



POLICY INSIGHTS

November 2018

*The view from our
fixed income experts.*

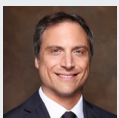
GLOBAL INVESTMENT TEAM



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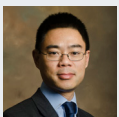
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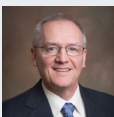
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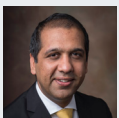
Quentin
Fitzsimmons



Ju Yen
Tan



Steve
Huber



Saurabh
Sud

Once a month, our fixed income experts, helped by our analysts and traders, conduct an in-depth review of the full fixed income opportunity set. This article highlights a particular theme that dominates markets today.

A NEW ERA OF FISCAL GENEROSITY?

A high-water mark seems to have been reached in 2018 as far as fiscal rectitude is concerned, but that discipline is now showing signs of waning. This “turning of the dial” is in good part a consequence of the rise of populism, which has been propelled by the pressure to maintain growth levels during difficult times. In our latest policy meetings, the investment team discussed these developments and considered their long-term implications for fixed income markets.

Populism has swept across developed markets in recent years, bringing with it the election of Donald Trump as U.S. president; the UK’s vote to leave the European Union; and, more recently, the formation in Italy of a coalition government comprising the anti-establishment parties League and Five Star. As a result, fiscal packages are being put together in some countries that are aimed at pleasing the electorate, but which compromise fiscal conservatism.

“It’s concerning when countries move away from fiscal prudence,” said Quentin Fitzsimmons, a portfolio manager and member of the fixed income global investment team. Ratings agencies take a similar view, as shown by their recent outlook cuts and downgrades of Italy’s sovereign rating in response to the government’s plans to increase welfare spending and cut taxes.

“Further negative rating action on Italy cannot be ruled out,” said Mr. Fitzsimmons. “The coalition’s fiscal plan is only consistent with public debt ratio stabilization; it leaves no fiscal space to respond to shocks.” Italy is the second-most indebted government in the eurozone after Greece, with debt exceeding 130% of gross domestic product (GDP). It is therefore no surprise that markets now demand a higher premium to hold Italian debt. The team concluded that spreads are likely to stay elevated and volatility is unlikely to abate unless the coalition reins in some of its spending plans.

“It’s concerning when countries move away from fiscal prudence.”

–Quentin Fitzsimmons, Portfolio Manager

The investment team noted that the UK government is also heading in a more spending-friendly direction, as demonstrated in the country’s recent October budget. This, combined with elevated inflation and the possibility of further interest rate increases, leaves gilts looking particularly vulnerable over a medium-term horizon.

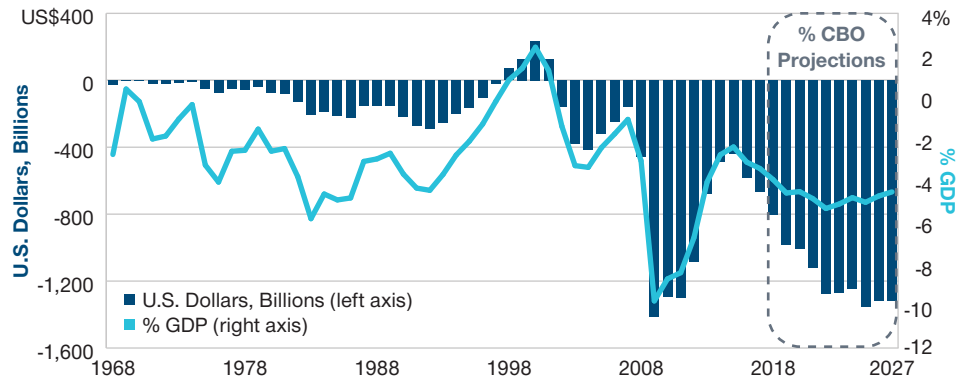
In the U.S., the government has already turned on the fiscal taps via tax cuts and a range of spending measures, which played a part in the near-17% rise of the budget deficit for the fiscal year ending in September 2018. According to the Congressional Budget Office, the annual budget deficit could exceed \$1.2 trillion by 2022, which would represent a fiscal deficit of 5.3% of GDP. The fiscal situation in the U.S. is clearly deteriorating, and the investment team questioned whether Treasuries' "safe haven" status may be vulnerable. "It may take considerable time, but when the market eventually does come to grips with the implication of large fiscal deficits for future generations, longer-dated Treasuries look most at risk," said Mr. Fitzsimmons.

Among emerging market countries, India stands out as one that has recently succumbed to the temptation of fiscal generosity. Ahead of elections that are expected to be tightly contested next spring, the government is trying to woo voters with increased public spending. "India's government spending spree is coming at the expense of fiscal discipline," said Mr. Fitzsimmons. "The investor community has responded to the deterioration by punishing domestic bonds and the rupee, although valuations in both are now moderately attractive."

Finally, China is a special case as its fiscal deficit never really recovered from its deterioration in 2016. China seems to be in an impossible situation in that it wants to reduce its budget deficit on the one hand, while on the other hand it

FIGURE 1: U.S. Government Accounts Are Expected to Deteriorate Further

As of November 14, 2018



Sources: Congressional Budget Office (CBO). Historical data from September 1968 to September 2017. Projections from September 2018 to September 2028. Projections from "The 2018 Long-Term Budget Outlook," June 2018. Actual results may vary, and the information should not be considered or relied upon as a guarantee.

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wants to cut taxes and boost spending to support its slowing economy. "While we do not see the Chinese renminbi breaking through the key level of 7 against the U.S. dollar, it may well be the sacrifice that the authorities have to make to satisfy their need to support the economy," said Mr. Fitzsimmons.

At a more strategic level, the investment team concluded that financial markets could be at an inflection point at which

easy monetary policy is superseded by fiscal stimulus, increased spending, and tax cuts. This is partly being driven by a growing perception that monetary policy has done as much as could have been hoped for in terms of raising economic growth rates around the world and that central banks are reacting to this view by raising interest rates.

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