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GLOBAL MACRO VIEWS

Fiscal concerns: from backdrop to forefront?

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The U.S. dollar's rally in the wake of the U.S. Federal Reserve kicking off its rate-cutting cycle is puzzling for many investors. While it can largely be explained by the pronounced backup in U.S. yields since the September rate surprise and ongoing U.S. growth exceptionalism, the moves also reveal investors' increasing focus on the worrying fiscal backdrop.

Burgeoning fiscal deficits

Noting the global economy is at a "strategic pivot", the IMF projects public debt globally will surpass $100 trillion this year and climb to 100% of global GDP by 2030. Nearly every major economy will face rising debt burdens and difficult decisions, which in turn, can inject volatility into markets, bring a higher cost of capital at the margin, and further crowd out discretionary spending as debt servicing costs balloon.

The backup in U.S. yields from mid-September heading into the U.S. election was partly attributed to fears of extended fiscal accommodation, with the deficit set to rise regardless of the outcome. The budget shortfall has already been widening despite a backdrop of relative economic strength, with debt servicing costs climbing to 3.1% of GDP. Investors started to demand higher compensation for the risk of holding long-term U.S. bonds with the 10-year term premium* rising above zero after nearly a decade in the red.

Investors' fiscal fears were also captured in the U.K. gilts selloff after a change in the debt rule by the U.K. Labour government failed to free up fiscal headroom. Instead, the additional buffer was allocated to higher current expenditure and not growth-enhancing investment spending. The limited fiscal cushion was squeezed from the subsequent rise in yields, while overly upbeat growth forecasts further added to the risk of additional tax hikes in the Spring, implying strains on the already-stretched fiscal capacity.

Much larger fiscal adjustments than currently planned are required to stabilize debt

Fiscal policy challenges have already been in focus across Europe, with French sovereign bonds coming under pressure earlier this year. The budget confirmed a difficult financial backdrop with the deficit (as share of the economy) projected to rise above 6% this year and remain elevated into next. A €60B budget gap must be filled through spending cuts and higher taxes, with doubts keeping the risk premium on holding French government bonds (versus German) near levels last seen in 2012. These dynamics underpin our structural underweight in French government bonds.

Despite a surprise economic rebound in the third quarter, Germany is likely to struggle to gather momentum owing to cyclical and structural headwinds. Consumer sentiment remains low as uncertainty prevails around high energy costs, trade tensions and inflation. The labour market is also weakening as plans to cut jobs or relocate production abroad weigh on sentiment. Together with challenging demographic dynamics of an aging population and structural growth headwinds, there is likely to be a growing need for further fiscal support.

Ample fiscal support is evident in China as the government looks to curb a weakening growth backdrop. The IMF warned that the country faces significant fiscal challenges from rising debt levels and a strained fiscal balance, with knock-on effects globally. While not an imminent risk, structural fiscal reforms to promote long-term growth will be needed to maintain investor confidence.

U.S. DOLLAR GRINDS HIGHER AS FISCAL BURDENS BACK IN FOCUS

Source: Bloomberg

How will challenging fiscal positions affect portfolios?

The IMF notes that much larger fiscal adjustments than currently planned are required to stabilize debt, warning that debt-to-GDP ratios three years ahead tend to come in higher than forecasted by six percentage points, on average. Prominent investors have also warned of risks, from "fiscal recklessness" to "all roads leading to inflation", while policymakers have long raised concerns on debt sustainability. These concerns played out in the past with pronounced dollar depreciation in the mid-2000s attributed to fears of the combination of trade and budget deficits, though the secular bond bull market at the time also played a role.

In theory, unsustainable deficits could trigger a dollar crisis driving inflation and yields sharply higher with the currency acting as the pressure valve. But the U.S. with its largest, most liquid bond market in the world affords the dollar a unique status and subsequent perceived safety for investors. Non-U.S. investors continue to demand Treasuries; even as some buyers, such as China, have decreased holdings this year, demand from others has been consistent (e.g. Japan) or increased (e.g. the U.K.).

Investing in a landscape of rising global debt burdens requires a strategy focused on diversification, risk management and quality assets. The time will come for austerity, though long-term investors can best position in high-quality assets, benefit from the depth of U.S. corporate credit markets, and be selective globally to mitigate risks.

For more information, please visit nuveen.com.

Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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