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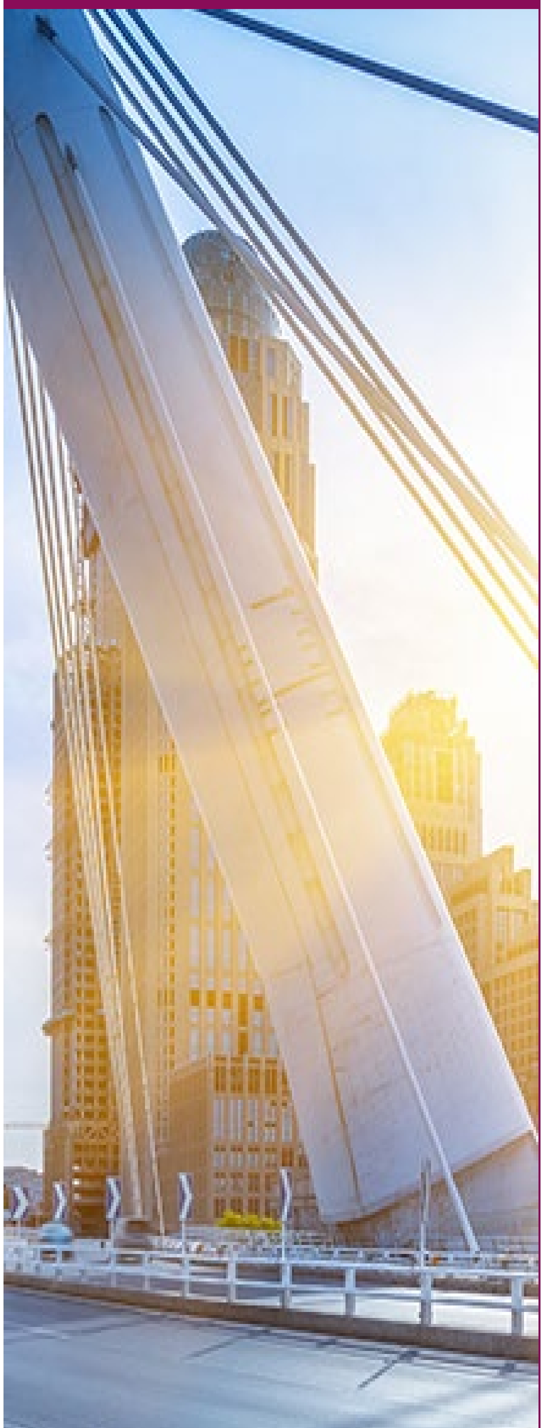
Market Ethos

The latest market insights from Richardson Wealth



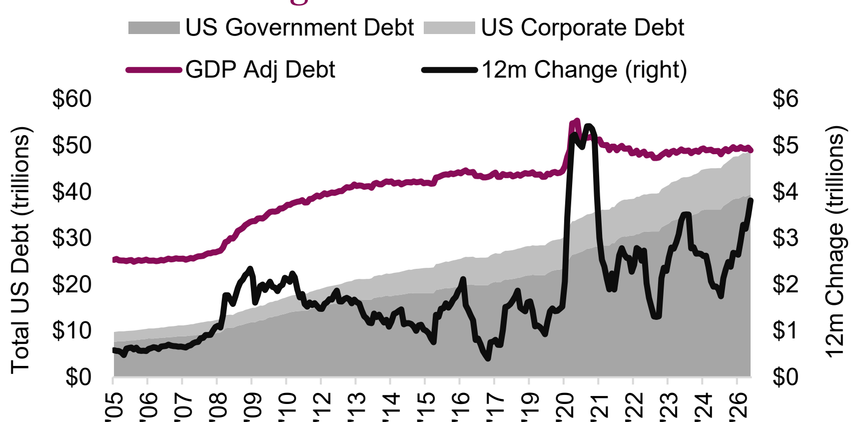
Craig Basinger

Running on credit

Economics is pretty cool. Trying to understand how the whole thing works, from the consumer to business behaviours, rates, jobs, prices, resource allocation, the list goes on and on. The impact of tariffs is on that list, but we are not going there as everyone has likely read or heard enough about that topic over the past week. Instead, we are going to talk about what a few dollars more of debt and leverage means for the economy or markets.

The Austrian economists [who weren't necessarily Austrian but that is another story] often put credit creation at the center of understanding what is going on in the economy. More recently in this century, Ray Dalio's content like *Big Debt Crises* really hammered home the importance of credit. If credit expands, those dollars are going to do something that has a positive economic impact. Conversely, if credit contracts or its pace of growth slows, the economic impact is negative.

More debt, more spending, more growth…for now



Source: Bloomberg, Purpose Investments

Let's unpack this chart a bit. This is U.S.-focused, with the grey shaded areas measuring the total amount of debt, both government (darker grey) and corporate (lighter grey). A bit scary as it was a mere $10 trillion in 2005 and is now over $50 trillion. With much of the recent banter around debt and deficits, this is at the core of that issue.

The purple line shows debt adjusted for the size of the economy, as measured by nominal GDP (the line has same shape as total debt to nominal GDP). The point is, debt is going up but so is the economy which has been keeping this purple line relatively flat over the past few years. Not saying there isn't a problem, but let's keep things in perspective.

Of more interest is the black line. This is the net change in debt over the past twelve months, and it is rising quickly. Although not adjusted for the size of the economy, up is still up. Furthermore, a higher percentage of this new debt is corporate, driven partially by the issuance of debt to build out AI infrastructure. More debt (or credit) equals more spending which equals more growth.

Not all credit growth is the same, as it depends on where it is used. Increased government debt (credit) used for health care or social programs has a positive impact on the economy (and provides an important social benefit). But the spending multiplier (aka 'k') is lower compared to infrastructure or defense spending from an economic perspective. We would also argue that the 'k' multiplier for credit growth is even larger if it is tech-spending related, which often goes global, given supply chains.

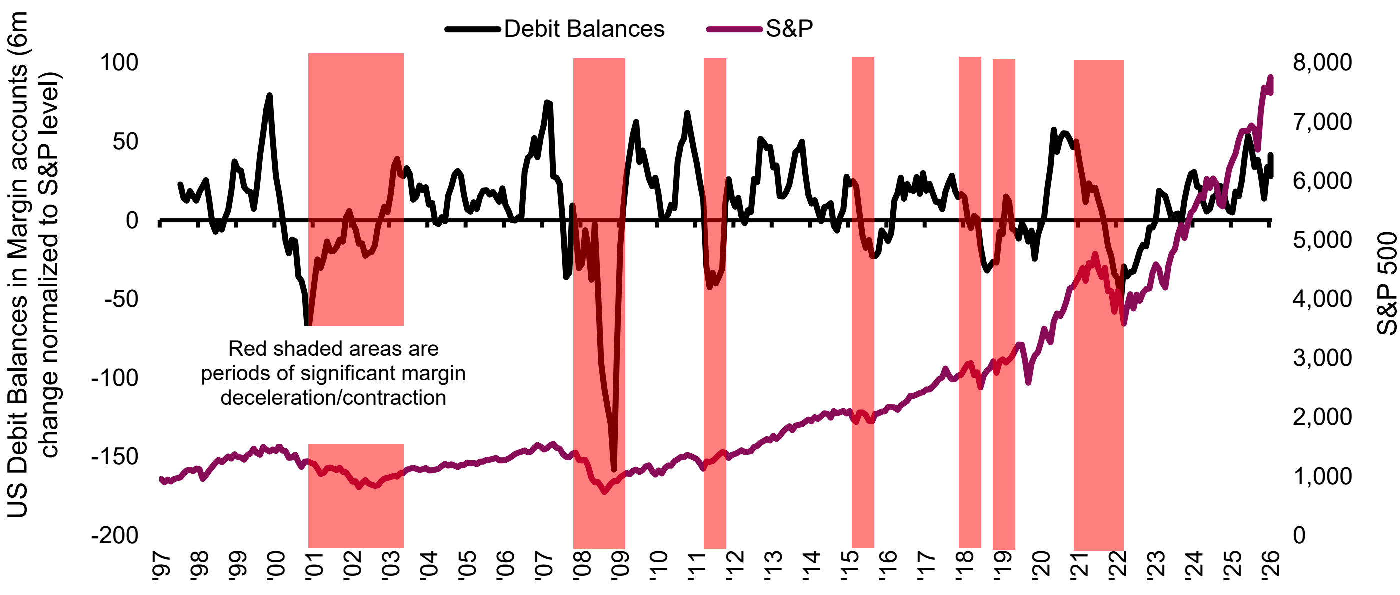
The takeaway here is that rising debt levels can lead to challenges (crowding out, imbalances, sustainability, cost), but in the near term it helps drive economic growth. Plus, the mix of credit growth today and its increased destination towards tech spending is a big positive for the economy.

More leverage, more market highs (for now)?

So, credit growth is a positive for the economy, with some potentially very serious side effects. Does this apply to the stock market as well? Certainly, there are some additional moving parts when it comes to the gyrations of the stock market, and in this case we are talking about leverage as opposed to bond issuance. Yet there are some similarities. If an investor was going to put $1 to work in the market but decided to open a margin account to use some leverage, they may end up putting $1.50 into the market.

Historically, leverage was easy to track for the U.S. via FINRA debit balances across brokerage firms. With thirty years of data, we plotted the six-month change in debit balances normalized to the S&P level to adjust for the change in the size of the market over time. Note that periods of declining debit balances, or declining margin, match very well with periods of market weakness. Admittedly, it is a bit of a chicken and egg riddle. Does a falling market cause investors to dial in leverage, or does a falling risk appetite to take on leverage lead to a falling market?

After rising leverage in margin accounts helped drive markets, the pace is slowed but is still growing

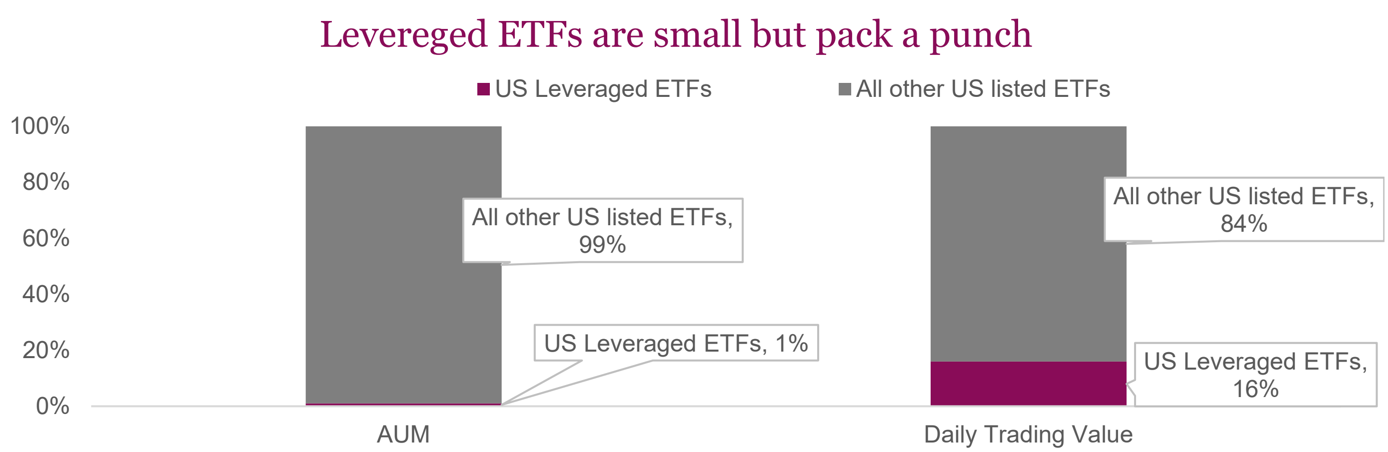


Source: Bloomberg, Purpose Investments, FINRA

Either way, debit balances are still growing, and this is helping put more dollars to work in the market. But debit balances may underestimate market leverage in today's market. With the rise of leveraged investment vehicles, investors don't need to open up a margin account to apply leverage in their portfolio. The number of investment vehicles that incorporate mild leverage, 2x, 3x, 4x, probably some 5x vehicles, have dramatically increased in popularity over the past few years.

Currently there are an estimated 868 U.S.-listed leveraged ETFs with almost $200 billion in assets, according to Bloomberg. Popularity is rising elsewhere from Canada to Europe and in Asia. That is not a huge amount of assets compared to the overall ETF market, totalling around 1%. But this small cohort of ETFs punches well above its weight in the market. Investors use these leveraged ETFs as short-term trading vehicles, often not staying put for long. As a result, that small 1% of AUM in leveraged ETFs represents 16% of daily trading volumes.

Making things easier is a sign of progress, and leveraged ETFs certainly make it easier for investors to use leverage. But there are some challenges including increased knowledge. Leverage has lifted parts of the market higher, but it can also work in the other direction. This was on full display in South Korea this year. Their market is very concentrated with a few names comprising very large index weights that also happen to be at the center of the AI infrastructure buildout. Adding to the boom was increased use of leverage from margin accounts to leveraged investment vehicles. This helped drive the KOSPI (S. Korean equity index) up 122% this year before giving back about half of those gains.



Source: Purpose Investments, Bloomberg
Notes: AUM as of Aug 6, 2026. Daily trading value is average over past 30 days

Clearly leverage contributed to these moves. Now regulators are trying to rein in leverage, including required education on using such vehicles. While the adoption in North America pales in comparison, flows into or out of leveraged investment vehicles can exacerbate the moves in the underlying holdings. This has led to more volatile intraday trading.

Final thoughts

More debt is not a bad thing. Neither is more leverage. Increased debt issuance leads to higher economic activity, and increased leverage can lift markets. But as many things in life, too much of a good thing can become very bad. Maybe society has already gone too far with government debt, we are certainly in uncharted territory. Maybe the corporate credit creation to build data centers will unleash a global productivity boom. Or maybe they will have trouble earning high enough returns to justify or service the debt. Maybe investors will responsibly use leveraged ETFs as a new tool in the portfolio construction toolbox. Or maybe they will use them to speculate on a day-to-day, hour-to-hour basis.

That is too many 'maybes' for one paragraph. The takeaway is to better understand the implications. Credit growth is helping economic growth but adding to the risks going forward. Just like leverage is helping lift markets but is adding to the risks going forward.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.