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# Capital Market Assumptions: The Potential Impact of Financial Repression

## Our historical analysis and forward-looking asset return estimates argue for greater diversification away from nominal Treasuries amid financial repression

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### KEY TAKEAWAYS

- Financial repression refers to monetary and regulatory actions that artificially suppress interest rates; these policy moves help fulfill government objectives but can be repressive to savers due to low yields.
- Financial market reliance on policy support in conjunction with unprecedented levels of government-issued debt raises the likelihood that we will remain in a prolonged period of financial repression.
- Our analysis suggests that financial repression will increase the relative performance of stocks versus bonds, whether policy actions result in a high- or low-inflation regime.
- Periods of financial repression highlight the importance of diversification. In this environment, nominal sovereign bonds may not be as effective as non-U.S. equities and real assets in providing diversification.

Our recent article, *Capital Market Assumptions: A Comprehensive Global Approach for the Next 20 Years*, emphasizes the principal relationships between economic trends, financial market inputs, and asset class performance to provide base case estimates for asset returns, volatilities, and correlations over the next two decades. While our capital market assumptions (CMAs) are intended to be used as estimates, we believe they provide a useful starting point for evaluating and discussing different dimensions of uncertainty that will influence asset returns in the future. In this chapter, we explore the impact of financial repression on the performance of assets across the capital structure, and how such central bank policies may influence our long-term asset return estimates. Our core conclusion is that amid financial repression, nominal sovereign bonds may not provide as robust a diversifying hedge against equity risk, and so an allocation to non-U.S. equities and real assets should be considered.

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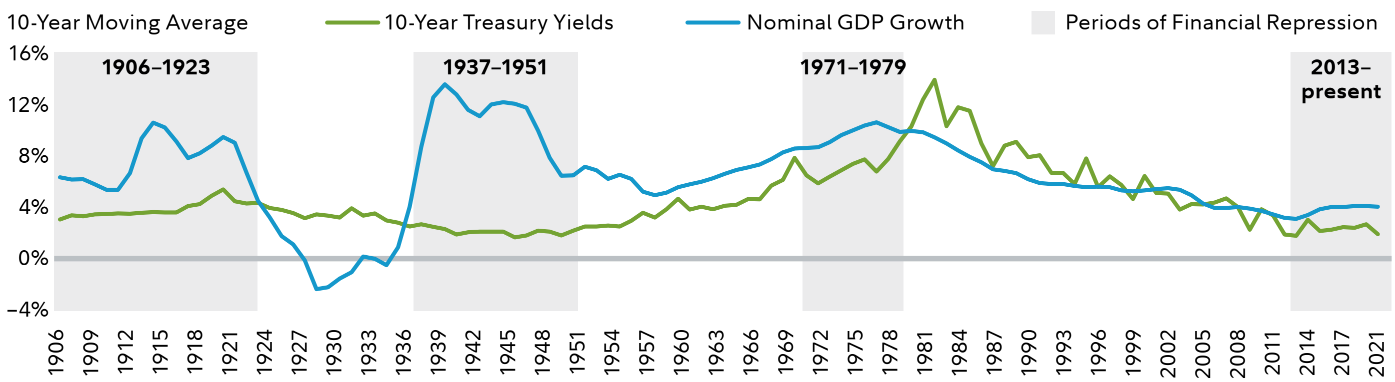
## Financial repression is a common phenomenon

Since the Global Financial Crisis, government debt has ballooned, fiscal deficits have widened, and global central banks have supported fiscal largesse through highly accommodative monetary policy. Developed market central banks have injected nearly $10 trillion in liquidity through quantitative easing and kept policy rates extremely low. Europe has held policy rates negative for nearly eight years, Japan has influenced the pricing of its government bond market through yield curve control, and China has injected trillions of yuan in funding to support its real estate market.[1] Global financial markets have grown increasingly sensitive to and dependent on extraordinary levels of policy support, leaving them potentially vulnerable if global central banks begin to remove accommodation.

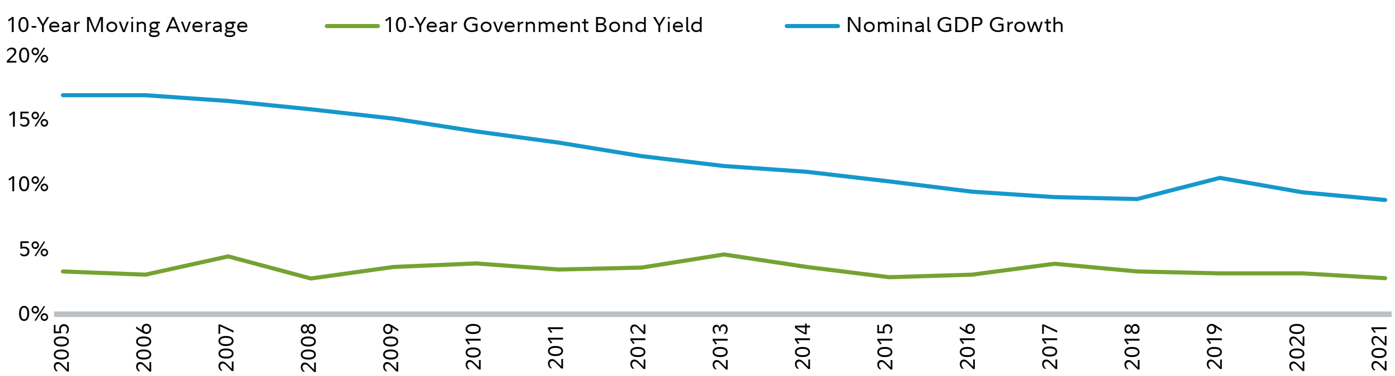
Financial repression refers to monetary and regulatory actions, whereby yields are artificially fixed or driven by fiscal needs to fulfill government objectives. In this environment, market clearing levels in fixed income rate structures do not reflect signals from economic fundamentals (growth and inflation). These actions are considered "repressive" because of their negative impact on savers. There are several historical periods of financial repression, with four distinct occurrences in the U.S. since 1900. Other notable periods include Japan's boom during the post-war years and China following its entry into the World Trade Organization (Exhibit 1).

**EXHIBIT 1: Financial repression occurs when policymakers suppress bond yields, causing nominal GDP growth to significantly deviate from nominal bond yields.**

U.S. Nominal GDP Growth vs. 10-Year Treasury Yields




China Nominal GDP Growth vs. 10-Year Nominal Government Bond Yields




Source: Global Financial Data, Fidelity Investments (AART), as of Dec. 31, 2021.

Financial market reliance on policy support in conjunction with unprecedented levels of government-issued debt raises the likelihood that we will remain in a prolonged period of financial repression. Such a secular backdrop could have a meaningful impact on asset returns; therefore, we look at historical episodes of financial repression to gauge the potential impact on our long-term capital market assumptions.

## Financial repression results in prolonged periods of negative real rates

An unavoidable mathematical phenomenon stemming from high government spending alongside accommodative monetary policy results in negative real (inflation-adjusted) interest rates. For analytical purposes, we therefore define financial repression as prolonged periods of negative real rates. To improve our sample size and broaden our analysis, we apply a global approach by observing the impact of negative real rates in 15 unique markets back to 1900.[2] We define real rates as short-term nominal interest rates minus consumer price inflation.[3] Throughout history, negative real rates have been quite common, occurring in 29% of 20-year rolling periods and averaging –2.8% during these periods compared to +0.6% over the entire period.

## The historical impact of financial repression on financial assets

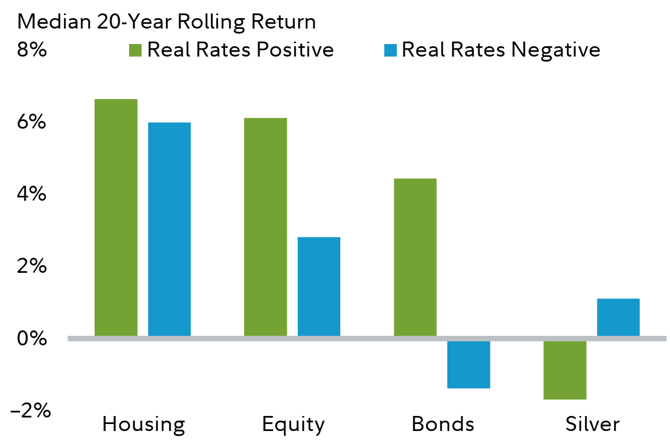
By observing historical global asset performance during extended periods of negative real rates relative to those when real rates were positive, we can better understand the fundamental underpinnings of financial repression and how it may influence asset markets moving forward.

Exhibit 2 illustrates the following historical effects of negative real rates:

- Sovereign debt securities experienced negative real returns.
- Equity returns were lower but remained positive.
- Real assets outperformed fixed income securities.
- Housing, although less liquid and thus more challenging to invest in, performed well in both negative and positive real-rate regimes.
- Silver—as a proxy for precious metals and a portion of the commodities complex—posted positive returns amid negative real rates (and declined when real rates were positive) but exhibited low risk-adjusted returns (Sharpe ratios) during both regimes.
- Negative real rates had less of an impact on risk-adjusted returns, a byproduct of suppressed cash rates and asset volatility in some cases.

**EXHIBIT 2: Historical episodes of negative real rates hampered the returns of fixed income securities and equities but benefitted commodities.**

Global Historical Asset Market Returns across Financial Repression Regimes (1900–2018)




Source: Elroy Dimson, Paul Marsh, and Mike Staunton, Credit Suisse Global Investment Returns Yearbook 2018, Fidelity Investments (AART), as of Dec. 31, 2018.

## The impact of financial repression on our secular CMAs

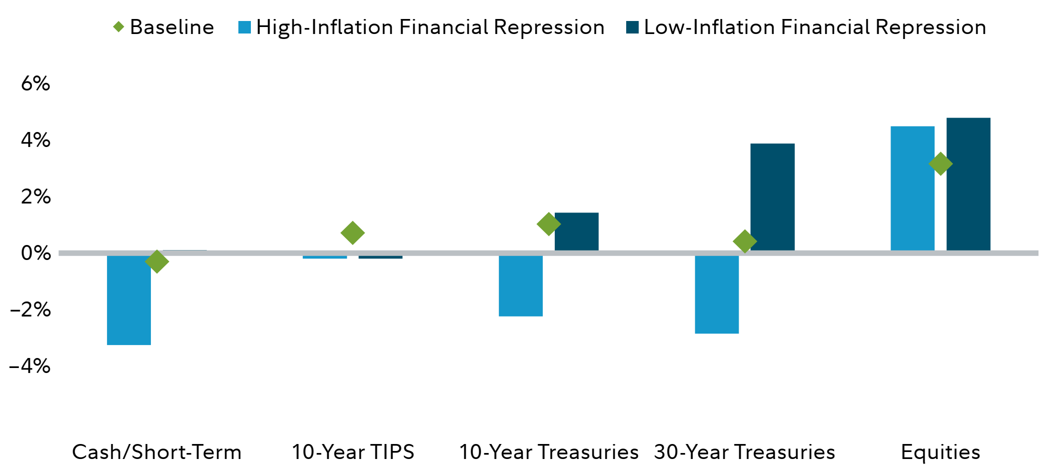
Using a forward-looking approach, we can apply these historical findings to estimate the impact of financial repression on our 20-year CMAs. We perform this analysis by adjusting the yield curve assumptions embedded within our CMA process and observing the impact on asset returns. For example, a central bank artificially keeping rates low can incentivize leverage as well as boost corporate profit margins and return on equity. However, yield curve control can have a very different impact on asset returns if such policies lead to a high-inflation regime. During periods of low inflation, there is seemingly no limit to the consequences of excess stimulus leading to higher growth. We have seen this play out during the current episode of financial repression, in the form of high equity market returns since 2013 amid low inflation. However, high inflation reduces the benefits of financial repression and has the potential to reduce asset returns. See *Capital Market Assumptions: Exploring the Potential Impact of Shifting Inflation Regimes* for further detail on the potential impact of inflation on long-term asset performance.

Exhibit 3 compares each of these scenarios to our baseline CMAs. We can observe the following based on these adjustments to our estimates:

- Financial repression boosts expected returns for both stocks and bonds during periods of low and stable inflation, and is less effective amid high inflation.
- We would expect stocks to outperform bonds across all scenarios, with the widest return differential during high-inflation periods.
- During inflationary periods of financial repression, nominal long-duration bonds would likely suffer but Treasury inflation-protected securities (TIPS) may hold up better.

**EXHIBIT 3: Financial repression tends to increase the expected performance gap between stocks and bonds, with higher inflation lowering asset return estimates.**

Fidelity Capital Market Assumptions for U.S. Assets Under Different Financial Repression Scenarios




**Our CMAs are forward-looking estimates but are not presented as investment recommendations or guarantees of actual future performance.** U.S. Cash/Short-Term—Bloomberg 1–3 Month US Treasury Bill Index; U.S. TIPS—Bloomberg U.S. Treasury Inflation Protected Notes; U.S. Equities—Dow Jones U.S. Total Stock Market Index. Sources: Fidelity Investments (AART), as of Feb. 28, 2022.

## Financial repression supports the need for greater portfolio diversification

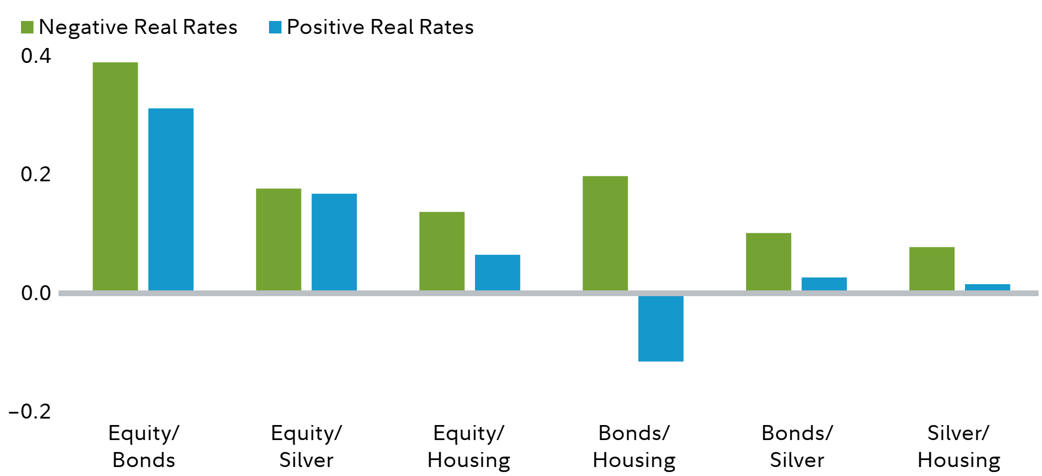
Since the range of potential outcomes is more uncertain during financial repression, strategic asset allocation decisions are essential to help mitigate unforeseen outcomes. Shifting growth and inflation regimes can spark a shift in the asset correlation structure and have a meaningful impact on portfolio construction. Our baseline expectations are for bonds to continue to provide diversification benefits within a multi-asset portfolio.

For example, in our paper, *Capital Market Assumptions: Exploring the Potential Impact of Shifting Inflation Regimes*, we proposed that a higher-inflation regime would reduce the diversification benefits of nominal bonds, warranting an allocation to inflation hedges, such as TIPS and commodities, when seeking better risk-adjusted returns and downside protection.

During periods of financial repression, we also see a change in asset correlations. In fact, all asset classes we analyzed across the 15 markets had higher correlations during periods of negative real rates (Exhibit 4). In particular, nominal bonds had the largest increases in correlations to other asset classes and the highest correlation to equities. Lower diversification properties of nominal bonds suggest it may be appropriate to increase exposure to real assets during periods of financial repression.

**EXHIBIT 4: Financial repression has historically lessened the diversification benefits of most asset classes, especially nominal fixed income securities.**

Global Return Correlations Under Different Financial Repression Scenarios




Source: Elroy Dimson, Paul Marsh, and Mike Staunton, Credit Suisse Global Investment Returns Yearbook 2018, Fidelity Investments (AART), as of Dec. 31, 2018.

## Strategic asset allocation implications

Based on our analysis, we arrived at the following conclusions about the potential impact of financial repression on strategic asset allocation decisions:

- During nearly all periods of financial repression, domestic nominal fixed income assets struggled and often produced negative real returns.
- Allocations to real assets (commodities and property), inflation-resistant bonds (TIPS), and international equities (both DM and EM) may help enhance portfolio diversification.
- A higher allocation to equities (both domestic and foreign) at the expense of bonds may boost risk-adjusted returns over the long-term.

We believe holding a highly diversified portfolio is a prudent investment strategy to help hedge against the uncertain implications of financial repression. The potential negative impact on nominal bond returns may have a particularly adverse effect on investors in or near retirement, who typically hold a larger share of bonds in their portfolios.

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's Asset Management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.


*Fidelity Thought Leadership Vice President Christie Myers provided editorial direction for this article.*


**Endnotes**

**1.** Note that we do not expect the U.S. Federal Reserve to embark on negative nominal interest rate policy to achieve its goals. **2.** Countries include Austria, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, the UK, and the U.S. **3.** Using historical annual data compiled by: Òscar Jordà, Moritz Schularick, and Alan M. Taylor. 2017. "Macrofinancial History and the New Business Cycle Facts." in *National Bureau of Economic Research (NBER) Macroeconomics Annual* 2016, volume 31, edited by Martin Eichenbaum and Jonathan A. Parker. Chicago: University of Chicago Press.

**Index definitions**

**Bloomberg 1–3 Month US Treasury Bill Index** is designed to measure the performance of public obligations of the U.S. Treasury that have a remaining maturity of greater than or equal to 1 month and less than 3 months. Bloomberg U.S. Treasury Inflation Protected Notes Index is a market value-weighted index that measures the performance of inflation-protected securities issued by the U.S. Treasury.

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**Dow Jones U.S. Total Stock Market Index℠** is a full market capitalization-weighted index of all equity securities of U.S.-headquartered companies with readily available price data.




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