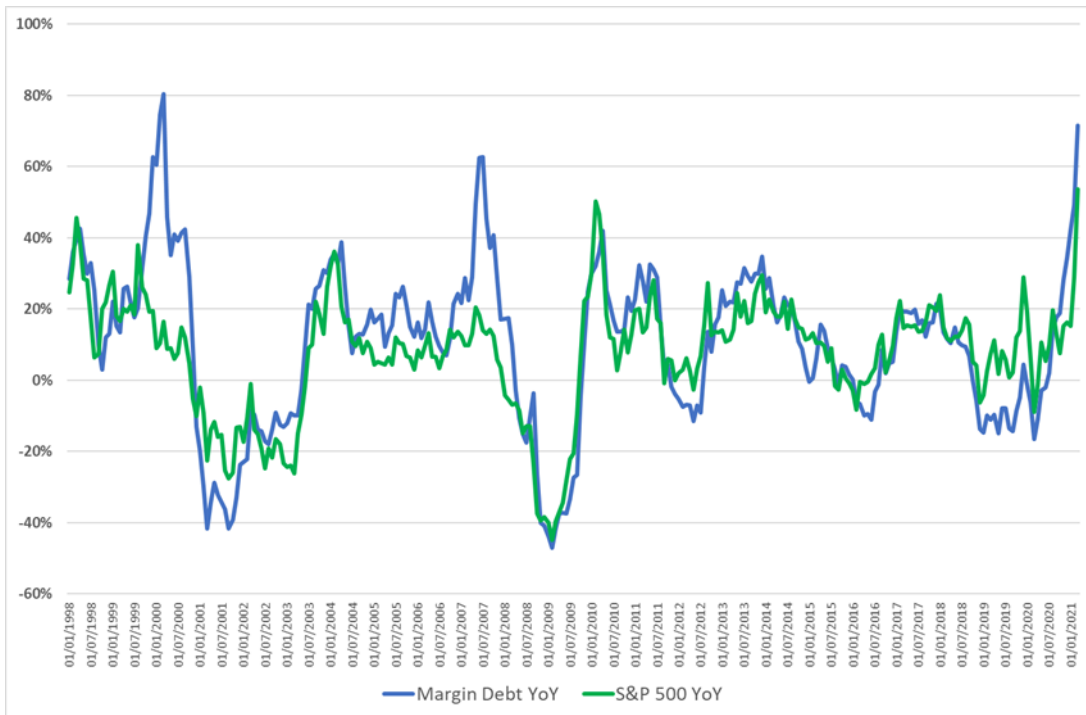
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OK, so how correlated is this with S&P500? Figure 3 below compares the two: Margin Debt %change year on year versus the year on year change of the S&P500. As you would imagine the resemblance is uncanny. Apart from a few instances of deviation, such as during the dot-com bubble which impacted some sectors and the NASDAQ more significantly than the large cap index, the extent of the move for margin debt was more significant in both instances - on the way up and the way down. The second episode also happened to be just before the global financial crisis.

*S&P500 has had its largest year on year rise over the period analysed, at +53.7% since last March*

As an aside, you may have also noticed that the S&P500 has had its largest year on year rise over the period analysed, at +53.7% since last March.

Figure 3 - Margin Debt (% Change Y/Y) vs S&P500 (% change Y/Y)



Another economic indicator blazing the newswires is the good old M2. So how does margin debt compare to M2 rather than GDP? Figure 4 below does indeed show a more sanguine picture with this ratio not being as extended this time round compared to the earlier crises of dot-com and GFC, where margin debt surpassed and approached 6% of M2, respectively. Instead we seem to be at a more comfortable 4.2% level as of March 2021 and therefore of less potential concern. Until that is, you take into account M2's recent behaviour...

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Figure 4 - Margin Debt / M2

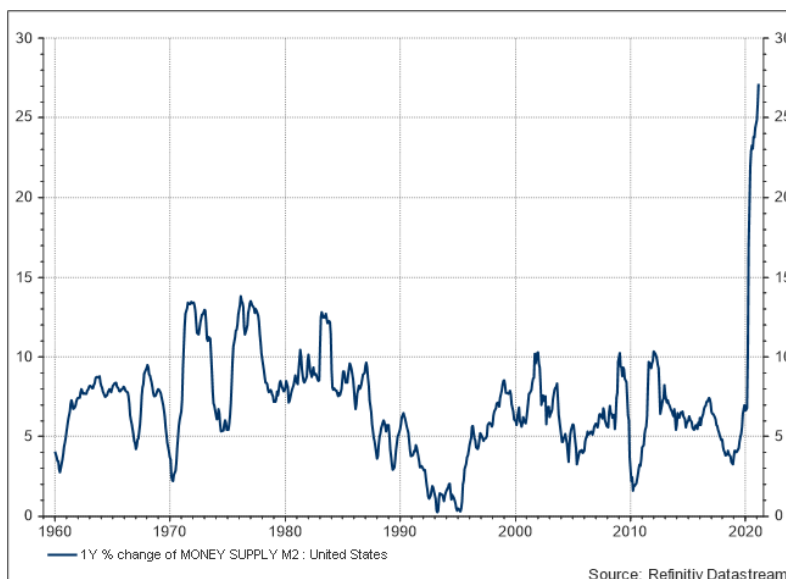


To take a good look at M2 we can't compare it to the recent market since 1997; instead we have to take it further back looking for higher inflationary periods and hence the money supply increase which preceded those. Thus, we go further back to the 1960s.

Furthermore, to get an even better perspective of the magnitude of recent developments we analyse the year on year change in M2 since last March. Figure 5 below depicts the latest year on year M2 move compared to the 1970s and 1980s. It is only then that the recent expansion in M2 can be truly appreciated!

*The latest growth of M2 has been unprecedented*

Figure 5 - US M2 (% Change Y/Y)

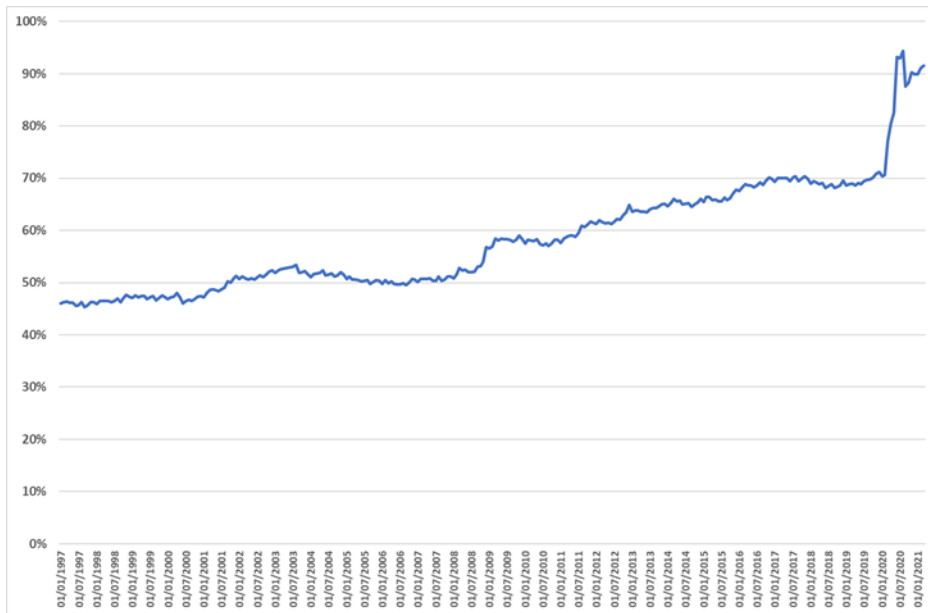


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Even if we were to adjust M2 for GDP as per Figure 6 below, we still see a significant shift up in money supply. M2/GDP has doubled since 1997 to well above 90% of US GDP... this being one of our six reasons for a shifting regime towards rising prices.

*this being one of our six reasons for a shifting regime towards rising prices*

Figure 6 - US M2 / GDP



In summary, therefore, it is not only the levels of margin debt which have risen to all time highs, but the speed with which this has occurred over the past year. Any shock or adverse external events could lead to sudden and deeper sell-offs driven by margin calls. The recent example of Archegos albeit in the unregulated part of the industry of family offices, is a case in point. Similar events could not only impact stocks which have to be liquidated, but the collateral risk to banking counterparties. Let alone the broader potential impact of the Passive funds and retail investors.

*Any shock or adverse external events could lead to sudden and deeper sell-offs driven by margin calls.*

Although the data and analysis above relates specifically to the US, China has also seen a significant amount of leverage and credit creation - a separate topic of discussion for another Viewpoint. Cognisant of this risk, however, Chinese policy makers have been tightening liquidity and credit, pricking potential bubbles of market exuberance which led to the recent stock market correction. Also the reason for calling off Ant Group’s IPO and adjusting the business model accordingly to control credit.

*Chinese policy makers have been tightening liquidity and credit, pricking potential bubbles of market exuberance*

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