

# On the Road Again: Fiscal Stimulus Around the World

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After months of market jitters, rallies and global growth concerns, fiscal stimulus could provide a boost that puts the economy on the road again. Weakness in financial markets has generally led central banks to adopt a more dovish attitude, most notably reflected in the recent US rate hike pause. However, we believe that fiscal stimulus programmes, many of which include large infrastructure spending initiatives, could be key to reducing the risk of recession in the near term. We expect further fiscal stimulus announcements from China, the US and the Eurozone, meaning that by the second half of 2019, we could see a cyclical upswing in infrastructure investment, which would go into 2020.

### China: Let the building begin

China's long-term goal of reducing leverage and improving industries' efficiencies has resulted in an economic slowdown and rising unemployment. The situation has been exacerbated by trade tensions with the U.S., leading to some signs of social unrest. In part to alleviate any potential tension, the Chinese government has started stimulating in a significant way, showing a strong commitment to stabilising their economy in the short term.

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“On the road again,  
I just can't wait  
to get on the  
road again.”

— Johnny Cash



To jump start the economy China is initiating a two-pronged fiscal stimulus programme focused on tax cuts and local government debt financed infrastructure projects. We expect the augmented fiscal deficit, which includes local government financing vehicles and other off-budget activity, to be 1.5%<sup>1</sup> higher than 2018.

At the same time, we have seen significant monetary easing, such as reserve requirement ratio (RRR) cuts and more targeted credit support to the private sector. If China's recent push on both the monetary and fiscal fronts helps it stabilise at the announced 6% to 6.5%<sup>2</sup> expected growth rate for 2019, then this should filter through to the rest of the world, particularly to Asia ex-Japan.

### United States building bridges?: Bipartisan support for infrastructure

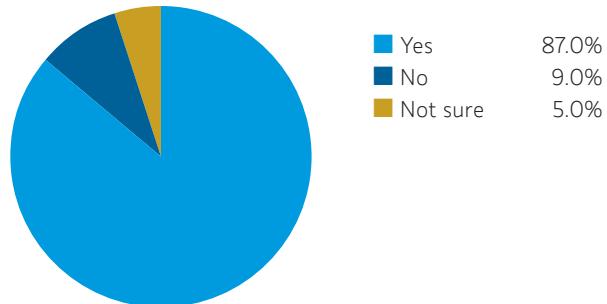
With a divided Congress, the U.S. is in a political stalemate. But one of the areas where a bipartisan agreement seems possible is infrastructure spending. Due to decades of neglect, U.S. infrastructure is in desperate need of an upgrade, garnering a D+ rating from the American Society of Civil Engineers in 2017.<sup>3</sup> Infrastructure spending would likely create jobs and improve the economy. It could also reduce transportation costs and increase safety, leading to higher profitability for businesses, which would then have the wherewithal to boost investment.

President Trump proposed a \$1.5 trillion infrastructure package in 2018, intended mainly to modernise aging roads, bridges and airports. The Democrats have disclosed

### DISPLAY 1

#### U.S. voters approve of infrastructure spending

Should the Democratic leadership in Congress and President Trump work together during 2019 to pass legislation that would improve other infrastructure?



Source: Poll was conducted 23-24 January 2019 by Rasmussen Reports for the American Road & Transportation Builders Association (ARTBA) and American Public Transportation Association (APTA). Results were consistent across voters who identified as Republican and Democrat.

their own plans to spend \$500 billion over 10 years, focused on infrastructure that would reduce fossil fuel dependence.

The most promising means of paying for an infrastructure package would be raising the gasoline tax—which has not been raised since the Clinton administration—by 25 cents per gallon over five years. Other avenues for funding include increasing the deficit, cutting other areas of the budget, a vehicle mileage tax or a financial transactions tax.

While the two parties' plans differ in detail, there is already powerful voter support from both Republicans and Democrats for passing an infrastructure bill in some form (*Display 1*). With support at 87% from likely voters,<sup>4</sup> we expect a joint bill will be introduced in May.

### Europe: Stimulus led by Italy and Germany

In the eurozone as a whole, fiscal stimulus for 2019 is nowhere near that of China or the U.S., but it is nevertheless expansionary. With ageing infrastructure across the Continent, European governments look like they will adopt stimulus programmes of approximately \$47 billion cumulatively.

Our belief is that these eurozone stimulus programmes are in part a reaction to the rise of the populist parties in countries like Italy. Populism has led to a rebellion against austerity. It also appears to have pushed more mainstream political parties towards greater spending to improve their economies—and protect their political positions.

<sup>1</sup> MSIM GBaR team estimate.

<sup>2</sup> 2019 China annual government work report.

<sup>3</sup> The American Society of Civil Engineers gave the U.S. a D+ for 2017, stating that its infrastructure was "mostly below standard" and failure to address this gap could potentially cost trillions of dollars and millions of jobs. <https://www.infrastructurereportcard.org/wp-content/uploads/2017/04/2017-IRC-Executive-Summary-FINAL-FINAL.pdf>

<sup>4</sup> <https://www.artba.org/2019/02/01/poll-shows-strong-partisan-divide-border-wall-funding-strong-bipartisan-support-broad-infrastructure-initiative/>

Spending levels differ significantly among eurozone countries. Italy has increased its structural primary surplus the most, by €18 billion (Display 2). Germany has been running a surplus, so it has more leeway to stimulate. By contrast, France and Spain have come under political pressure to abandon their attempts to keep deficits below the 3% threshold. The French government was forced by protesters to scrap some planned tax increases, and the Spanish government failed to get its budget through parliament. Such pressures may result in more expansionary measures, so we may actually see the net number surpassing the projected \$47 billion.

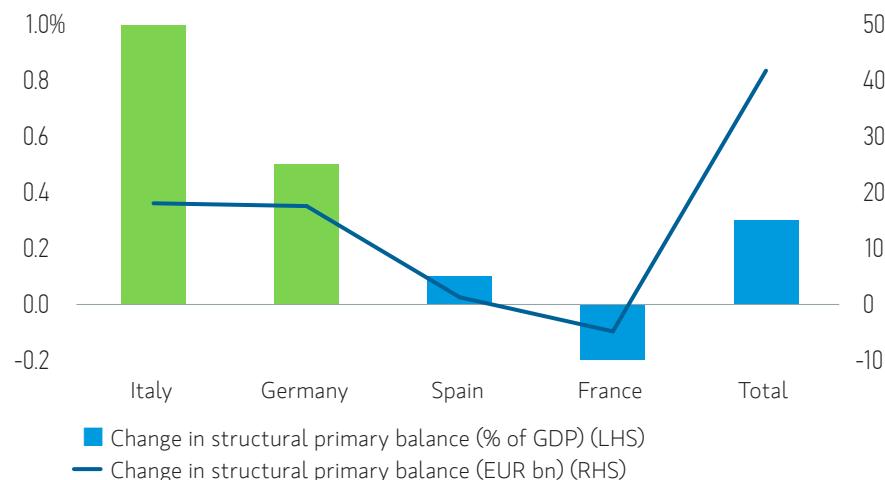
### Japan: Infrastructure spending to offset VAT

Japan will raise its VAT from 8% to 10% in October 2019 to help finance ballooning social security costs. The last time the VAT was increased—in 2014, it caused a noticeable slowdown in the Japanese economy, a risk the government is clearly aware of and is taking action to pre-empt.

Specific actions include pressuring businesses to increase wages and to offset the tax increase, a record budget for 2019 that includes 2 trillion yen to be spent on measures such as shopping vouchers for low-income households and 500 billion yen in state subsidies to encourage cashless transactions. It is worth noting that the budget includes about 1 trillion yen designated for public works – essentially infrastructure projects.

These spending initiatives add up to about 6.5 trillion yen while the tax revenue increase from the VAT is projected to be 5.6 trillion yen—so the net effect is 0.9 trillion yen of positive stimulus, approximately \$9.8 bn or 0.16% of GDP. Therefore, we believe the strong

### DISPLAY 2 Big spenders: Italy & Germany



Source: European Commission, MSIM. As of 6 March 2019.

commitment to avoiding a repeat of 2014 should help Japan's domestic economy to navigate the tax hike.

### Emerging Markets: Fiscally expansive overall, with a focus on infrastructure

Despite variance among countries, there is a consistent theme of positive fiscal stimulus—particularly infrastructure spending—in most emerging markets:

- **EMERGING ASIA:** The region is strongly positive overall. India is undertaking spending on roads, railroads and rural development, as well as welfare spending on farm income support and tax relief. The Philippines is also increasing spending and raising its budget deficit ceiling to boost infrastructure. In South Korea, the government is pursuing the largest budget increase since the 2008 financial crisis, up 9.5% from last year, primarily in response to economic weakness in China. Taiwan's spending

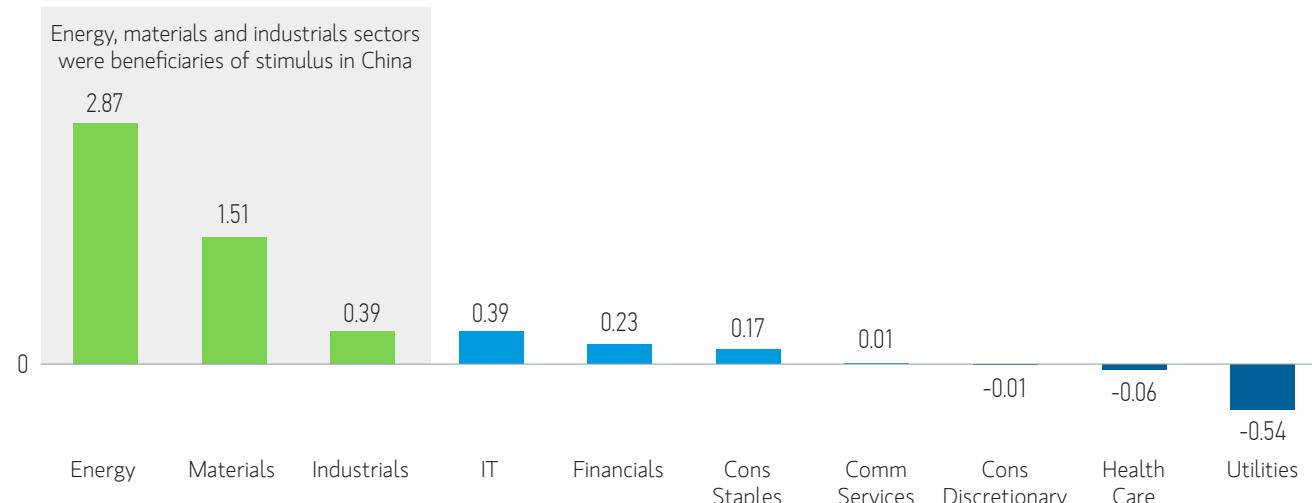
remains neutral, while Indonesia is one of the region's outliers, having postponed infrastructure projects.

- **LATIN AMERICA:** Overall the region is positive on infrastructure spending, but with net fiscal tightening. In Brazil, the government has an incredibly strong pipeline for infrastructure spending, including 12 airports and a major rail line. It will auction four port leases in March, while monetary policy has eased. The new president has brightened the investment outlook, though some in the market have governance concerns. In Mexico, where decade-high interest rates serve to dampen ambitious plans, infrastructure spending remains neutral.

- **EASTERN EUROPE, MIDDLE EAST AND AFRICA:** Russia has launched a 'development fund' for co-financing infrastructure projects, which is a positive step. However, the latest sanctions threaten to inhibit investment.

**DISPLAY 3****Inferring from China's experience**

Beta of 12 month Change in 12 month Forward EPS Growth of the MSCI All Country World



Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Source: IBES, Datastream, MSIM. Beta calculated using monthly data between February 2011 - February 2018

**Implications: Beneficiaries of infrastructure spending**

For investors, infrastructure spending has implications across various sectors. To infer what those implications might be, we can look at China's experience with its recent stimulus programme. *Display 3* shows the effect of stimulus on China's credit impulse expectations year over year for various sectors. It suggests energy,

materials and industrials sectors may have the most upside for equity investors. We are also constructive on industrial metals due to their importance in infrastructure, in spite of their low ranking in this table.

From a fixed income point of view, stimulative policies suggest a positive outlook for global growth, and a bottoming out of recent weakness. While short term weakness in economic data

and a dovish Fed may cause bond yields to drop, our view is that the return to owning longer dated bonds relative to the risk remains unattractive. The flatness of the yield curve means that any evidence of renewed growth—due for example to a significant US infrastructure stimulus programme—could lead to a sharp rebound in yields and negative returns to longer dated bonds from current

**DISPLAY 4****Near-term risks to our outlook for infrastructure**

A number of events with likely binary outcomes could lead to heightened volatility

**UPCOMING RISK EVENT**

UPCOMING RISK EVENT	POTENTIAL BINARY OUTCOMES
1. China-US trade agreement	If successful (moderate positive), or if trade agreement fails (significant negative)
2. US imposes tariffs on European auto imports	If done (significant negative), or if not done (neutral)
3. US sends troops into Venezuela	If yes (significant negative), if not (neutral)
4. US agrees to implement substantial infrastructure fiscal stimulus programme	If yes (significant positive), or if not (moderate negative)
5. UK Brexit negotiations lead to hard Brexit	If yes (significant negative), or if resolved with a deal (significant positive)
6. Iranian oil sanctions waivers extended in May	If yes (modest positive) – or not extended (significant negative)

Source: MSIM. As of 26 March 2019. The views, opinions and forecasts are those of the investment team and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. The views express do not reflect the opinions of all portfolio managers of Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the firm offers.

levels. Fiscal stimulus would also suggest greater bond issuance, which would likely drive yields higher. Our outlook is for a stronger economy, possibly a modest increase in inflationary expectations, and a greater supply of debt—all of which is negative for long-duration bonds.

### Major risk events could change our outlook

What complicates this generally positive outlook for infrastructure—and the sectors that stand to benefit from it—is an unusually large number of binary risk events that could temporarily setback the markets and dampen the enthusiasm for fiscal stimulus. We would use these more as buying opportunities than commitments to negative positions. These risks are outlined in *Display 4*.

These binary risks are mostly skewed to the downside.

### Let the builders build

The renewed focus on infrastructure is a global trend. Even in Japan, where overall fiscal spending is down, infrastructure spending is marginally higher (*Display 5*). New projects—in the form of roads, bridges, improved transportation hubs, rural development and many other initiatives—are likely to minimise the threat of a recession. In fact, we think it could get the global economy “back on the road again,” headed toward a meaningful cyclical upswing going into 2020.

### DISPLAY 5 Spending on infrastructure: A global trend

#### ESTIMATED CHANGE IN FISCAL SPENDING IN 2019\*

	US	EUROPE	CHINA	JAPAN
% of nominal GDP	0.5%	0.3%	1.5%	-0.4%
Value USD	\$304bn	\$47.4bn	\$225bn	-\$18bn

#### ESTIMATED CHANGE IN INFRASTRUCTURE SPENDING IN 2019

	US	EUROPE	CHINA	JAPAN
% of nominal GDP	0.2%	n.a.	0.8%	0.1%
Value USD	\$50bn	n.a.	\$120bn	\$8.4bn

Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Source: Ministry of Finance (Japan), Congressional Budget Office, European Commission, MSIM. As of 6 March 2019.

\*This metric is calculated as the estimated change in the primary budget balance in 2019 vs. 2018. The US fiscal year runs from 1 October – 30 September. The above figures reflect the 2019 fiscal year ending in September 2019.

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