



The world after fiscal stimulus

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The global fiscal tap has been unleashed to fight the impact of the COVID-19 outbreak. We think the impact of this stimulus is binary. If sustained, it could break the decade-long disinflationary cycle. In contrast, if austerity measures are subsequently imposed, the era of low rates and low inflation will likely continue for the foreseeable future.

The combined scale of fiscal and monetary response has been massive - estimated to be around USD17 trillion at the time of writing¹. The quantum of stimulus provided this year is also significantly higher than the 2008 Global Financial Crisis (GFC). This is not surprising since monetary policy has far less wiggle room now. Moreover, the pandemic is not due bad economic decisions; there will be little backlash on governments supporting affected sectors (airlines, banks, small retailers etc.).

Although we saw countercyclical fiscal stimulus after the GFC, it was followed by significant austerity measures as governments were worried about the inflation implications of quantitative easing

(QE). But inflation never returned. The past decade has demonstrated the effect of loose monetary policies: negative interest rates, flatter yield curves, low inflation, accumulation of corporate debt, and narrowing credit spreads, among others. But we have little experience of knowing the combined effects of expansionary fiscal and monetary policies on economies and markets.

A POWERFUL TWIN POLICY-MIX

A key difference between monetary and fiscal policy is that while monetary stimulus creates a large positive liquidity shock, it requires households and companies to be willing to take on debt and spend. On the other hand, fiscal spending adds directly to aggregate demand with no private sector debt build-up. Large unemployment benefits and "helicopter" money are windfall gains to consumers and leave no debt behind. If the stimulus is directed towards public capital expenditure which ultimately increases economic growth and creates jobs, it would eventually crowd-in private spending and the multiplier effects would fuel higher growth.

Source: ¹As at May 2020.

Recent fiscal packages have focused on mitigating the initial impact of COVID-19. When the second-round of impact hits i.e. higher unemployment, corporate defaults and bankruptcies, more fiscal support will likely be announced. Of course, if these stimulus packages prove to be one-off and governments hit the pause button on the deficits or actively seek to reduce it, the medium-term implications will likely mirror the conditions post GFC.

However, if countries see renewed waves of COVID-19 outbreaks, unemployment rates may stay elevated for a number of years. Against this backdrop, and with demographics not in favour for many developed and some emerging markets, countries that have limited binding constraints will probably continue to run large deficits.

THE FISCAL IMPACT DIVERGENCE

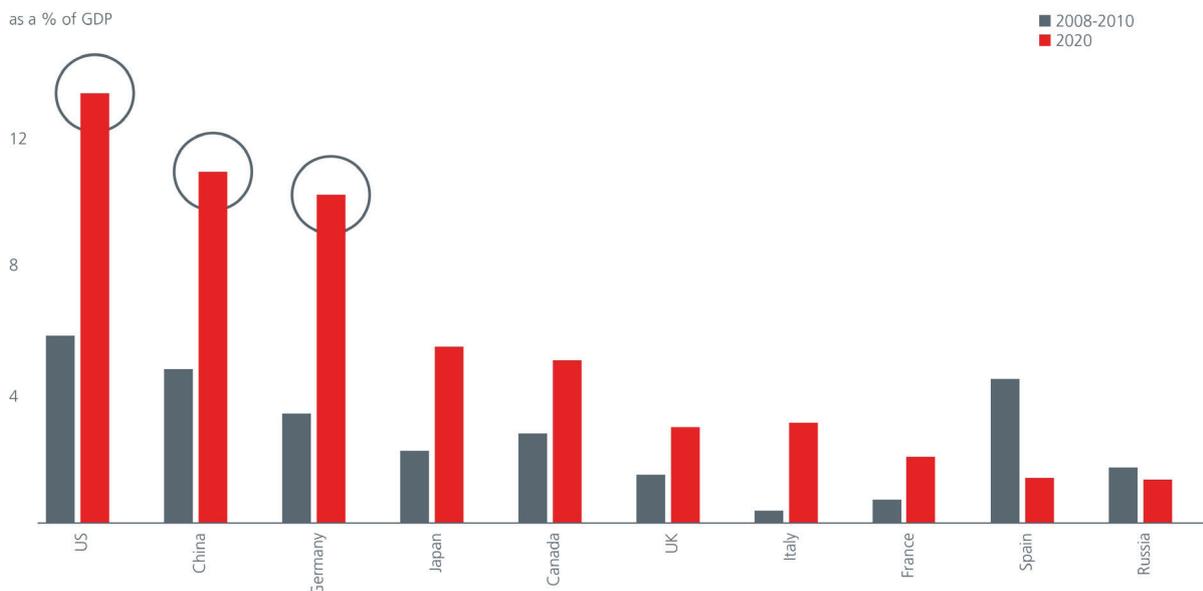
There will likely be divergences in the impact of fiscal stimulus on developed markets (DM) and emerging markets (EM). DM economies that have the benefit of low rates, low external debt, and

low inflation can afford to keep monetary and fiscal policy easy, facilitating the cycle of higher demand, higher inflation and steeper curves. But not all DM economies are in the sweet spot, particularly within Europe where monetary and fiscal policy do not work in tandem; certain countries may only be able to announce stimulus with constraints.

However, within EM economies, there are potentially two groups – one which does little fiscal stimulus to start with given their prudent approach, and one that continues with fiscal stimulus despite weak external balance sheets and therefore potentially face vulnerabilities in their foreign exchange and bond markets.

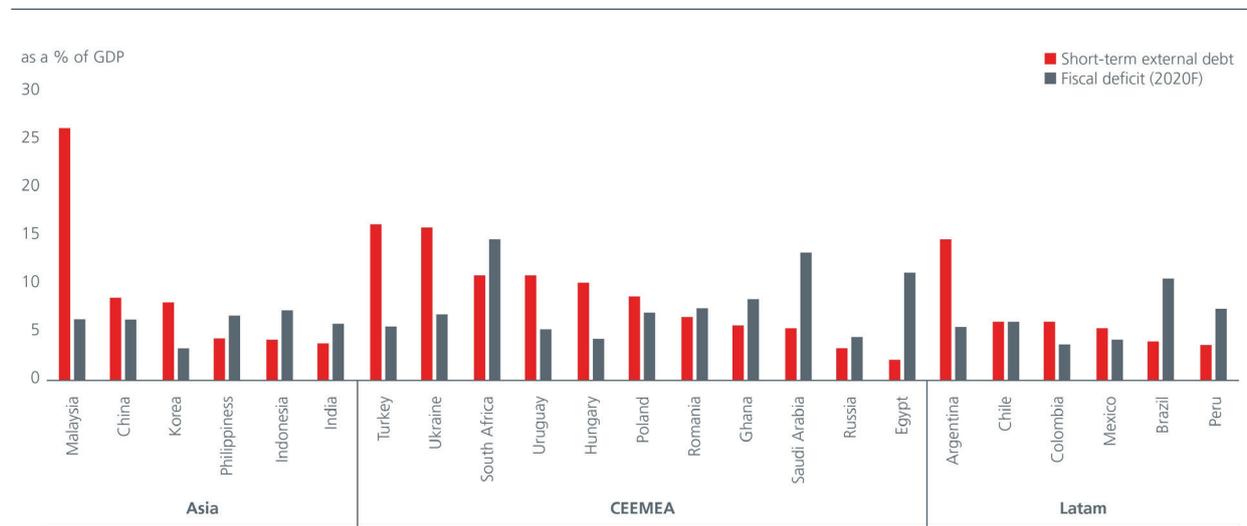
Looking at the EMBI universe, CEEMEA (Central & Eastern Europe, Middle East and Africa) countries stand out as being the most vulnerable as they have higher short-term external debts and are expected to run large fiscal deficits this year. These economies indulging in fiscal extravagance may face sovereign rating downgrades, spike in bond yields, and steeper yield curves, and eventually be forced to undertake austerity measures. EM Asian

Fig 1: Global fiscal stimulus exceeds 2008



Source: BCA Research, as at March 2020.

Fig 2: EM Asia appears to be better placed



Source: Oxford Economics, Refinitiv Datastream as at May 2020.

economies appear as relatively stronger, with most having short-term external debts lower than 10% of GDP, with the exception of Malaysia.

While rising fiscal deficits are bringing debt sustainability questions to the fore, it is important to highlight that debt issuances are a problem mainly when interest rates are higher than nominal GDP growth. If interest rates remain low (as they are now) and fiscal spending leads to higher growth, then debt/GDP ratios might fall or at least remain steady.

INFLATION OR DISINFLATION?

Sustained fiscal deficit, combined with synchronised monetary stimulus may eventually break the decade-long disinflationary trend. Adding to this tailwind to inflation is the potential negative supply side shock driven by the end of globalisation and the reversal of supply chain efficiencies. This scenario can be thought of as being akin to the post World War II period; after the negative demand shock and low inflation, the US economy saw a sharp rise in inflation led by

stimulus, eventually forcing monetary policy to tighten substantially.

The process may be more gradual this time; it will take a while for the current economic slack to narrow. Besides, structural changes such as more remote working and less demand for business travel and commercial real estate will likely dampen inflationary pressures.

There are several market trends that have relied on subdued inflation expectations. First would be the impact on the yield curve. Post GFC, the yield curve steepened significantly as fiscal policy eased, but reversed as soon as austerity measures kicked in. Yields have fallen substantially since and yield curves flattened as inflation expectations have plummeted and monetary policy has remained easy.

However, this trend may reverse; a spike in US treasury yields and a steeper yield curve is possible if the fiscal stimulus sustains. This in turn would have positive repercussions on rate sensitive equities, particularly financials and other 'value' sectors.

BINARY OUTCOMES

The risk of higher interest rates also implies that policymakers need to strike the right balance. Too swift a rise in yields could increase the debt burden and complicate refinancing issues for governments. Equally, rising inflation with no change in nominal rates could impede central bank credibility.

Central bankers over the past few decades have allowed market participants to price in appropriate risks and maintained stability in bond markets, in particular. However, if central bank actions begin to differ from their stated objectives due to other interests, market participants will find it difficult to accurately price in various scenarios, leading to lower market confidence, higher market volatility and hinder price transparency.

But in today's situation central banks may be forced to maintain accommodative policies for longer periods to maintain solvency and liquidity of the government, keeping front-end rates well anchored. If this were the case despite rising inflation, real rates would decline even further, and wealth transfer would take place from savers to

borrowers. From an asset allocation perspective, this would imply greater weight on equity over bonds in portfolios in order to meet stated investment objectives.

In our view, the unprecedented fiscal stimulus we have seen post COVID-19 can lead to binary outcomes. If the deficits sustain, the world will evolve more akin to post World War II with higher demand, higher inflation expectations, and steeper yield curves. Alternatively, if governments are forced to impose austerity measures once demand returns to normal, as with post GFC, then the era of low rates and low inflation will continue for the foreseeable future.

Fig 3: Yields have declined substantially since GFC



Source: Bloomberg as at 14 May 2020.

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