NEWTON
Investment Management

HOW THE RISE OF POPULISM COULD HIT YOUR BOND RETURNS

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Paul Brain
Investment leader, fixed income

Part of BNY MELLON

The last decade has been dominated by quantitative easing and unprecedented asset purchasing by central banks. While a systemic global financial collapse was avoided, one unintended consequence has been to widen the disparity between the rich and the poor.

The effect of this uneven distribution has been to trigger a rising tide of populism across much of the world, which has been one catalyst for a marked change in direction by policymakers, who find themselves under pressure from disaffected voters.

This article explains why we believe the next political and economic phase makes taking an active and flexible approach to fixed-income investing more important than ever.

Over the last decade, financial markets have been dominated by loose monetary policy and central banks buying up huge swathes of the bond market, which has had the effect of increasing the correlation between asset classes and broadly dictating their respective returns. But times – along with monetary policy – are changing, and we are entering a new and less predictable phase which could have a profound impact on bond markets and the potential returns to be derived from them.

The primary intention of the billions of dollars of 'quantitative easing' pumped into the global economy in the aftermath of the global financial crisis was to shore up the global banking system and prevent a systemic collapse of the financial system.

While that scenario was successfully avoided via the printing of billions and billions of dollars, yen, euros and sterling, and by unprecedented government bond-buying programmes, the wider impact has been to distort asset prices upwards, to screw down the yields available from most conventional assets, and to drive interest rates down and maintain them at close to historic lows.

The growth of inequality

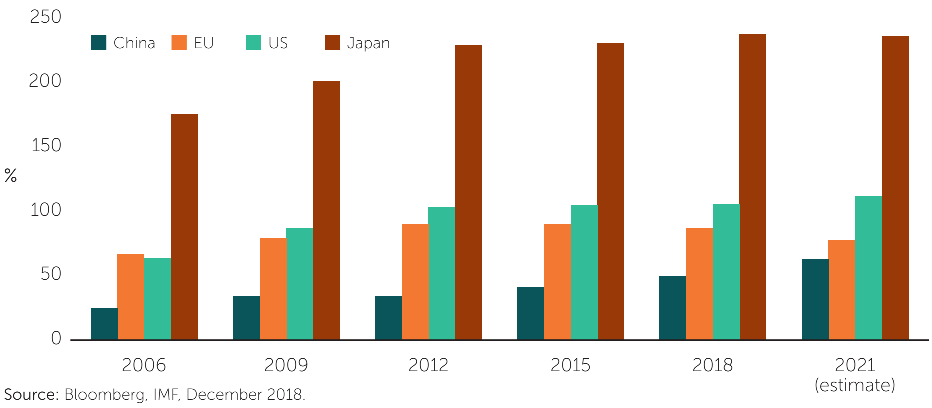
It is now broadly accepted that the unintended consequence of this prolonged period of cheap debt and easy money has been to increase the wealth gap between the rich and the poor by disproportionately benefiting the rich, and subsequently fuelling a growing wave of dissatisfaction among voters.

The effect of this uneven distribution has been to trigger a rising tide of populism across much of the world and to act as a catalyst for a marked change in direction by policymakers, who find themselves under pressure from a disaffected populace.

With global monetary policy tightening and central banks slowly withdrawing from bond markets, we have seen a growing trend for government and central-bank policy to pivot away from monetary easing towards fiscal easing: printing more money, and promising to give more money to the people, which in many cases leads to growing budget deficits. The chart below shows how government debt in the world's biggest economies has been steadily rising over the last 12 years, and, with fiscal easing measures likely to grow in many economies, it is predicted to continue doing so.

In the United States, particularly since the election of President Donald Trump, we have seen the administration embark on a huge tax-reduction programme while cutting domestic programmes and increasing spending in areas such as defence. The result is US public debt currently sitting at $15.8 trillion for the fiscal year 2018.[1]

Exhibit 1: **Total government debt as a percentage of GDP**



Source: Bloomberg, IMF, December 2018.

1 https://www.ft.com/content/513e170a-65a9-11e9-a79d-04f350474d62

Three phases of policy response

In our post credit-crisis world, we see the authorities responding in three distinct phases.

Phase 1: **Quantitative easing**

The first phase involves the imposition of ultra-low cash rates and bond rates through the mechanism of quantitative easing, which has characterised much of the last decade.

Phase 2: **Fiscal stimulus**

In the second phase there is fiscal stimulus (or slippage), where, in the broadest sense, austerity is replaced by increased spending and tax cuts.

We are seeing this happening on both the left and right side of the political divide. For example, some US Democrats, and in particular supporters of Bernie Sanders' 'Democratic socialism' campaign, are arguing for increasing taxes for the wealthiest individuals in order to raise a targeted amount of up to $250 billion to support domestic spending in areas such as health care and housing.

Phase 3: **Modern monetary theory**

The third phase is modern monetary theory (MMT). Indeed, there has recently been a sharp spike in interest in MMT (see exhibit 2), which espouses tax hikes for the wealthy but goes further.

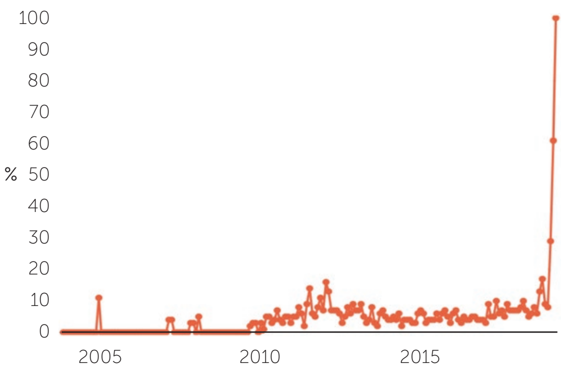
Proponents of MMT argue that governments that control the printing presses for their own currency should take on as much debt as is required to achieve set policy objectives (such as income redistribution, a universal basic income, full employment, or a national health service, for example), on the view that, as long as inflation is contained, servicing an increased level of debt will not become a significant problem.

We would term such a 'direct-action' form of monetary and economic policy, where money is created and distributed more directly to people, as 'helicopter money', which is likely to weigh on bond market returns.

Notably, MMT has gained credence among US Democrat policymakers such as Stephanie Kelton, an adviser to Bernie Sanders' 2016 and 2020 US presidential campaigns.

And, of course, there are repercussions for growing deficits. Even at current spending levels, the International Monetary Fund (IMF) expects the US's total interest bill to rise over the next three years by around $100 billion if interest rates do not rise from their current level, as exhibit 3 indicates. This money has to be found from somewhere.

Exhibit 2: **Web search interest for 'modern monetary theory'**

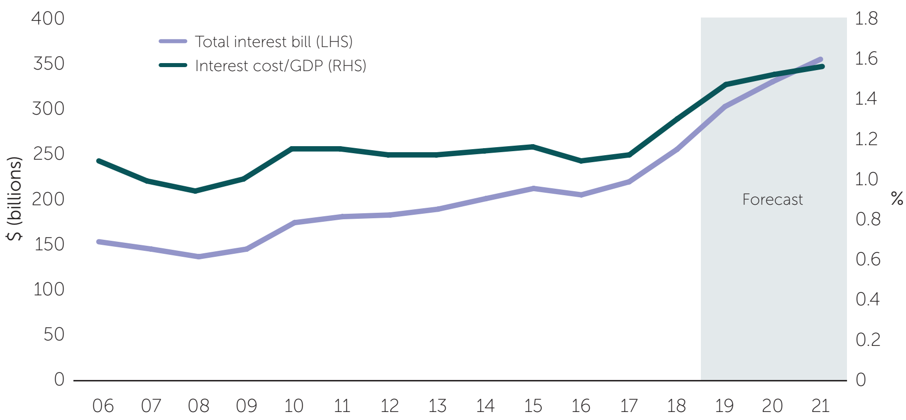


> "There has recently been a sharp spike in interest in MMT, which espouses tax hikes for the wealthy but goes further."

Source: Google Trends, 2018.

Note: Numbers represent a search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term.

Exhibit 3: **Total US interest bill rise over next three years – if interest rates remain at current levels**



Source: Bloomberg, IMF, December 2018.

The trend towards increased spending and growing deficits is not simply confined to the US. In the UK, Labour Party leader (and potential next British prime minister) Jeremy Corbyn has pledged to dramatically increase government spending in the public sector after a decade of relative financial austerity and budgetary cuts following the global financial crisis. Indeed, the broad thrust of the Labour Party's financial agenda once in government would be to lower taxes for lower-income earners while at the same time raising taxes for wealthier earners and increasing government spending.

Populism's march in Europe

If we turn to continental Europe, the continued rise in populism (and potential monetary policies that could be deemed populist) also have implications for bond investors. The tendency of populist parties (or populist elements within parties) to promise their electorates easier fiscal policies is likely ultimately to lead also to higher budget deficits.

Additionally, repercussions could stem from parties' failure to deliver enough fiscal easing to satisfy elements of the electorate, subsequently leading to the creation of yet more left and right-wing populist parties.

This has been the case in Spain, where continuing voter dissatisfaction created two of the newest parties, Podemos and Ciudadanos, which have broadly failed to make a significant impact. A new right-wing challenger, Vox, has recently joined the fight, picking up 24 seats in Spain's latest general election that produced a socialist government but no clear winner.

"As we now see in Spain, this in turn leads to coalition governments that have limited ability to effect any meaningful change both in terms of monetary and broader policy decision-making."

We expect such electoral dissatisfaction to continue as a global trend and to bring about a continual increase in the number of parties diluting the overall vote in many countries. As we now see in Spain, this in turn leads to coalition governments that have limited ability to effect any meaningful change – both in terms of monetary and broader policy decision-making – thus making it difficult for bond investors to discern a predictable or consistent pattern of political or monetary policy behaviour.

Beyond Spain, last year's Italian general election and French president Emmanuel Macron's reversal of some economic reforms in France after pressure from the 'gilets jaunes' movement, are just two further examples of populist behaviour executed to appease dissatisfied electorates.

The days of easier returns are over

So why should these shifts in potential monetary and economic policy matter to fixed-income investors? We would argue that, with policy now shifting toward fiscal easing, the era of easy money is coming to an end but geopolitical risks remain heightened.

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The fixed-income sector is a hugely diverse and complex universe to navigate, and we believe that the next market phase will see the asset class likely to be buffeted by changes in monetary and political direction, characterised by increased public spending and widening budget deficits. We predict that this backdrop will throw up opportunities to unlock value for active and flexible fixed-income investors, which in our view would be hard for investors in a passive bond index to replicate.

Owing to broadly correlated returns for asset classes and reasonably predictable returns for bond investors derived from governments' bond buying over the last decade, both passive and active bond managers have fared reasonably well in recent times.

Understandably, many investors may have chosen a passive-bond strategy owing to its lower relative cost, which is likely to have worked reasonably well over the last few years. However, given the new market phase we are entering, there is every chance that some sectors of the bond market will incur negative returns. If a bond index loses 1%, but an active manager achieves a flat return, the active investor may still be happy, while it is possible that the passive investor will be dissatisfied.

WHY WE BELIEVE AN ACTIVE APPROACH WORKS

This is what we believe a good flexible active fixed-income investor should be able to do: limit the downside in uncertain times and protect investors' capital, while being alive to opportunities and anomalies that less predictable and changing market conditions might fleetingly throw up.

Bond markets are diverse, with a raft of different types of debt available to buy beyond the broad bond asset classes. Indeed, a large company may have hundreds or even thousands of different tranches of debt of varying quality and maturity.

"We believe it is time for investors to wake up to the changing macroeconomic and political backdrop, and consider the potential advantages of taking an active, flexible approach to navigate the uncharted fixed-income territory that may lie ahead of us."

In our view, a flexible, active approach allows one to seek out opportunities to add alpha from different parts of the fixed-income universe, at a time when being passively invested in one particular bond index could heighten the risk of locking in a capital loss. We believe it is time for investors to wake up to the changing macroeconomic and political backdrop and consider the potential advantages of taking an active, flexible approach to navigate the uncharted fixed-income territory that may lie ahead of us.

FOR MORE INFORMATION

Business development

Sebastien Brown
T: +852 3926 0695
E: sebastien.brown@newtonim.com

Phil Filippelis
T: +61 2 9260 6670
E: phil.filippelis@bnymellon.com

Client director

James Mitchell
T: +44 20 7163 2009
E: james.mitchell@newtonim.com

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