# The beneficiaries of global fiscal stimulus

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Economics
Global

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## Fiscal policy eases back to the forefront

After several years of government belt-tightening, fiscal stances around the world have generally become more supportive of growth. Recently, the prospects for additional fiscal stimulus have improved in a number of countries. For example, Japan, Korea, and Canada have already announced stimulus plans, while our economists forecast fiscal easing is likely in the US and UK. These actions should benefit equity markets globally, not only directly in certain sectors with lower taxes and higher spending, but also more generally through increases in GDP growth and confidence. Even without major new stimulus expected, fiscal policy remains modestly growth-supportive in the Euro area and China.

## The case for fiscal stimulus

A persuasive case can be made for additional fiscal stimulus today in many countries, in our view. It can complement central bankers who have run low on tools and thus keep recoveries on track. A particularly strong argument can be made for those fiscal policies that can help boost productivity and potential output, such as infrastructure investment and tax simplification, as underlying trend growth has slowed markedly around the globe. These are structural motivations, in contrast to the various countercyclical policies adopted in response to the global financial crisis. Today only post-Brexit UK may need some fiscal easing to counteract a looming cyclical downturn.

## Rewards more than offset the risks

There are risks to fiscal easing as well: it could be mistimed, poorly designed, or subverted by special interests. But these are addressable issues, not intrinsic failures. With global yields continuing to decline and no sign of the bond vigilantes, it has never been cheaper for governments to fund investments in transportation and information infrastructure or training and education programs. Continued easy monetary policy and global investors' demand for defensive assets should mitigate any upward pressure on yields. As a result, we see limited risk of "crowding out" the private sector – indeed, many public investments should support expanded private activity. And after years of inflation running (well) below central banks' targets and market worries about deflation, any modest inflationary pressure from fiscal easing would be welcome, in our view.

## Several equity sectors stand to benefit

In our view the most-discussed form of fiscal stimulus – additional public infrastructure investment – should return the greatest benefits to the industrial, materials and energy sectors, with potential spillovers into others. Additional spending on defense or public health care would be likely to aid those sectors. The sectorial consequences of tax reform depend on the specific changes made. For example, a repatriation tax holiday would most benefit those industries with substantial overseas cash holdings, such as US technology firms; a cut in VAT or personal income taxes might benefit consumer discretionary stocks the most.


**Refer to important disclosures on page 12 to 13.**

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This report is an extract of a report of the same name published 21 Aug 2016.

# Beneficiaries of global fiscal stimulus

## Fiscal policy eases back to the fore

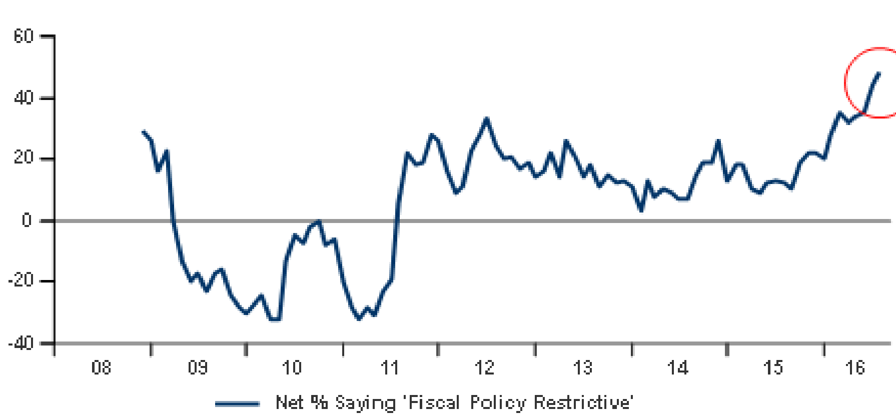
After several years of government belt-tightening, the global conversation has swung back to fiscal stimulus. For example, at the July G20 meeting the International Monetary Fund (IMF) called for countries to adopt "growth-friendly fiscal policies." But it's not just talk: Japan, Korea and Canada already have announced stimulus plans; both major-party US presidential candidates have proposed public infrastructure programs and other fiscal measures; Spain and Portugal have been given extra breathing room within the EU budget rules (and Italy may soon follow); the UK has indicated a post-Brexit "reset" of fiscal policy that should entail outright stimulus. While not the case everywhere (for example, Latin America), in general the stance of fiscal policy globally has shifted from predominantly contractionary to expansionary. Yet investors still view fiscal policy as "too restrictive," according to our latest Global Fund Manager Survey: a record 48% on net (Chart 1). This finding suggests easier fiscal policy would be a positive surprise.

Michael Hanson on our Global Economics team first flagged the possibility of more fiscal stimulus, particularly public infrastructure and other supply-side policies, back in March. In May he and Ethan Harris documented the shift away from tight fiscal policy in major economies in May, noting soon thereafter that Japan had joined this global trend. In recent quarters Michael Hartnett has advised asset allocators to anticipate a "policy flip" from monetary to fiscal stimulus, to the benefit of investments related to Main Street over Wall Street. Savita Subramanian and the US Equity Strategy team recently analyzed how various US election scenarios might impact equity markets there, in particular various stimulus plans from the major party candidates.

This piece expands this analysis to encompass the global trend toward fiscal easing. Speaking broadly, public infrastructure investment would most likely benefit the industrial, materials and energy sectors, with potential spillovers into others. Additional spending on defense or public health care could aid those sectors. The sectorial consequences of tax reform depend on the specific changes made.

Policies that boost near-term activity, whether on the tax or expenditure side, would tend to produce faster GDP growth and thus should push equity markets higher overall. Such policies could have positive knock-on effects for investor, business and consumer confidence as well. More importantly for some countries, appropriate fiscal policy may also be able to bolster longer-run trend growth. There are, of course, risks as well: the wrong kind of fiscal easing under the wrong economic conditions could simply result in higher interest rates, higher inflation, or higher indebtedness. It also can take a long time for democratic political systems to reach compromise on stimulus plans (outside of a crisis), which may increase the risks that a fiscal boost is mistimed. Other risks include policy that is poorly designed or subverted by special interests. However, none of these

Chart 1: GFMS: views on fiscal policy given current state of the business cycle (%)




Source: BofA Merrill Lynch Global Fund Manager Survey risks are intrinsic to fiscal policy; well-designed programs should have benefits that far outweigh these potential costs.

One important consideration is how fiscal stimulus affects monetary policy. Several central banks are already stretched well into unconventional tools. In the near term, however, fiscal policy is far more likely to complement to monetary policy than to substitute for it. Over time, a more balanced policy mix should allow central banks to begin normalizing policy sooner. But that switch-over is likely years away for all but a handful of central banks, and even for the Federal Reserve it could be many quarters before the Fed is comfortable hiking more quickly on the back of fiscal support.

## The case for fiscal stimulus now

Skeptics might view the re-emergence of fiscal stimulus as merely the latest attempt by policy makers to artificially push up growth and markets, or regard it as a cynical way to buy off angry voters with populist policies. However, in our view a reasoned case can be made for certain types of fiscal stimulus in several economies at this time. With a few exceptions, such as post-Brexit UK, the argument for fiscal policy now is not to counteract a looming cyclical downturn as it was in 2008. Rather it is either to complement monetary policy to keep recoveries on track, or to help raise underlying potential growth rates. Even with a full set of tools at their disposal, central banks generally cannot do much to address the latter. In light of how weak global growth has been in recent years, a particularly strong case can be made for fiscal stimulus plans that might boost productivity.

### Cooperating with the central bankers

A typical argument for fiscal stimulus now presupposes that monetary policy has already reached its limits. We are skeptical: central banks clearly have fewer options than in “normal” times, and central bankers’ support for negative interest rates in particular has dissipated. But there is a substantial difference between a depleted set of tools and none whatsoever. Recent easing by the Bank of Japan and the European Central Bank – both of which have extensively deployed unconventional monetary policy tools – still had the desired effect of reducing market-based estimates of these banks’ “shadow policy rates” (what the main policy instrument would be if there were no lower bounds on how negative interest rates could go). That said, in the current environment fiscal policy can usefully and effectively complement monetary policy, as recent analysis by Ethan Harris with a modified IS-LM modeling framework suggests. But in most economies it would be counter-productive for monetary policy to stop providing support for on-going recoveries simply because fiscal policy stepped in.

Recent research suggests that fiscal policy typically is more powerful when interest rates are at their effective lower bound. (In economic lingo, the fiscal “multiplier” is larger under these conditions.) When interest rates are low, there is little risk that fiscal stimulus will “crowd out” private economic activity. Continued easy monetary policy in conjunction with fiscal easing can help keep interest rates from rising too much. Such cooperation does not require central banks to relinquish their independence, nor does it leave so-called “helicopter money” as the only alternative. Additionally, tax and spending policies are transmitted directly to firms or households, another potential advantage over monetary policy which has to work through what may be an impaired financial transmission mechanism. These are all good reasons for fiscal stimulus in an economy with low interest rates and that still is below full employment or experiencing a cyclical shortfall, in our view.

To the extent that easier fiscal policy closes output and employment gaps, it may also assist central banks with getting inflation back to their targets. Of course, too much of a good thing can be bad – and for economies that have already reached full employment, additional demand-side fiscal stimulus does risk overdoing it and thereby creating higher-than-desired inflation and real interest rates. The notable exception here is Japan: its economy appears to have reached full employment without any sustained shift away from its mild if persistent deflationary trend, so any boost to the inflation outlook would be welcome.

### The structural side of stimulus

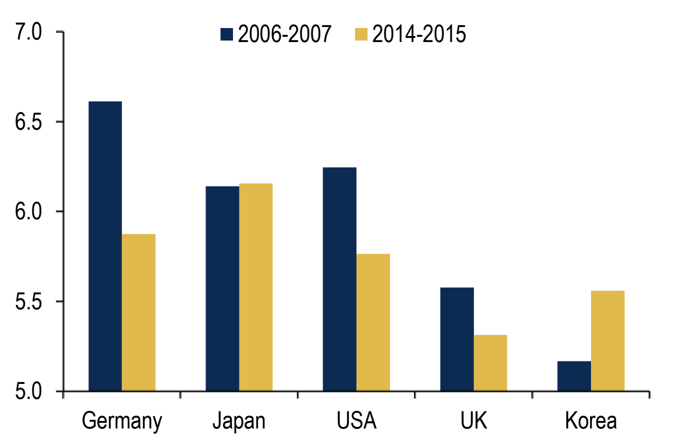
A stronger argument for certain forms of fiscal stimulus now comes from structural rather than cyclical reasons. One defining characteristic of many countries' recovery from the Global Financial Crisis has been a slower pace of potential or trend growth than before. Infrastructure spending that boosts the productive capacity of the economy or complements the private sector (such as transportation and communication networks, job training and placement, etc.), can help raise the underlying level of economic growth. This, potentially, is a very big deal. Productivity has slowed around the world, and both the quality (Chart 2) as well as the amount (Chart 3) of public capital has deteriorated in a number of countries in recent years.

Concerns about high and rising government debt levels represent counter-arguments for taking on additional fiscal stimulus. These are legitimate, but an important lesson of the past several years is that austerity that precludes GDP growth only serves to raise the debt/GDP ratio. As countries have moved toward more supportive fiscal stances and their economies have started to grow again, debt/GDP ratios have stabilized or even declined. Moreover, interest rates are near record lows globally: the bond vigilantes simply are nowhere to be found. Rather, borrowing in the current environment is likely as cheap as it will ever be. In cross-country data there is virtually no correlation between government debt levels and the interest rates they must pay.

Certainly governments cannot borrow with impunity forever – if for no other reason than this is politically infeasible. Policy makers need to be aware of this constraint and design stimulus plans that will maximize the boost to growth. But given how strong the demand for defensive assets is globally, the very low yields on government debt suggest there currently is a shortage of these assets. Estimates of "fiscal space" – how much higher a country's government debt/GDP ratio can rise before it becomes unsustainable – suggest most countries have ample room to increase borrowing if needed (Chart 4).

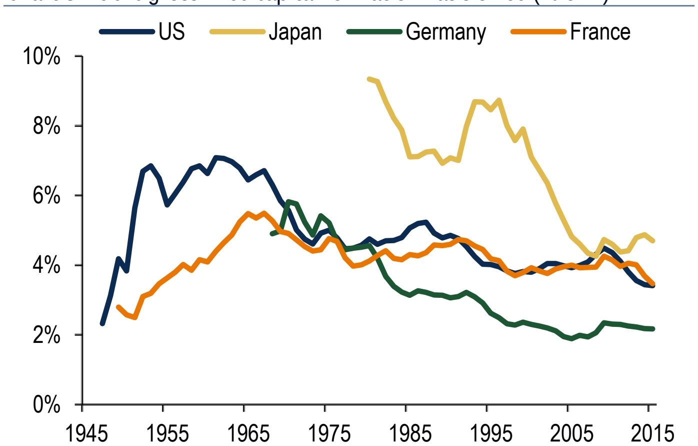
Putting all these arguments together, a fundamental economic case for fiscal stimulus can be made today, particularly for policies that may be able to help raise longer-run GDP growth rates or bring more long-term unemployment back to work. Fiscal policy is likely to work like a force multiplier for easy monetary policy, which in turn can help to keep interest rates low. Such an outcome should be beneficial for a wide range of equity market sectors around the globe.

Chart 2: Deteriorating global infrastructure quality (1-7 score, 7 best)




Source: International Monetary Fund

Chart 3: Public gross fixed capital formation has slowed (% GDP)




Source: BofA Merrill Lynch Global Research, Bureau of Economic Analysis, Cabinet Office of Japan, Statistisches Bundesamt. Haver Analytics, Institut National de la Statistique/Economique

## Transition from stimulus to austerity and back again

A brief history of how we got to this point also helps make the case for fiscal stimulus at this time. In the immediate aftermath of the Global Financial Crisis, a number of economies aggressively eased both monetary and fiscal policy. But within a relatively short period of time, that stimulus was replaced by fiscal austerity as governments over-estimated how quickly growth would rebound, fretted about growing debt levels, and passed the buck to central bankers. Conventional wisdom within mainstream economics viewed monetary policy as the primary tool for stabilizing an economy after a recession; fiscal policy was judged a less desirable and less effective alternative.

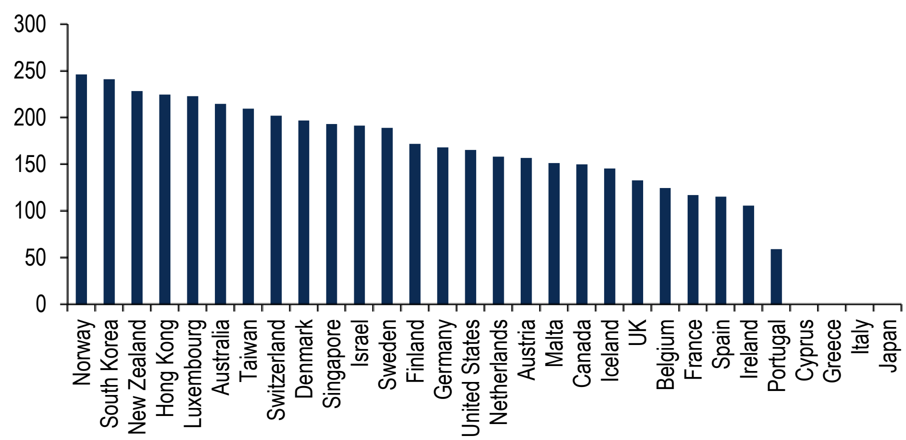
### Stage one: backing away from austerity

The recent re-emergence of support for fiscal easing has occurred in two stages. The first was the fading appeal of austerity as recoveries meandered, interest rates continued to fall, and voting populations grew weary of continued belt-tightening. Boosts to consumer and business confidence from focusing tight fiscal policy on reducing debt levels – derided by critics as "confidence fairy" stories – simply failed to materialize. A key turning point was the IMF's admission in 2013 that it had dramatically underestimated the damage to growth caused by fiscal austerity. That analysis undercut a key argument in favor of austerity, as tight fiscal policy often reduced the denominator of the debt/GDP ratio even more than the numerator.

This period was marked by the confidence-sapping debt downgrade, fiscal cliff and government shutdowns in the US; by a double-dip recession in the Euro area, and by the unexpectedly sharp contraction in activity in the wake of Japan's consumption tax hike. China eased quite dramatically from 2008 to 2010 – by some estimates its stimulus amounted to nearly four-times that of the US post-crisis response when scaled to the size of its respective economy – and did not see a sharp contraction in growth as the stimulus faded. While Chinese authorities have become more circumspect of large-scale fiscal easing in recent years, they did not aggressively tighten fiscal policy as most other large developed markets had by 2011 or 2012.

That has changed over the past year or two, as policy has gradually drifted from a contractionary stance to one that is slightly accommodative. In the US, the net contribution of fiscal policy to GDP growth has moved from a sizable negative to a slight positive (Chart 5). Similarly for the Euro area, fiscal policy has switched from a headwind to a modest tailwind. Earlier this year, Japan decided to postpone the next round of its sales tax hike until October 2019 (from April 2017). Fiscal policy in China remains modestly supportive as the economy undergoes its structural transformation.

Chart 4: Fiscal space: distance to country-specific limits on debt (debt/GDP ratio, ppts)




Source: Moody's Analytics

### Stage two: active fiscal easing

Stage two is the re-embrace of outright fiscal stimulus. Japan led the way with a ¥28.1 trillion (roughly $275 bn) program this summer, with ¥4.7tn ($45bn, or 0.9% of GDP) of new government spending occurring in the current fiscal year. Korea has announced a KRW 28tn ($25bn) stimulus plan, including a KRW 11tn supplemental budget for this year. The Canadian government has pledged C$60bn of new infrastructure spending over the next decade. This doubled the previously planned amount and is focused on public transportation, housing and water systems.

For other economies, the outlook for fiscal stimulus is based more on expectations than realizations. With the US presidential election this fall, markets are anticipating stimulus as each major-party candidate has outlined a range of fiscal policies designed to promote growth, including infrastructure spending. Our US economics team notes that the size and extent of US fiscal stimulus next year will depend importantly on whether divided government remains in place. A sweep by either party should increase the odds of a larger stimulus plan in their view, although that is not their base case.

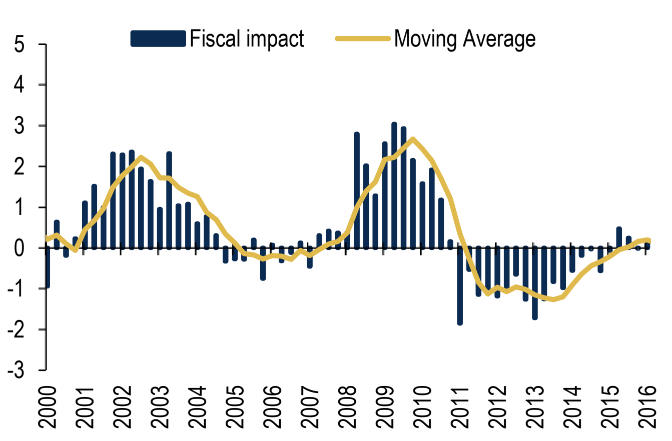
In Europe, prospects for additional fiscal stimulus are more mixed. The UK government has already hinted that post-Brexit budgetary policy would be more supportive of growth; details are still forthcoming. Our European economics team thinks temporary cuts to the VAT and housing tax along with a large infrastructure push would be most sensible. Meanwhile the European Commission has given both Portugal and Spain a pass this year on breaching budgetary rules, deciding not to heavily fine either. Italy may also be allowed to surpass budget limits this year. More generally, the "government spending impulse" in the Euro area has moved back into positive territory over the past year, at about 1% of GDP – a similar pace as during the pre-crisis period, and as in the US in recent quarters (Chart 6).

Elsewhere the scope for fiscal stimulus is more limited: China is unlikely to engage in large-scale fiscal stimulus this year, but should maintain the current modest level of support. Latin American countries have tightened both monetary and fiscal policy following adverse currency and commodity price shocks. Because these economies are geared to global trade and activity, however, stimulus elsewhere could have positive spillovers into these regions as well.

## The geography of fiscal stimulus

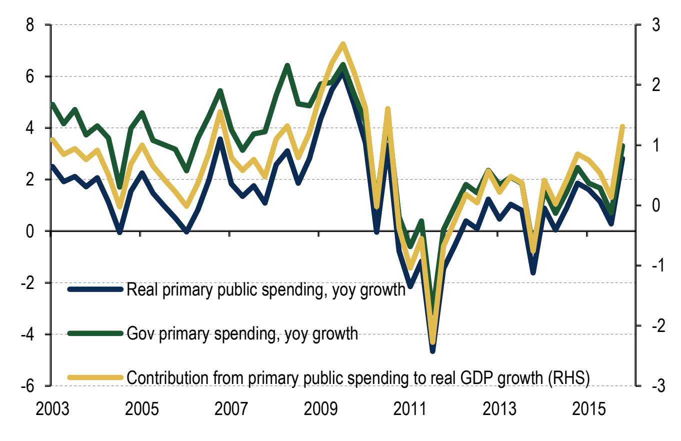
We now turn to a more in-depth look at several of the economies cited above, exploring specific stimulus options and their implications for equity sectors in some cases. The main conclusion is that a wide range of equity sectors stand to gain from announced or planned stimulus in Japan, the US, the UK and Europe. Firms in China and Latin America

Chart 5: Contribution of fiscal policy to US GDP growth (%)




Source: BofA Merrill Lynch Global Research, Hutchins Center on Fiscal and Monetary Policy

Chart 6: **Rebound in Euro area "government spending impulse" (%)**




Source: BofA Merrill Lynch Global Research, Eurostat are not expected to experience stimulus from their home governments, but should benefit from global spillovers of easier fiscal policy.

### Japan: a return to reflation

Japan stands out as the most notable example of fiscal stimulus this year, announcing in August a new economic package, totaling ¥28.1tn. This includes ¥7.5tn in fiscal spending and ¥6tn from the Fiscal Investment and Loan Program (FILP). Table 1 provides a more detailed discussion of the components of the package.

The government argues the package will boost GDP by 1.3%. Our economists raised GDP forecasts for Japan by 0.5pp for 2016 and 2017, which seems reasonable considering anticipated delays in public investment and the likelihood that households will save a portion of distributed money. A more immediate impact should come from the ¥4.5tn supplementary budget (and to a lesser extent the ¥3.3tn FILP fund) that will be spelled out this fiscal year. These stimulus actions should help close Japan's output gap, which is estimated to be no more than 1% of GDP (Chart 1).

Shusuke Yamada and our Japanese strategists have noted that one key question from investors after the July Upper House election is whether the Abe administration would use this opportunity to prioritize constitutional reform over ending deflation. (See Solid performance by LDP, coalition, and constitutional reformists 11 July 2016.) So far, Abe has clearly emphasized economic priorities, while also refraining from making any aspirational remarks about constitutional reform since the election. Our Japan strategists believe this may signal a strategy to first boost the economy and markets through fiscal and monetary easy – recall the Bank of Japan expanded its ETF purchase plan in July – and then pivot to constitutional issues if Abe's Liberal Democratic Party (LDP) is successful enough in the general election (which he could call early) to extend his presidency for another term.

The challenge for the medium-term economic and financial market outlook for Japan is that, with constitutional revision now a real possibility, less political capital will probably be put toward structural reforms, the third arrow of Abenomics. For now, it appears that the Abe administration is returning to the first and second arrows of reflationary policy: monetary easing and flexible fiscal policy (see Japan Macro Watch: 02 August 2016).

Table 1: **Supplementary budget and fiscal investment loan program for this fiscal year under Japan's new economic package**

| Category | Item | Expenditures of central and local governments ("real water")* | Fiscal Investment and Loan Program (FILP)* |
|---|---|---|---|
| Promoting Dynamic Engagement of All Citizens | ･Support for caretakers<br>･Support for younger generation, women<br>･Support for income and consumption | 1.50 | 0.50 |
| Infrastructure development for 21st century | ･Infrastructure improvement for tourism<br>･Strengthening agriculture, forestry, fisheries industries<br>･Quickening construction of linear shinkansen railways<br>･Support for infrastructure exports<br>･Enhancing productivity | 1.02 | 2.42 |
| SMEs support by mitigating risks from the Brexit, ext. | ･Financial support for SME<br>･Support for SME's business management, productivity<br>･Regional revitalization<br>･Preparation for risks | 0.36 | 0.39 |
| Reconstruction and Prevention from/for natural disasters | ･Reconstruction from Kumamoto earthquake<br>･Reconstruction from Great Tohoku earthquake<br>･Preparation for future disasters<br>･Improving safety | 1.62 | 0.00 |
| Total | | 4.50 | 3.30 |

Source: BofA Merrill Lynch Global Research, Cabinet Office

Numbers are our estimate. In the original government's plan, 7.5tn JPY is to be spent as expenditures of central and local governments and 6tn JPY under FILP across years. The government plans to unleash 4.5tn JPY and 3.3tn JPY this fiscal year, respectively. Numbers in each category is pro-rata base.

Includes only fiscal components, which split into actual spending by governments and Fiscal Investment and Loan Program. Other support measures are excluded as these will depend on private participations and take years to materialize

With the margin of monetary expansion becoming increasingly limited, the importance of fiscal policy has increased. Ending deflation is critical for the Japanese equity market. Policy's return to nominal reflation is likely to boost Japan shares over the medium term.

The broad equity market has already digested this set of information so additional impact on macro markets is unlikely near-term. That said, we cannot ignore its positive impact on growth in coming quarters as Japanese equity market struggles to recover clear under strong yen. Our main scenario is that Japan will move back on track for nominal reflation in 2017, which will be bearish for the yen and positive for equities.

### US: electing to ease fiscal policy

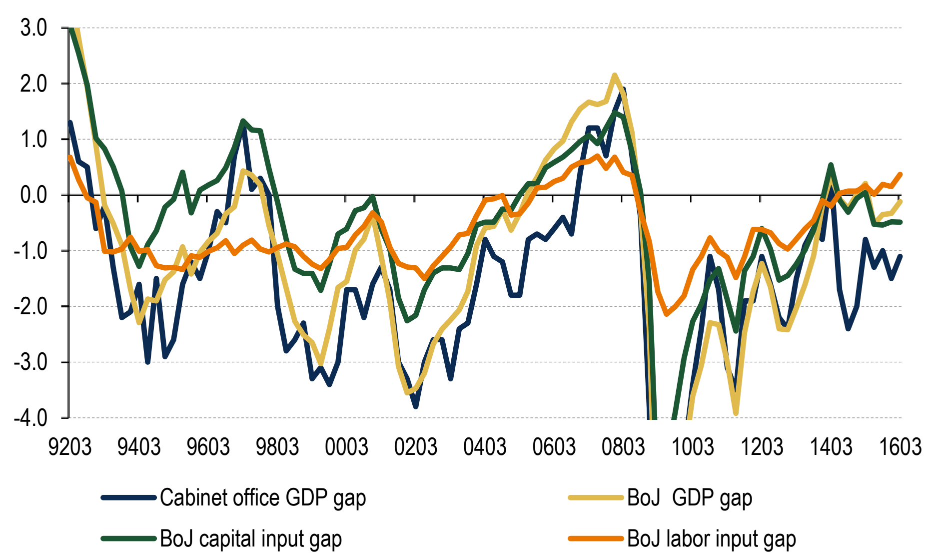
The US fiscal stance has come a long way from the 2010 to 2014 period of austerity and uncertainty. Tight fiscal policy was a significant headwind to growth during that period (Chart 5). Elevated policy uncertainty around the US debt downgrade, the fiscal cliff, the government shutdown, and the debt limit battles (Chart 8) only further undermined confidence. By late 2015, however, Congress agreed to a bipartisan budget deal without the kind of drama of preceding years.

Just how likely subsequent deals can be reached under the new administration in early 2017 will determine how much fiscal easing will be enacted then. The base case of our US Economics team is that divided government continues, most likely with a Republican House and Democrat Clinton winning the presidency. This outcome is consistent with a range of current polls and analysis (including FiveThirdEight.com and the Cook Political Report) as well as the Iowa Electronic Markets.

What impact would continued divided government have on the US equity market? Savita Subramanian and our US equity strategy team note that – in an admittedly small sample – divided government with a Democratic president tends to coincide with the highest average returns to the S&P 500 during an election year (Chart 9). However, a divided government is arguably less likely to generate as large a fiscal stimulus than a sweep of the presidency and both houses of Congress by one candidate.

Moreover, given the different policies promoted by each candidate, the type of fiscal stimulus – and thus the beneficiaries across sectors – would likely differ. The one stimulus idea they both agree on is infrastructure spending. They diverge much more significantly on other spending (higher under Clinton's plan) and tax policy (large corporate and individual tax cuts under Trump; lower taxes for middle- and lower-

Chart 7: **Public estimates of Japan's output gap**




Source: BoJ, Cabinet Office

income Americans under Clinton, offset by higher taxes on upper-income individuals and certain corporate transactions).

A key difference is that Clinton has proposed to pay for all of her tax cuts and spending increases with offsets elsewhere in the budget in order to not increase the deficit or federal debt. Conversely, the nonpartisan Tax Foundation estimates Trump's tax proposes could reduce revenues by $10 trillion over 10-years, after accounting for positive supply-side impacts. The nonpartisan Committee for a Responsible Federal Budget (CRFB) projects Trump's tax plans would increase the national debt by $11 to 15 trillion over a ten-year period. In textbook economics, the balanced-budget fiscal multiplier (Clinton's plan) is much smaller than a deficit-financed multiplier (Trump). However, such short-run analysis does not take into account the potential longer-term consequences for debt sustainability of such a large increase in government debt. Whether such a plan would receive support from fiscal conservatives in Congress is an open question as well.

Given the base case of divided government after the 2016 US election, our US economics team expects a small stimulus overall, assuming the two parties can compromise on some tax cuts and simplification along with a modest increase in infrastructure spending that might boost US GDP growth by 0.1pp next year.

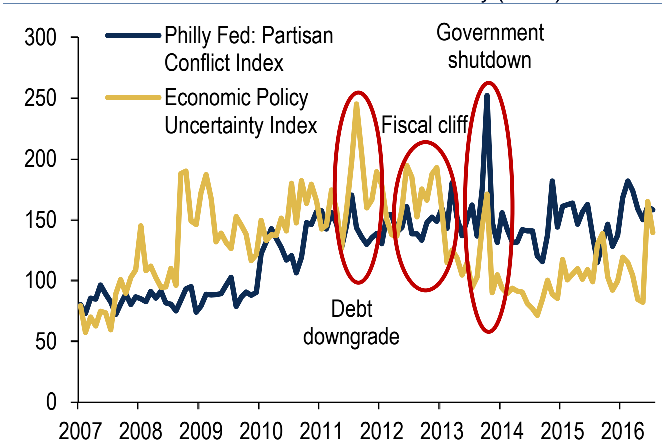
Our equity strategists note that the health care sector faces the most uncertainty given the very different policy proposals by the two candidates. Infrastructure spending would benefit industrials subsectors. The technology sector stands to gain the most from changes to tax repatriation given many companies hold more than half their cash overseas. Labor policy matters the most to restaurants.

### Europe: easing by accident

In Europe a stronger case can be made for traditional demand-side stimulus: unemployment remains high in a number of countries and inflation is very low with risks skewed to the downside. The uncertain spillover from Brexit adds to the downside risks for the Euro area outlook. But while the European Central Bank has taken a range of supportive actions – and our European economics team expects the ECB to expand their asset purchases in September – we do not expect a broad-based fiscal easing in the region.

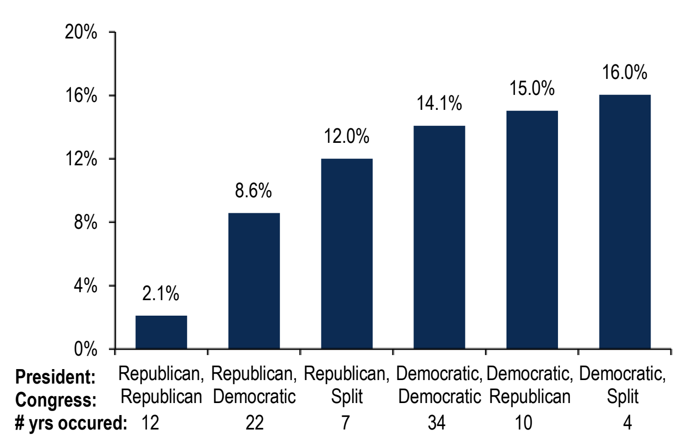
That said, two considerations mentioned above are more positive for Europe. First, while the European Commission could have imposed significant fines on Portugal and Spain for exceeding European Union budget limits, it declined to do so. While only a temporary reprieve, this leniency does allow both countries more time to bring their budgets back in line with EU requirements. Both countries had undertaken fiscal

Chart 8: US fiscal fracas takes its toll on uncertainty (index)




Source: BofA Merrill Lynch Global Research, Philadelphia Fed, PolicyUncertainty.com

Chart 9: Average annual S&P500 returns by party mix, 1928-present




Note: Excluding 2008, average for Republican president/Democratic congress is 10.2%.
Source: BofA Merrill Lynch US Equity & US Quant Strategy, S&P, FactSet

adjustment and structural reforms, but this breathing room allows for a looser fiscal policy stance than otherwise for now, which should support continued recovery in both economies.

Second, and more generally, fiscal policy across the Euro area has become more supportive over the past year or so. The contribution from real government spending (excluding interest) to GDP growth at the end of last year reached its highest level since late 2010, back in line with its pre-2008 average pace. As our European economics team has noted, this was more by chance than by design: with the possible exception of Italy, Euro area countries have not been engaged in an explicit stimulus move. Moreover, there is no “burden sharing” in place: those countries with the most accommodative fiscal policy stances are not the ones with the widest fiscal space to maneuver. Given that Europe still appears to be demand-constrained as well as grappling with low productivity, Gilles Moec recommends targeted “old style” fiscal stimulus in combination with structural reforms. German skepticism remains the biggest obstacle here, although news reports suggest Finance Minister Schäuble is open to some tax relief for Germany.

In the UK, Brexit has been met by aggressive easing by the Bank of England and has forced the Treasury to consider a “reset” of fiscal policy, likely announced in its Autumn Statement. This would be the first increase in borrowing since 2010. There has been no formal announcement of the forms a fiscal stimulus might take to help prevent a recession. One of the many potential policy levels would be a temporary cut in the VAT. Our European economics team estimates a reduction to 17.5% could offset the first year of the adverse effect of Sterling’s depreciation on consumer spending, at of cost of around 0.7% of GDP.

James Barty and Tommy Ricketts on our European Equity Strategy team note that policy interventions remain unspecified in many parts of the globe at this stage. Any increase in spending on transport infrastructure and energy networks is likely an incremental positive for industrials (both directly and through supply chains) and some utilities. Accelerating industrial activity would also provide a lift to oil sector demand into 2017. They conclude that a sales or employment tax cut in the UK that cushioned the blow to UK growth and consumer confidence would favor the discretionary consumer sector, including retail and media.

### China: steady as they go

David Cui notes that out China economists and strategists do not anticipate additional monetary or fiscal easing in the near term, although the current proactive fiscal stance will be maintained. This modest counter-cyclical policy easing should continue to support aggregate demand and provide a stable macro environment for structural supply-side reforms. Over the past four years, policy-driven mini cycles featured targeted policy easing rather than broad-based stimulus. In their view, the probability of a substantial fiscal easing before the end of the year is low, barring a significant downturn caused by global macro forces. They see only limited prospects for a significant increase in public infrastructure investment or purchases of residential housing inventory.

China has raised its targeted budget deficit to RMB2.18tn (3.0% of GDP) in 2016 from RMB1.62tn (2.3% of GDP) in 2015. In addition to the on-budget items, the government also relies heavily on off-budget financing, such as local government financing vehicles (LGFVs), to extend its capabilities for infrastructure spending. After taking into account of such quasi-fiscal activities, we estimate augmented fiscal deficit rose to 9.6% GDP in 2015 from 8.9% in 2014. We expect a further increase in 2016, evidenced by recent measures including (1) increased quasi-fiscal easing through policy banks and (2) improved local government funding through local government debt swap and relaxation of LGFV bond issuance.

Although China’s general government debt level is still relatively low at 65% of GDP in 2015, we are concerned that high public sector leverage could potentially limit the government's capacity to stimulate the economy out of the current growth downturn. This leaves policy makers with a fiscal dilemma: they need to resist the temptation to excessively ease, which lowers their capacity to later stimulate in the event of a crisis. On the other hand, they need to take enough actions to ensure fiscal policy is proactive enough in order to prevent a further deterioration in growth. We believe this tradeoff implies limited upside for further fiscal easing before growth shows notable declines.

If, contrary to our expectation, the government decides to implement another round of major fiscal stimulus, we believe that key beneficiaries may include auto, industrials, metals & mining, oil & gas, and property.

### Latin America: spillovers si, stimulus no

Felipe Hirai notes that most Latin American governments are still in fiscal consolidation mode. Therefore leverage to fiscal spending most likely will be highest at companies with meaningful exposure to the indirect effects of other countries' fiscal stimulus. In particular, the fiscal policies of the US and China create the most opportunities for key Latin America stocks.

With 80% of its exports to the US, Mexico would see meaningful benefits from stronger fiscal stimulus in the US. Mexican exports to the US of infrastructure-related products as well as US operations of Mexican companies in infrastructure-related areas such as cement should benefit most from fiscal stimulus. Higher oil prices from a strengthening US would benefit Mexico even though oil's weight in the economy has been declining (oil revenues as a % of total revenues declined from 33% in 2014 to 13% in 1Q 2016). From a corporate revenue perspective, Mexico has the highest exposure to the US at 11.6%, followed by Colombia at 6.8%.

The other countries in the region could also be indirectly impacted, especially if additional fiscal stimulus globally leads to higher metal prices. China represents a significant part of exports from Chile (24%), Peru (18%) and Brazil (18%).

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