



Preparing for a Populist Future

Markets have yet to grasp the impact of radical economic policies.

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KEY INSIGHTS

- The current era of populism is likely to last—the frustrations that have persuaded voters to turn against mainstream politics are not going away.
- Populist regimes typically pursue policies that directly challenge central bank independence, corporate governance, and property rights.
- In the past, these policies have resulted in unsustainable fiscal deficits and high inflation, eventually leading to slower capital formation.



Nikolaj Schmidt
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The resurgence of populism has abruptly reshaped global politics over the past few years, but what it means for economic growth and financial assets has yet to become clear. Although markets are quick to respond to individual events—such as a populist party’s rise to power or the introduction of a tax cut or spending increase—they have not yet grasped how populism could affect the global economy over the long term. This poses a challenge for investors, as they need to understand the economics of populism to effectively position their portfolios over the years ahead.

It is likely that the current era of populism is still in its infancy. The frustrations that have persuaded voters in so many countries to turn against mainstream parties will not disappear any time soon, and it seems probable that the populist leaders voted into office over the past few years are just the first of many. Globalization is very likely the cause of this. Free trade and the liberalization of capital markets have made many countries richer, but most have

become less equal in the process. The 2018 World Inequality Report showed that, following decades of falling inequality, income and wealth inequality have risen almost everywhere since 1980. More recently, the prices of financial assets such as stocks, bonds, and property have surged to record levels, putting them out of the reach of ordinary people.

The growth of inequality has proved to be fertile ground for populism, which typically divides the world into virtuous “ordinary” people on the one hand and corrupt elites and outsiders on the other. The system has made the elites richer, populists claim, while ordinary people have been ripped off. They argue that the only way to restore fairness to the system is through interventionist redistributive economic policies enacted by political leaders that act on behalf of the many, not the few. These arguments are resonating and will lead to major policy changes that will impact the global economy for many years to come—and it is this longevity that the markets struggle to grasp.







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(Fig. 1) Three Policy Risks of Populism

Central bank independence, corporate governance, and property rights can be challenged.

As of January 31, 2019

Policy	Risk	Examples
 Challenge to central bank independence	 The independence of central banks can be weakened, particularly with regard to inflation management.	Argentina —Successive left-wing populist governments used the central bank to fund public spending 2003–2015. United States —U.S. President Trump applies pressure on the Federal Reserve to contain rates.
 Challenge to corporate governance	 Corporate governance can be damaged when “national interest” overrides shareholders’ interests.	United States —President Trump has pressured companies to keep production facilities and associated high-paying jobs in the U.S. Left-wing populist senators Chuck Schumer and Bernie Sanders have proposed that companies should be prevented from buying back their own shares unless they first pay workers at least \$15 per hour and offer other benefits.
 Challenge to property rights	 Property rights are typically well protected by the law, but some of the more extreme tax initiatives favored by populists can challenge those rights.	Venezuela —After Hugo Chavez was elected president in 1998, many companies have had their property expropriated by the government. Hungary —Viktor Orbán’s government ended mandatory payments into private pension schemes in 2010 and nationalized most of the money contained in the pension system.

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Redistribution is Key to Populist Thinking

Much is often made of the difference between left-wing and right-wing populism, but in reality, they probably have more points in common than of difference. The key economic objective of both, for example, is redistribution. Left-wing populism draws a line at a certain income threshold and defines everybody below that as “the people,” then seeks to redistribute resources to the people through aggressive taxation and cheaper, more widely available, public services. Right-wing populism restricts the definition of “the people” primarily to the middle class, excluding immigrants, ethnic minorities, and the very poor. Whereas left-wing populists can be hostile to business, right-wing populists usually favor making business more competitive through tax cuts and deregulation to prevent jobs from being outsourced overseas. Both left-wing and right-wing populists are hostile to free trade, regarding it as damaging to the employment and earnings prospects of “the people” as they regard them.

Although the aim to reduce inequality and raise social mobility is laudable,

the loose fiscal policies adopted by populist regimes have historically been combined with policies that directly challenge central bank independence, corporate governance, and property rights. Typically, these policies have resulted in negative economic outcomes, such as unsustainable fiscal deficits and high inflation, which eventually lead to slower capital formation as business confidence ebbs. While growth might initially be supported by some of these policies, it is likely to suffer over the longer term as their effects mature.


Economically, this picture resembles the United States in the 1970s—a decade in which inequality fell meaningfully before it started to rise in the 1980s along with expanding corporate profit margins. The economic policies of the 1970s were characterized by a combination of price controls to limit inflation and expansionary fiscal policies to support real income growth amid shocks from rising oil prices. According to the findings of Romer and Romer’s 2002 paper “The Evolution of Economic Understanding and Postwar Stabilization Policy,” throughout the 1970s the U.S. Federal Reserve adopted a “defeatist” attitude toward


170 million


The number of Europeans ruled by a government with at least one populist in the cabinet.¹

inflation: The Fed leadership believed that monetary policy was futile as an inflation management tool—a stance not too dissimilar to that of a central bank that, under political pressure, keeps monetary policy too accommodative.

The main impacts of the economic policies of the 1970s on asset markets were as follows:

 **Equities**—Against a backdrop of just above 7% inflation, the S&P 500 rose at an annual rate of around 1.5%. The equity market's failure to keep up with inflation was probably, in part, a reflection of the compression of profit margins that followed once wage pressures were allowed to develop.

 **Bonds**—Nominal yields rose, but real yields fell. The yield on the 10-year U.S. Treasury note began the period at 7.75% and ended the period at 12.75%. In contrast, real yield on the U.S. 10-year Treasury note (calculated as nominal yield minus observed inflation) started the 1970s around 1.5% and ended the period at -0.25%.

 **Currency**—Throughout the 1970s, the U.S. dollar depreciated against other major currencies.

These return profiles provide an insight into what one might expect from populist governments that seek to deliver on overzealous election promises. Pressure on central banks to adopt accommodative

monetary policies will typically lead to increased inflation expectations, steeper yield curves, lower real yields, and currency depreciation. At the same time, the push for income redistribution and higher wages reduces profit margins, which, in combination with rising macro uncertainty, challenges equity valuations. Both sovereign and corporate credit spreads can be expected to widen when governments undertake fiscal expansion amid a backdrop of limited fiscal space.

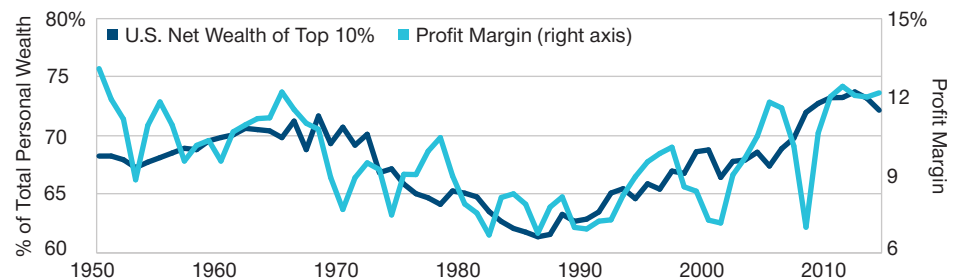
The early stages of the policy profile outlined above can be glimpsed in President Trump's deficit-financed tax cuts and the ruling Italian populist coalition's battles with the European Union (EU) to push through an expansionary budget. The fiscal accounts of Hungary and Poland have structurally deteriorated after the election of right-wing populist governments, and the markets price in a fiscal deterioration in Mexico under the newly elected left-wing president Andrés Manuel López Obrador. It is worrying that most of the populist governments that undertake these fiscal expansions lack the fiscal space to do so.

How Does it End?

It seems unlikely that the current generation of populist politicians will deliver the income redistribution and social mobility that their base demands. Jobs that have been outsourced to other countries cannot easily be repatriated, and excessively loose fiscal policies invariably

(Fig. 2) Increasingly Unequal

U.S. net wealth of top 10% vs. corporate profit margins.
As of January 31, 2019



Sources: World Inequality Database, Bureau of Economic Analysis, and T. Rowe Price.

¹The Guardian newspaper.

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have outcomes that dent business confidence and reduce capital formation and job creation—i.e., the initiatives are a drag on growth, which probably makes income redistribution and social mobility harder, not easier, to deliver.

However, it would be a mistake to think that the potential failure of populist politicians will lead to the early demise of populist politics. The median voter’s demand for greater equality and social mobility will not be silenced until those demands have been met—and if the first populist government that is voted into power fails to deliver, voters are more likely to elect another populist candidate than to vote for mainstream candidates. Therefore, we should not think about the elections of Donald Trump in the U.S., Viktor Orbán in Hungary, Andrés Manuel López Obrador in Mexico, Jair Bolsonaro in Brazil, and the coalition of the Five Star Movement and the League in Italy as isolated events; rather, they are likely to be the first in a string of such victories.

Moreover, it is not only populist, “alternative” candidates who promise greater equality and mobility; incumbent politicians are likely to shift their stances to address the populist threat. To keep populist politicians from power, mainstream parties will find that they must offer a viable alternative—that is, center-right parties must shift further right, and center-left must shift further

left. In this way, populist movements can exert considerable influence over policy without actually gaining power.

For the eurozone in particular, the political backdrop has become increasingly problematic: In the north of Europe, right-wing populists regard their southern European neighbors as “lower class” countries that need to be subsidized by northern European taxpayers. Conversely, in the south of Europe, the left-wing populist narrative pushes the establishment to deliver the traditional redistribution from rich to poor in the form of debt forgiveness. The growing support for the populist parties in both the north and south of Europe is bound to keep political fracture lines under pressure. At best, for Europe the backdrop seems to be one that preserves that status quo, not one that facilitates further integration.

The path forward is fraught with uncertainty. However, it is important for investors to at least embrace the possibility that the populist movement is a long-term, structural phenomenon. If it is, we will likely contend with the profound implications of populism on economies and financial markets for many years to come. In this case, active management—with a strong emphasis on deep research, local knowledge, and the ability to switch positions quickly—is likely to be the most effective approach to navigating the period ahead.

WHAT WE’RE WATCHING NEXT

Ahead of May’s EU elections, Italy’s ruling populist coalition seems to be stepping up its rhetoric and picking fights with the bloc’s establishment. Elsewhere, Eduardo Bolsonaro, a member of Brazil’s Congress and son of President Jair Bolsonaro, recently announced that he would represent South America in The Movement, the consortium of populists founded by Donald Trump’s former campaign manager, Steve Bannon. If a deadlock over Brexit results in new elections in the UK, it will be interesting to see how Jeremy Corbyn’s Labour Party performs.

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