GLOBAL PERSPECTIVES

THE HANGOVER

JULY 2020

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Highlights

- America's fiscal policy response to the pandemic has been the most aggressive in the world. This is a near-term plus for the global economy and financial markets.
- The fiscal hangover could result in persistently negative real interest rates, higher U.S dependence on foreign capital, and a multi-year slide in the U.S. dollar.
- Investors can hedge their portfolios against a slide in the dollar through higher non-U.S. equity exposure.

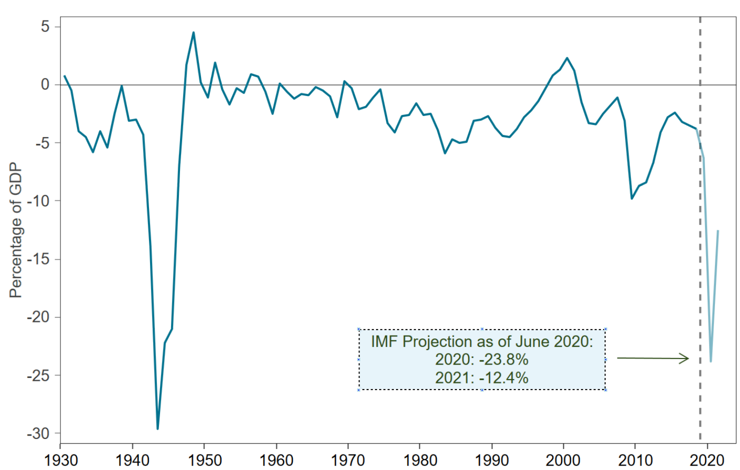
America's Fiscal Policy in a League of its Own

America's fiscal response to the pandemic has been truly exceptional. According to the International Monetary Fund (IMF), America's overall fiscal deficit is expected to expand from $ 1.3 trillion in 2019 to $4.7 trillion in 2020 (Chart 1). Relative to the size of the economy, that represents a shift toward deficit spending that far eclipses anything seen since the dark days of World War II. In comparison, the $800 billion Recovery Act following the Global Financial Crisis in 2009 was small change. That Act earmarked only $185 billion of new spending for 2009 with the rest spread out over the next few years.

America's fiscal response is also in a league of its own from an international perspective. To facilitate international comparisons, consider changes in deficits as a percentage of GDP. The IMF projects the U.S. deficit going from 6.3% of GDP in 2019 to 23.8% in 2020 (Table 1). The change from 2019 to 2020 represents a so-called "fiscal impulse" of 17.5% of GDP. In contrast, the Eurozone's fiscal impulse is expected to be about 11% of GDP while China's is expected to be 6% of GDP.

These projected fiscal impulses are massive because the current global downturn is so much more severe than all previous business cycles since the 1930s. With few exceptions, most governments have chosen to embrace quasi-wartime finance to cushion the impact of the pandemic on their economies. It is the size of America's fiscal response that stands out, relative to both the nation's history and to the responses of other nations.

CHART 1: U.S. Budget Deficit for 2020 is Expected to be Largest Since World War II



Source: GW&K Investment Management, International Monetary Fund, and Macrobond

The IMF projects that the U.S. government budget deficit will soar from 6% of GDP in 2019 to nearly 24% of GDP in 2020. This would reflect the most aggressive fiscal stimulus of any major nation.

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We believe the exceptional size of America's stimulus helps explain the recent flurry of strong U.S. economic data as economic surprises have skyrocketed to all-time highs. Consider Citi's Economic Surprise Index for the U.S., which monitors how economic reports differ from economists' expectations. As of mid-July, that index had soared into uncharted territory, nearly six standard deviations above the norm. The surprise index reflects blowout reports on job growth, retail sales, purchasing mangers' indexes (PMIs), and pending home sales (Chart 2).

Here too American exceptionalism is evident. Citi maintains similar economic surprise indexes for China, Europe, Japan, and the Emerging Markets. In most foreign data, we have seen nothing like the degree of upside surprises as we have in the U.S. We suspect that the exceptionally large and heavily front-loaded U.S. fiscal stimulus is a key reason for this divergence.

Will America's Fiscal Exceptionalism Result in a Financial Hangover?

In the midst of a global health emergency, many investors must be relieved that global financial markets have been so resilient. While the rapid expansion of central banks' balance sheets gets much of the credit, we doubt that the recovery of stock and bond markets would have been either as robust or as rapid had it not been for America's massive and speedy fiscal response. By putting money directly into the hands of consumers and businesses, fiscal policy can support economic activity and corporate profits far more rapidly and directly than monetary policy, which typically works with long and variable lags.

That said, strong medicine can have strong side effects as well. The IMF's fiscal projections suggest that America's government debt to GDP ratio will rise from 109% of GDP in 2019 to 146% in 2021. Against that backdrop, it is not too early to ask what kind of financial hangover could face investors in the aftermath of the pandemic crisis.

Few economists have studied the impact of high government debt levels more than Carmen Reinhart, who is currently chief economist of the World Bank. In her 2012 paper, "The Liquidation of Government Debt," she described "financial repression" as one of the most common and least disruptive ways governments have used to deal with large debt overhangs[1]:

> *"Periods of high indebtedness have historically been associated with a rising incidence of default or restructuring of public and private debts. Sometimes the debt restructuring is more subtle and takes the form of 'financial repression'. Consistent negative real interest rates are equivalent to a tax on bond holders and, more generally, savers."*

Our takeaway from Reinhart's work is that an extended period of negative real rates seems likely. We have collectively borrowed from our future selves to make it through this emergency. More specifically, we have borrowed from the select set of our future selves who own assets. And if history is any guide, those asset owners will face a tax on their savings in the form of persistently negative real interest rates. U.S. real rates are already deeply negative, with the current yield on the 10-year Treasury Inflation-Protected Securities (TIPS) at -0.80%. This seems likely to represent the "new normal."

TABLE 1: IMF Projections of Government Fiscal Balanced and Implied Fiscal Impulses for 2020 and 2021 (% of GDP)

Based on IMF estimates, the U.S. in 2020 will have the largest fiscal impulse by far of any major nation. That will leave the U.S. with correspondingly greater pressure for fiscal consolidation after the crisis.

	Overall Fiscal Balance					
			Current Projections		Fiscal Impulse (Change from Previous Year)	
Nation/Region	**2018**	**2019**	**2020**	**2021**	**2020-2019**	**2021-2020**
World	**-3.1**	**-3.9**	**-13.9**	**-8.2**	**10.0**	**-5.7**
Group of Twenty (G20)	**-3.7**	**-4.5**	**-15.4**	**-9.1**	**10.9**	**-6.3**
Advanced Economies	**-2.7**	**-3.3**	**-16.6**	**-8.3**	**13.3**	**-8.3**
Advanced G20	-3.3	-4.0	-18.0	-9.1	14.0	-8.9
United States	-5.8	-6.3	-23.8	-12.4	17.5	-11.4
Euro Area	-0.5	-0.6	-11.7	-5.3	11.1	-6.4
Germany	1.9	1.5	-10.7	-3.1	12.2	-7.6
France	-2.3	-3.0	-13.6	-7.1	10.6	-6.5
Italy	-2.2	-1.6	-12.7	-7.0	11.1	-5.7
Spain	-2.5	-2.8	-13.9	-8.3	11.1	-5.6
Japan	-2.5	-3.3	-14.7	-6.1	11.4	-8.6
United Kingdom	-2.2	-2.1	-12.7	-6.7	10.6	-6.0
Canada	-0.4	-0.3	-12.6	-5.8	12.3	-6.8
Australia	-1.2	-3.9	-8.6	-8.4	4.7	-0.2
Korea	2.6	0.4	-3.6	-2.4	4.0	-1.2
Emerging Market Economies	**-3.8**	**-4.9**	**-10.6**	**-8.5**	**5.7**	**-2.1**
Excluding MENAP Oil Producer:	-4.0	-5.0	-10.6	-8.5	5.6	-2.1
Emerging G20	-4.3	-5.4	-11.3	-9.1	5.9	-2.2
Asia	-4.5	-6.0	-11.4	-9.8	5.4	-1.6
China	-4.7	-6.3	-12.1	-10.7	5.8	-1.4
India	-6.3	-7.9	-12.1	-9.4	4.2	-2.7
Indonesia	-1.8	-2.2	-6.3	-5.0	4.1	-1.3
Europe	0.4	-0.6	-6.9	-4.8	6.3	-2.1
Russia	2.9	1.9	-5.5	-3.9	7.4	-1.6
Turkey	-3.7	-5.3	-8.4	-7.5	3.1	-0.9
Latin America	-5.2	-4.0	-10.3	-4.8	6.3	-5.5
Brazil	-7.2	-6.0	-16.0	-5.9	10.0	-10.1
Mexico	-2.2	-2.3	-6.0	-4.0	3.7	-2.0
MENAP	-2.9	-3.9	-9.8	-7.8	5.9	-2.0
Saudi Arabia	-5.9	-4.5	-11.4	-5.6	6.9	-5.8
South Africa	-4.1	-6.3	-14.8	-11.0	8.5	-3.8
Low-Income Developing Count	**-3.8**	**-4.1**	**-6.1**	**-5.1**	**2.0**	**-1.0**
Nigeria	-4.3	-5.0	-7.3	-5.7	2.3	-1.6
Oil Producers	**-0.6**	**-1.0**	**-8.4**	**-5.5**	**7.4**	**-2.9**
Memorandum						
World Output (percent)	**3.6**	**2.9**	**-4.9**	**5.4**		

Source: International Monetary Fund, World Economic Outlook, June 2020 Update

While many countries will face similar pressures to keep rates low and stable in the aftermath of the pandemic, these pressures are likely to be most acute in America due to its exceptional debt surge. Refer to Table 1, which shows the negative fiscal impulses for 2021 implied by the IMF's deficit projections. America is projected to have a negative fiscal impulse of -11.4% of GDP in 2021 compared to -6.4% for Europe and only -1.4% for China.

We suspect these figures overstate the degree to which governments will be able to quickly wean themselves from large deficits in 2021. But they probably are good indicators of which nations will face the largest pressures for multi-year fiscal consolidation and for resorting to financial repression as a way of coping with the unpleasant arithmetic. America looks like it will be at the top of that list.

Along with negative real rates, we think a multi-year period of U.S. dollar weakness could also result from America's fiscal exceptionalism. Of course, textbook economics suggests that expansive fiscal policy combined with tight monetary policy is a recipe for currency strength. And U.S. nominal bond yields remain higher than those in many other DM nations, a situation supported for the moment by the expansive stance of America's fiscal policy.

However, textbook economics also suggests that the U.S. trade deficit is likely to widen as national savings declines relative to investment thanks to America's uniquely expansive fiscal policy. Indeed, America's monthly trade deficit has expanded by nearly $20 billion since February as imports have fallen much less than exports (Chart 3). If the trend to wider trade deficits continues, as we expect it will, America's dependence on foreign capital inflows will rise substantially. Without higher interest rates to attract those flows, we would expect to see a weaker U.S. dollar as the key adjustment mechanism.

Interestingly, some of the most pointed criticisms we have seen of America's fiscal response to the pandemic have come from China, the nation's largest creditor. As a recent article in the South China Morning Post noted:

> *"Chinese officials have recently taken aim at the unprecedented coronavirus stimulus in the United States, which has seen American debt levels balloon and stoked concern in Beijing about the devaluation of the U.S. dollar assets held by Chinese financial institutions."* [2]

This type of criticism is somewhat ironic, since China's focus on supply-side stimulus for its economy appears designed to take advantage of demand-side stimulus in the U.S. to increase its trade surplus.

Watch the Trade Data and Consider Higher Non-U.S. Equity Exposure

In conclusion, the potential for widening trade imbalances to help trigger a prolonged slide in the U.S. dollar is a clear implication of America's fiscal exceptionalism. For that reason, monthly trade data should receive increased scrutiny by investors.

If we are correct, a material widening of trade imbalances could usher in a significant regime shift in global equity markets in the post-pandemic world. History shows that when the dollar strengthens, U.S. equities tend to outperform non-U.S. equities – and vice versa (Chart 4).

If this history is a guide, investors can hedge their portfolios against a multi-year slide in the U.S. dollar by increasing their exposure to non-U.S. equities.

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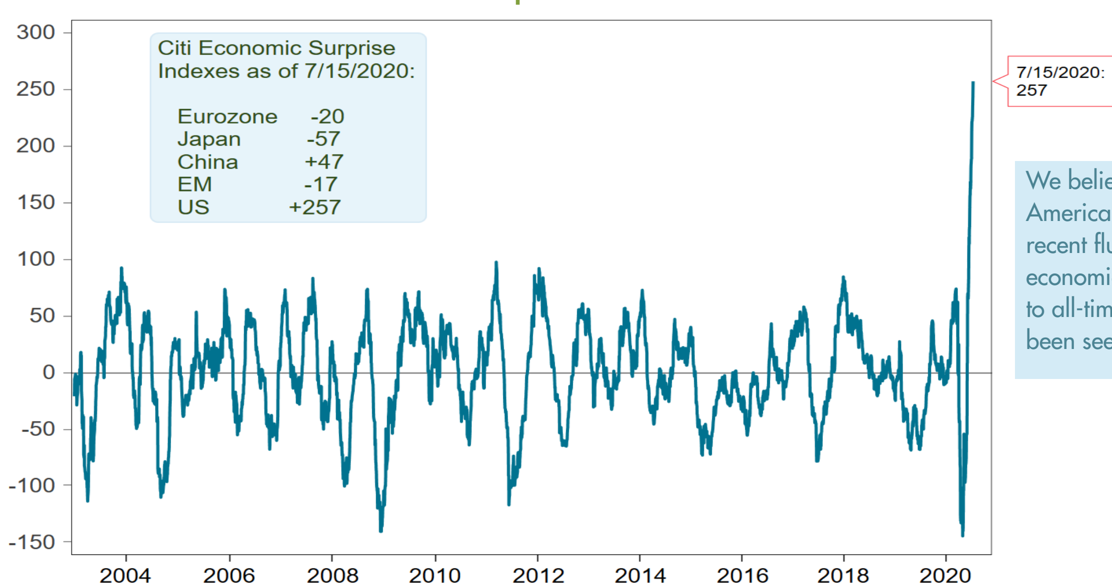
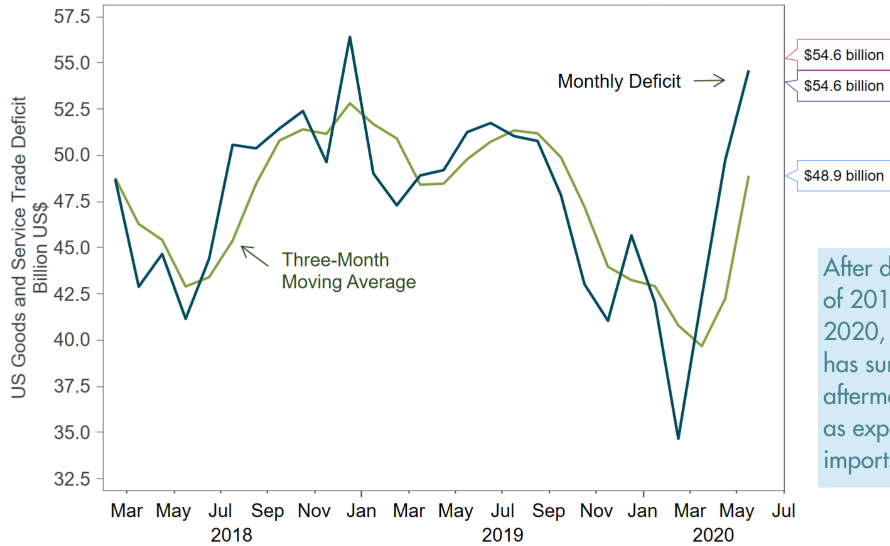
CHART 2: Off the Charts: Citi Economic Surprise Index - United States



Source: GW&K Investment Management, Citi Research, Bloomberg, and Macrobond

We believe the exceptional size of America's stimulus helps explain the recent flurry of strong U.S. data as economic surprises have skyrocketed to all-time highs. This pattern has not been seen elsewhere.

CHART 3: U.S. Trade Deficit Surges as Pandemic Hits the Economy

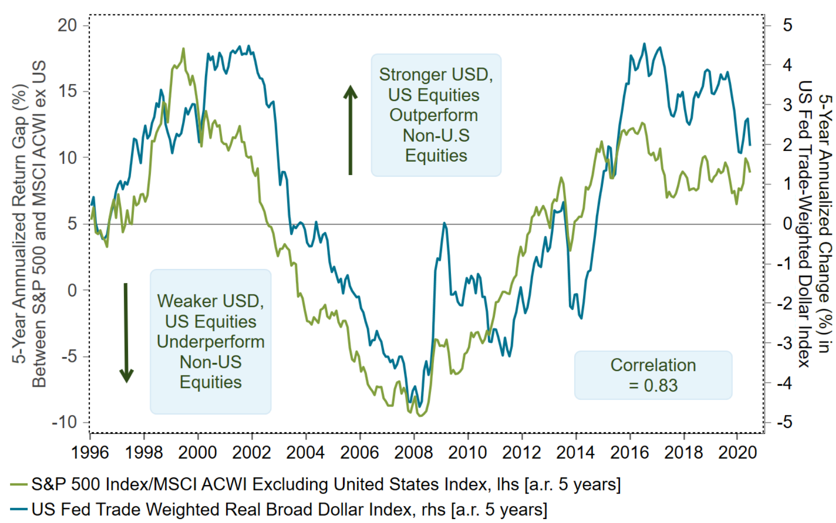


Source: GW&K Investment Management and Macrobond

After declining through most of 2019 and through early 2020, America's trade deficit has surged in the immediate aftermath of the pandemic, as exports fell by more than imports.

CHART 4: 5-Year Annualized Rolling Returns of USD versus S&P 500/MSCI ACWI ex. U.S.

Historically, when the U.S. dollar has been strengthening, U.S. equities have tended to outperform non-U.S. equities by a significant margin. Conversely, a weakening U.S. dollar favors non-U.S. equities.



Source: GW&K Investment Management, MSCI, Bloomberg, and Macrobond

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Endnotes:

1 Carmen M. Reinhart, M. Belen Sbrancia, "The Liquidation of Government Debt," National Bureau of Economic Research, Working Paper No. 16893, March 2011

2 Harry Pearl and Karen Yeung, "US coronavirus stimulus reignites China's criticism of dollar hegemony, but no alternative seen any time soon," South China Morning Post, July 7, 2020