

Populism: would markets vote for it?



Stefan Hofrichter, CFA
09/09/2024

Populists may excite many voters, but markets often aren't fans of the higher spending, inflation, and lower growth their policies tend to bring.

KEY TAKEAWAYS

- We see reasons why populism is set to remain a key feature of politics and potentially influence the outlook for some economies in the foreseeable future.
- Income inequality and opposition to immigration have fuelled a sense of social injustice among some voters, stoking support for populism.
- Our research shows markets tend to perform poorly over the longer term when populist policies are adopted.
- Under populist governments, we found a mixed performance for fixed income, underwhelming results for equities and weaknesses for currencies.

Populist talk has been everywhere during a busy year for elections. From former US president Donald Trump's pledge to pursue "America First" trade policies to France's left- and right-wing

parties' plans to reduce the pension age, populism has been front and centre on campaign trails. So, what are the implications of populism for investors?

In summary, our research shows markets tend to perform poorly over the longer run when populist policies are adopted. But what is populism? Political scientist Cas Mudde describes populism as a "thin-centred ideology" that considers society to be split into two, the "pure people" and the "corrupt elite", and which argues that politics should be an expression of the general will of the people.¹

A common feature of all populist parties, whether on the left or right, is their anti-establishment agenda, often centred around a strong leader sometimes characterised as giving a voice to popular opinion neglected by other parties. Most are inclined towards nationalism – identifying strongly with their nation and its interests – and against globalism. The vote by the UK in 2016 to exit the European Union and the election of Mr Trump as US president the same year are often seen as populism's high-water mark.

We think understanding populism as a political force is critical to positioning portfolios actively in a changing landscape.

Populism may be gaining ground

The share of populist governments has risen since the early 1980s. Globally, the populists' vote share hit around 25% just before the Covid-19 crisis.² Populism's ascent since has been less clear. In India, Narendra Modi – often described as a populist – has been sworn in for a historic third term as prime minister – but with a weakened majority. In France's recent election, a left-wing coalition thwarted the far-right National Rally's (RN) bid for power. But the RN and other populists, on the left and right, made gains in June's European elections. And in September, Alternative for Germany (AfD) triumphed in a vote in the German state of Thuringia, the first time a far-right party has won a regional election in the country's postwar period. The new populist Sahra Wagenknecht Alliance (BSW) also did well in the votes in Thuringia and Saxony.

In the US, political polarisation has risen in recent years. Mr Trump is often – rightly – seen as embodying contemporary US populism. However, the current US administration under President Joe Biden has continued the tough stance on trade with China. November's presidential election between Mr Trump and Vice President Kamala Harris remains a close call.

We see reasons why populism is set to remain a key feature of politics and influence broader political thinking for the foreseeable future.

Inequality and immigration are key to populism's rise

Among a myriad of reasons for populism's support in recent years, we think two factors play a significant role:

1. Inequality: globalisation and the automation of production processes has created bigger gaps between the richest and poorest in advanced economies since the 1980s. But while income inequality has actually edged down in the past ten years or so in many countries, wealth inequality has continued to rise.

2. Immigration: the fear of losing out economically to immigrants has gained ground among some voters in Europe during the past decade or so. Many of those also fear a loss of cultural identity.

More recently, the cost of funding the war in Ukraine and the green transition were cited by political observers as additional reasons for the far-right's popularity in the European elections.

Memories of the global financial crisis also linger when government bailouts were provided to banks at great cost to economies. Some euro area periphery economies also received support during the European debt crises. For some voters, that support triggered a lasting sense of unfair treatment.

Still, none of the above factors can fully explain the increased support of populists. Hence, it's also important to acknowledge the influence of false claims across social media in fuelling a sense of social injustice, as well as the loss of collective memories of hard times during dictatorships and wars.

Economic impact: sugar rush then hangover

Academic research suggests economic growth tends to suffer significantly under populist governments.³ Economic growth can be between 0.6 and 1 percentage points lower per year in the five to 15 years following the instalment of a populist government. True, populists tend to stimulate their economies through higher spending and lower taxes initially – but the drag on growth typically starts two to three years later:

- International trade tends to fall as populists put the interests of their economies first and hike tariffs.
- Government debt-to-GDP ratios climb as spending rises – usually slowing growth in the long run.
- Inflation increases as demand stimulus grows and international trade falls.
- Freedom tends to contribute to greater prosperity, research suggests.⁴ Research also shows freedoms like political rights and civil liberties can be eroded under some extreme populist governments.⁵

Market impact: disappointing results

Our research focused on how financial markets performed in the long run after a populist becomes the head of a government.⁶ We analysed median real (inflation-adjusted) returns (all in USD) for the three, five, 10 and 15 years from the year that a populist government came into office, even when that government did not remain in power over the entire period and compared the results to the long-term real returns of financial markets.⁷

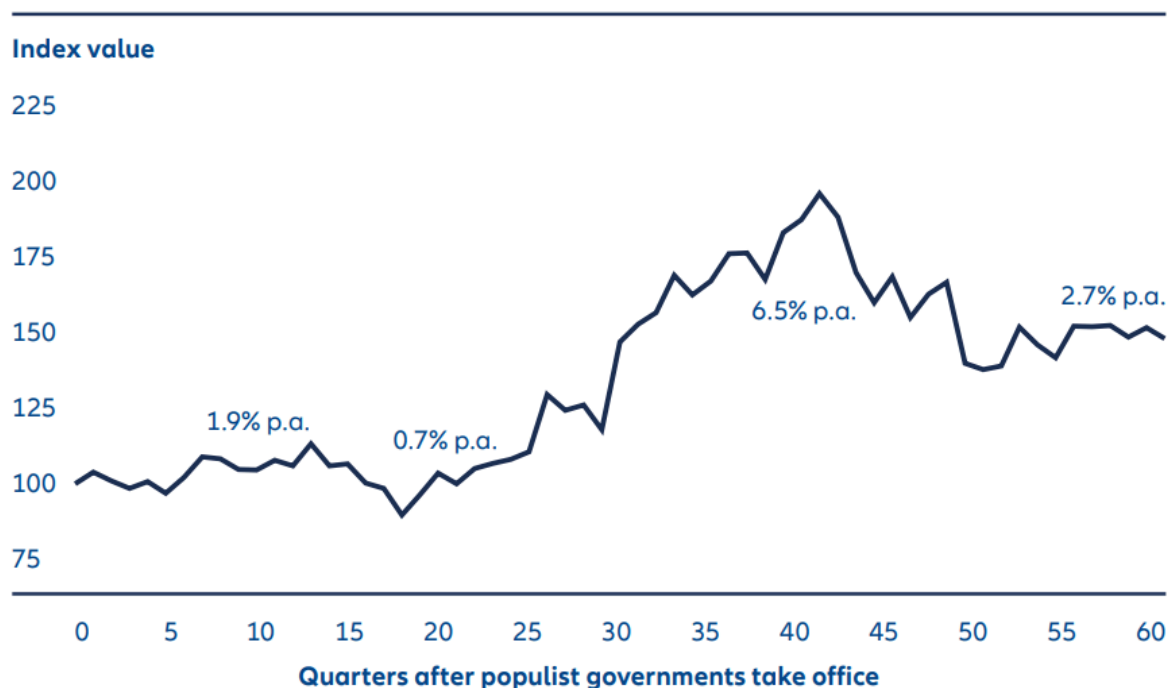
1. Fixed income: higher debt can mean lower returns

Annual bond performance under populists in the first three years was 1.9%, around the same as long-term global bond market performance. Performance slipped over the five years, with the 0.7% returns lower than the long-term bond average (see Exhibit 1). The rise in the public debt-to-GDP ratio under populists tends to weigh on bond returns.

Although returns over 10 and 15 years were higher than the median long-term market performance, the results are somewhat skewed by the inclusion of several populist governments between the 1990s and just before the Covid-19 pandemic when global bond markets did well.

Exhibit 1: Bond performance is mixed once populists come to power

Median inflation-adjusted bond return index (in USD) in advanced economies after 1900



Source: Allianz Global Investors (own calculations), LSEG Refinitiv, GFD. Quarterly data as at Q4 2023. Legend: populists as defined by Funke, Schularick, Trebesch. Note: performance has been calculated

starting from the year that populists came to power until 20 years thereafter, even when populists have not been in power for the entire time span.

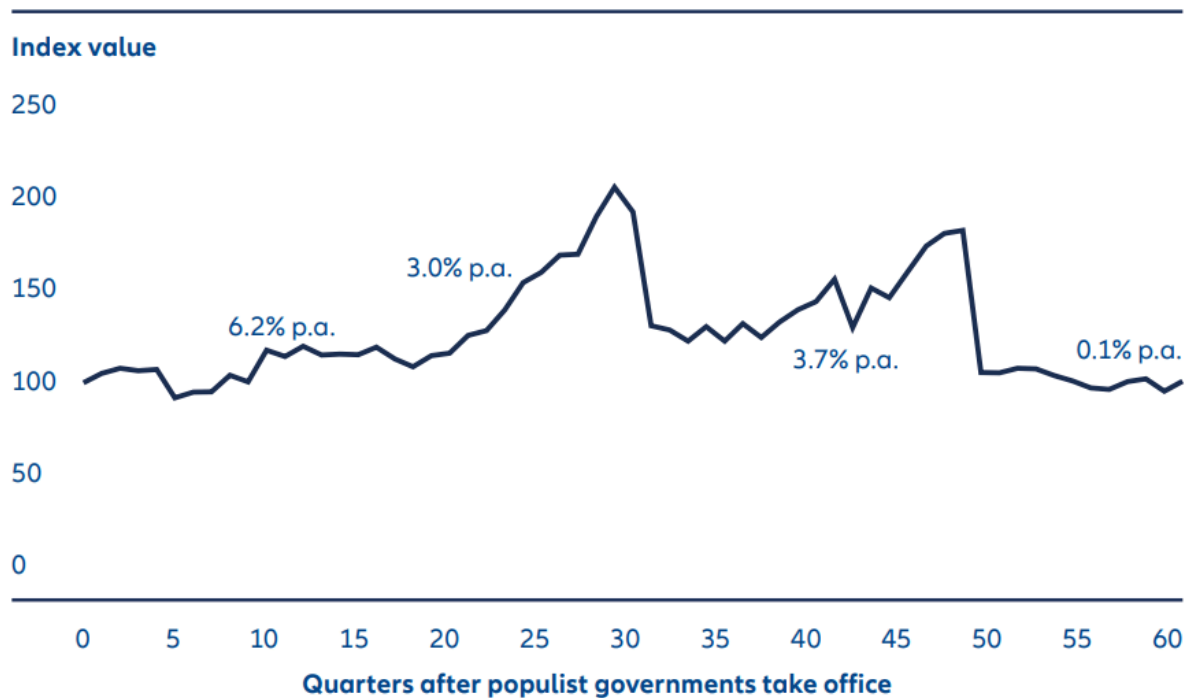
2. Equities: underwhelming performance in the longer term

Equity returns were solid in the first three years (around 6% a year), but weak in the years afterwards, falling close to 0% annually over 15 years, (see Exhibit 2). This compares with long-term US equity returns of close to 7% and non-US equity returns of close to 5%.

We see the underwhelming performance in line with the negative longer-term hit to economic growth. The initial steadiness in equities is consistent with the expansionary fiscal policy pursued by populists and the stable economic growth rate in the first two to three years under a populist government.

Exhibit 2: Long-term equity performance is disappointing under populists

Median inflation-adjusted equity return index (in USD) in advanced economies after 1900



Source: Allianz Global Investors (own calculations), LSEG Refinitiv, GFD. Quarterly data as at Q4 2023. Legend: populists as defined by Funke, Schularick, Trebesch. Note: performance has been calculated starting from the year that populists came to power until 20 years thereafter, even when populists have not been in power for the entire time span.

3. FX: lower growth weighs on currencies

Our analysis found currencies tend to fall in real terms in the long run (see Exhibit 3). We think the combination of lower growth, higher inflation, higher government debt and less financial openness often weighs on currencies.

Exhibit 3: Currencies tend to depreciate under populists in the long run

Median inflation-adjusted FX index (in USD) in advanced economies after 1900



Source: Allianz Global Investors (own calculations), LSEG Refinitiv, GFD. Quarterly data as at Q4 2023. Legend: populists as defined by Funke, Schularick, Trebesch. Note: performance has been calculated starting from the year that populists came to power until 20 years thereafter, even when populists have not been in power for the entire time span.

Investment factors to consider under populists

We see three themes investors should watch for when populists come to power:

1: More inflation and lower earnings from deglobalisation

Populists tend to reject the belief that greater economic integration is beneficial. They generally favour higher tariffs and other trade barriers, which can push up inflation. Deglobalisation leads to

less productivity growth in the long run, as access to productivity-enhancing technology is hampered.

Inflation may also become more volatile as prices become more linked to local supply and demand, rather than international trade markets. Higher inflation and higher inflation volatility point towards lower equity multiples, as our work shows.

Deglobalisation also carries implications for labour markets. Less immigration implies a narrower labour supply and, as a result, more bargaining power for workers. Higher pay could fan inflationary pressures, drag on corporate margins and provide a headwind to equity and bond valuations.

2: Higher interest rates and a potential bond market reckoning

More profligate government policies can push interest rates up. In our view, such a scenario increases the likelihood of interest rates staying higher than under a non-populist government.

A government spending splurge raises the risk of re-pricing of bond markets, generally a gradual process. But re-pricing may be rapid – as was the case during former UK Prime Minister Liz Truss's short-lived time in office in September 2022 when planned tax cuts caused bond market turmoil.

3: The country factor comes into play again

Populist governments tend to prioritise their domestic economy by boosting spending and raising trade barriers in an effort to protect homegrown businesses. For investors, that means more careful scrutinisation of politics within a country when selecting assets.

Active management can help negotiate a populist world

The rise in populism is a clear signal from voters who feel left behind by globalisation. However, populists often fail to improve inequality and can undermine economic growth and market performance in the long run. For sure, other factors – notably valuation and structural growth trends – remain important for long-term investors. But populism must be reckoned with rather than dealt with passively because it can present upheaval. Active managers who understand the economic dimensions of politics can help investors take advantage of the opportunities and manage the risks associated with this powerful political force.

1. The Populist Zeitgeist, by Cas Mudde, Government and Opposition, Volume 39, Issue 4, 2004.
2. , by Manuel Funke, Moritz Schularick and Christoph Trebesch, American Economic Review, December 2023
3. , by Manuel Funke, Moritz Schularick and Christoph Trebesch, American Economic Review, December 2023
4. Democracy Does Cause Growth, by Daron Acemoglu, Suresh Naidu, Pacual Restrepo, James A. Robinson, Journal of Political Economy, January 2019
5. (freedomhouse.org); Populist Leaders and the Economy, by Manuel Funke, Moritz Schularick and Christoph Trebesch, American Economic Review, December 2023.
6. We followed the definition of populist governments used by Manuel Funke, Moritz Schularick and Christoph Trebesch.
7. After a change in government, it often takes several years to unwind decisions taken by previous administrations. Therefore, policy changes can have an impact over a long period. Our approach follows that of Manuel Funke, Moritz Schularick and Christoph Trebesch.

Disclaimer

Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security.

The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted.

This material has not been reviewed by any regulatory authorities. In mainland China, it is for Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations and is for information purpose only. This document does not constitute a public offer by virtue of Act Number 26.831 of the Argentine Republic and General Resolution No. 622/2013 of the NSC. This communication's sole purpose is to inform and does not under any circumstance constitute promotion or publicity of Allianz Global Investors products and/or services in Colombia or to Colombian residents pursuant to part 4 of Decree 2555 of 2010. This communication does not in any way aim to directly or indirectly initiate the purchase of a product or the provision of a service offered by Allianz Global Investors. Via reception of this document, each resident in Colombia acknowledges and accepts to have contacted Allianz Global Investors via their own initiative and that the communication under no circumstances does not arise from any promotional or marketing activities carried out by Allianz Global Investors. Colombian residents accept that accessing any type of social network page of Allianz Global Investors is done under their own responsibility and initiative and are aware that they may access specific information on the products and services of Allianz Global Investors. This communication is strictly private and confidential and may not be reproduced, except for the case of explicit permission by Allianz Global Investors. This communication does not constitute a public offer of securities in Colombia pursuant to the public offer regulation set forth in Decree 2555 of 2010. This communication and the information provided herein should not be considered a solicitation or an offer by Allianz Global Investors or its affiliates to provide any financial products in Brazil, Panama, Peru, and Uruguay. In Australia, this material is presented by Allianz Global Investors Asia Pacific Limited ("AllianzGI AP") and is

intended for the use of investment consultants and other institutional /professional investors only, and is not directed to the public or individual retail investors. AllianzGI AP is not licensed to provide financial services to retail clients in Australia. AllianzGI AP is exempt from the requirement to hold an Australian Foreign Financial Service License under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order (CO 03/1103) with respect to the provision of financial services to wholesale clients only. AllianzGI AP is licensed and regulated by Hong Kong Securities and Futures Commission under Hong Kong laws, which differ from Australian laws.

This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors (Schweiz) AG; Allianz Global Investors UK Limited, authorized and regulated by the Financial Conduct Authority; in HK, by Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; in Singapore, by Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; in Japan, by Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business Operator [Registered No. The Director of Kanto Local Finance Bureau (Financial Instruments Business Operator), No. 424], Member of Japan Investment Advisers Association, the Investment Trust Association, Japan and Type II Financial Instruments Firms Association; in Taiwan, by Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan; and in Indonesia, by PT. Allianz Global Investors Asset Management Indonesia licensed by Indonesia Financial Services Authority (OJK).

Allianz Global Investors is comprised of the worldwide. Product availability will vary by jurisdiction.

© Allianz Global Investors GmbH 2024. All Rights Reserved.