In a clear signal from voters who feel left behind by globalization, populist political parties have been gaining ground around the world. This could create serious long-term headwinds for economies and markets, including lower growth and higher inflation.

**Key takeaways**

- Support for populist parties globally has recently skyrocketed to the highest level since the early 1930s
- The global rise in income inequality since the 1980s is boosting populist support
- Populism is not a fad; it is a challenge to the current order and a headwind for economic growth and markets
- Valuations and structural growth trends are still of utmost importance for long-term investors
- In an age of populism, opportunities exist for active managers who understand the economic dimensions of politics

The populist phenomenon has been making headlines since last year – the Brexit vote and the election of President Donald Trump were two of the more notable examples. But unlike some other political trends, this one has the potential to create significant challenges for economic growth and markets. For investors, understanding populism as a political force is critical to positioning portfolios actively in a changing landscape.
Populism isn’t new, but it’s enjoying a resurgence

Before we analyse populism’s effects on the markets, it may be helpful to define what it is, where it comes from and where we are seeing it today.

Political scientist Cas Mudde has an insightful definition: "Populism is best defined as a thin-centred ideology that considers society to be ultimately separated into two ... groups, the ‘pure people’ and the ‘corrupt elite’, which argues that politics should be an expression of the ... general will of the people ... (but) it says little about the ideal economic or political system."

The support for populist parties globally has recently skyrocketed – reaching the highest levels since the early 1930s, according to the hedge-fund management group Bridgewater. More importantly, this wave has recently swept several populists to power, including President Trump in the US, Victor Orban in Hungary, Jaroslaw Kaczinsky in Poland and the Finns Party in Finland. In the UK, the populist-fuelled Brexit vote led to a major change in the country’s political landscape and future direction.

Not all populist movements have been winning: Dutch, French and German voters recently voted for the establishment

However, this pushback does not imply that populist parties are in retreat overall. In Austria, the populist Freedom Party of Austria (FPÖ) has been garnering a surprising amount of support with its far-right views. And in Italy’s spring 2018 elections, Beppe Grillo’s Five Star Movement may attract more votes than any other party.
It is worth noting that the recent populist surge is not a sudden phenomenon: it has been building for some time. Votes for populists began to rise in Europe back in the 1980s (see Figure 1). In the US, which essentially has a two-party system, the rise in the political polarization is painting a similar picture (see Figure 2). It started to lift off around 35 years ago, according to social scientists H. Rosenthal and K. Poole, and has culminated in the election of Donald Trump as president of the United States.

Income inequality holds the key to populism’s rise

We believe the key to understanding the growth of populism lies in the global growth of income inequality since the 1980s. For instance, in the US, the Gini coefficient – the traditional measure for income inequality – is at a roughly 90-year high after having troughed in the late 1970s (see Figure 3). Similar developments can be observed in other countries, both advanced and emerging.

There are several interrelated factors that have contributed to growing income inequality.

First, from the early 1980s through today the biggest beneficiaries of the trend towards automation and the widespread use of computers have been more highly skilled workers. By contrast, less skilled workers have seen their labour income decline (when adjusted for inflation). Moreover, many middle-income jobs have simply vanished in the last 40-plus years, replaced by either high-income/high-skill jobs or low-income/low-skill jobs.

The second factor contributing to rising inequality has been international trade, which accelerated from the early 1980s onwards. In advanced and emerging economies, this has generated winners and losers, both on a relative and absolute basis. This is not to say that globalization was “bad” from a global perspective; quite the contrary, in fact. Overall, income inequality and poverty has declined substantially over the last 30 years or so, with household income and living standards improving significantly – most notably in emerging-market countries.

The third factor that has worsened income inequality is financial globalization – that is, the deregulation of financial markets nationally and internationally via the opening of capital accounts. Efforts at financial globalization have not been evenly spread within societies: Those who have been in a position to invest since the 1980s, be it via physical or financial assets, have watched their incomes and wealth go up in line with the boom in credit, fixed-income and equity markets. In addition, from the early 1980s through the financial crisis that began in 2007, employees in the financial industry – particularly in the US securities business – saw a sharp rise in income. Yet when the bubble burst 10 years ago, many of those who hadn’t enjoyed the market boom still suffered from the deep recession that ensued. As a result, many blamed the “establishment” and, in particular, the financial system.

All three of these factors contributing to income inequality hit the middle class – especially the ones who, because of their ages or their lack of appropriate education, were not able to adjust and retrain themselves as the global economy changed around them. Of course, these angry, overlooked people are also voters – and in the US, they made up much of the base that elected President Trump.
Populism is not a fad

With inequality remaining at historically high levels, we expect populism to be not just a passing trend, but a political force for a considerable time.

This shift in the political mood in favour of populists is not entirely surprising, particularly if one follows the argument of Harvard economist Dani Rodrik. He believes that societies cannot pursue globalization, strong nation states and democratic rights at the same time: One objective always has to give.

That may explain why today, the pendulum may be swinging away from deep economic integration and towards individually stronger nation states. For example, the pro-globalization mindset of a previous era favoured global trade agreements, used the World Trade Organization to settle trade disputes, and constructed strong economic and monetary unions. Today, populists are fostering national sovereignty rights and cancelling international agreements – the Brexit vote and the new US administration’s withdrawal from the Trans Pacific Partnership are prime examples.

Clearly, populist parties are in direct alignment with a general shift in the world’s overall political mood, even though the agenda of many populists and movements can differ significantly (see Figure 4). Some are explicitly market friendly – such as the populists within the US administration or the “Brexiters”. Others pursue policies characterised by significant state intervention into business life – for example, Syriza in Greece or Marine Le Pen’s National Front in France.

Some populist parties have market-friendly policies, but others seek significant state intervention into business life.

At the same time, several beliefs are similar across most populist organizations. Chief among them are the desire to foster national sovereign rights at the expense of supranational and international organizations, and a preference for direct democracy over representative democracy.

Figure 4: Despite Mixed Views, Populists Clearly Share Certain Values
Party programmes show almost universal support for strong nation states and direct democracy

<table>
<thead>
<tr>
<th>Country</th>
<th>Party Movement</th>
<th>Globalization</th>
<th>Nation State</th>
<th>Democracy</th>
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Source: Allianz Global Investors, University of Texas, OECD. Data as at 2013.
With a few exceptions, many populist platforms have other shared planks, such as implementing anti-immigration policies and restricting the free movement of goods and services. Addressing inequality is also a common theme in many populist groups, though certainly not all of them.

Interestingly, however, and contrary to what one might have expected after the financial crisis, tougher regulation of the financial sector is not a widespread goal of populist parties. President Trump wants to reduce banking regulations, and the UK government is trying to minimize Brexit’s minimum impact on its financial system in the hopes of keeping London’s position as the leading global financial centre.

Economic growth tended to benefit from a rise in government spending and investment activity. However, there are several reasons why using Mr Schularick’s empirical work to draw firm conclusions about how populism affects economies today may be a questionable endeavour. Even though the median returns shown in this study were positive, its performance numbers covered a wide range. In addition, and most importantly, the majority of the countries included in the analysis had small economies and/or were governed by populists who rose to power in the three-decade-long run-up to the financial crisis. These were years characterized by decent global growth and globalization, which may have skewed the results toward the positive side.

Markets have recently shrugged off populist wins

If we are right to expect that populism will not fade any time soon, what are the likely implications for economic growth and capital markets? When looking at market movements in 2016, the answer becomes less obvious than one might think:

- The UK’s unexpected pro-Brexit vote was swallowed by the markets within days.
- The markets shrugged off President Trump’s surprise election victory within hours.
- Hardly anyone recalls the market blip that occurred after the December 2016 referendum in Italy, in which Premier Renzi lost out to the opposition led by the Five Star Movement.

The market’s reactions to these recent events feel like outliers – one expects the market not to like political surprises – but is that justified? Unfortunately, the answer is not clear.

Academic work by Professor Schularick (University of Bonn) et al. on countries where populists had come to power shows that, based on 27 historical observations, the two- and five-year median inflation-adjusted performance numbers of equities, bonds and currencies in these countries was not that bad. Economic growth tended to benefit from a rise in government spending and investment activity.

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## 7 reasons why populism could create serious long-term headwinds

This begs the question of what could happen today if major economies, notably the US and the UK, began trying to turn back time and pursue anti-globalization policies. Would the results be as positive as the ones shown in this study?

We believe that if today’s populist trends turn into policy, we could see several negative economic and market implications – some of which may be severe.

1. **Closed borders could hurt growth**

Anti-trade and anti-immigration policies are generally detrimental to productivity, which is the key driver of economic growth in the long run. Various academic studies clearly show that free trade is conducive to growth. This is not only because free trade enhances productivity gains through a better division of labour on an international level, but also because it enables a transfer of know-how. In the same vein, migration is a productivity-enhancing activity – particularly, but not exclusively, when a foreign labour force with different skills is being added to a local workforce.
Moreover, almost all advanced economies are facing labour shortages in the coming decades, and migration would help to alleviate this problem. As a result, erecting walls is – at least from an economic point of view – the opposite of what is required to stimulate growth. Unfortunately, the number of walls at national borders worldwide has increased more than threefold since the financial crisis, according to the Financial Times.

Consequently, as populist parties increasingly implement their agendas, trend growth – a country’s long-term average economic growth rate – is likely to be limited in advanced economies. Against this backdrop, the US administration’s ambition to lift trend real GDP growth to more than 3 per cent each year is inconsistent with the results it should expect from implementing its anti-globalization agenda.

**Trend growth in advanced economies is likely to slow as populist parties increasingly implement their agendas**

2 Protectionism could cause inflation

Anti-globalization policies become inflationary as imported goods become more expensive – for example, because of tolls or tariffs. Alternatively, prices may rise implicitly if domestic goods are preferred over imported goods at same prices – even if the quality is lower. As a result, we believe that rising populism globally means that inflation premia are set to rise.

3 Rising wages could hurt risk assets

The wage share is likely to rise and the profit share set to decline in a world governed by populists. Why? Reducing globalization, whether in goods or in labour markets, means shielding domestic labour markets from international competition, which could drive up wages. Moreover, this could, at the margin, reverse the 40-year trend toward a flatter Phillips curve – the model that central banks use to measure how increased levels of employment result in higher inflation. As a result, we believe that rolling back globalization means wages would, at the expense of the profit share, increase by more than expected (see Figure 5). While this development would be supportive for private consumption, it would – if past experience is any guide – also turn into a headwind for risk assets such as equities.

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**Figure 5: As Markets Soared, Compensation as a Share of Profits Fell**

Inflation-adjusted S&P 500 vs. employee comp as a percentage of net corporate products

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4 The country factor will come into play
Investors will need to pay more attention to vari-
ances between countries as different risks arise. Populists won’t come to power everywhere – but even when they do, some will have market-friendly policies while others will not. This “country factor” can be seen at work within the Group of Seven nations. Consider Germany, Canada and Japan on the one hand: These are “safe” countries because populists are not enjoying a resurgence there – and the fewer anti-globalization policies are enacted, the better for economic growth. On the other hand, in countries such as the US and UK, where populism is on the rise, investors may encounter greater risks to growth. Consequently, we expect to see a pick-up in the global dispersion of economic growth rates – which is currently close to a two-decade low.

5 Real yields could move higher
Real yields may rise in developed economies – particularly if populists implement redistribution policies that cause a drop in ex-ante (projected) aggregate savings and an uptick in ex-ante aggregate investment plans. Why?
- Private households with lower incomes could see their incomes rise due to redistribution policies and/or higher wages. These low-income earners have a lower propensity to save. At the same time, the rise in income may have a positive impact on their real estate plans.
- Governments would likely save less, and instead would increase investment and consumption spending.
- Companies’ profit shares could come down, which would most likely cause them to save less. The impact on investment plans is unclear: While deglobalization implies more domestic rather than international investment, the lower general growth outlook will have an offsetting effect. Projected savings and investment plans can, in such a scenario, only match when real yields rise.

6 Yesterday’s ‘winners’ could become today’s ‘losers’
Countries and regions that have benefited most from globalization by building current account surpluses are particularly at risk if the anti-globalization trend takes root. This is especially true for emerging economies, but it also applies to developed nations. Consider Germany, which has a current account surplus of 8 per cent of gross domestic product. This gives Germany a strong economic footing, and it may also help keep in check the support for populists who are very much against globalization. Germany’s economy stands to lose from an eventual worldwide anti-globalization trend.

Many countries are seeking new trade agreements to fight the populist-driven anti-globalization trend.

As a result, we are already seeing significant attempts by various countries to make profound changes to their economies. China is among those nations attempting to shift their existing growth models away from exports towards domestic and consumption-driven growth. Other countries are working on bilateral and regional trade agreements to fight the populist-driven anti-globalization trend. Among the more significant examples of this are:
- The Comprehensive Economic and Trade Agreement (CETA) between the European Union and Canada.
- The Japan-European Union Free Trade Agreement (JEFTA).
- The Regional Comprehensive Economic Partnership (RCEP) between the ten Association of Southeast Asian Nation (ASEAN) countries plus six more in the Asia-Pacific region, including China and Japan.
Political uncertainty could raise volatility
With economic policy uncertainty increasing due to populists gaining voters’ backing, one would expect capital markets to price in higher risk premia. So far, this has not happened: The improvement in cyclical data since last summer has masked the populists’ wave (see Figure 6). However, once economic data start to weaken, markets may begin to reconsider the environment of heightened political uncertainty.

The benefits of active investing in an increasingly populist world
The rise in populism is a clear signal from voters who feel left behind by globalization and have suffered from growing income inequality. We believe populism is not just a temporary phenomenon; it will remain a challenge to the current order for some time.

Moreover, populism may cause potentially serious headwinds for both economic growth and markets, though this fallout will likely be felt more over the long term than in the immediate future. Of course, other factors – notably valuation and structural growth trends – remain of utmost importance for long-term investors. But populism must be reckoned with rather than dealt with passively, because the waves it could cause may be severe to those who are unprepared.

Active managers who understand the economic dimensions of politics well should help investors take advantage of the opportunities and manage the risks associated with this powerful political force.