Many investors who fled to safe-haven investments in the wake of stock-market uncertainty have become unwitting victims of a global set of government policies known as “financial repression.” Even as its first phase winds down in the US, another phase of financial repression has kicked in, and investors can expect continued low yields and slow growth, renewed market volatility and the potential return of inflation. Here’s how to understand what financial repression means—and how to fight it—to help get your portfolio back on track.

How did we get here?
All around the world, economic growth has slowed while government debt has ballooned to unsustainably high levels. In the US, for example, debt is expected to increase to more than 114% of gross domestic product (GDP) by 2017, according to the International Monetary Fund—an unsustainably high level that can create a significant drag on growth.

To reduce their debt levels, governments have historically had four options to choose from—but not all of them are viable today:

**Laissez-faire growth**
With high debt levels around the world and many economies still on the mend from the financial crisis of 2008, growth isn’t happening fast enough.

**Default/debt restructuring**
A draconian measure that Greece imposed in 2012, it’s widely deemed too disruptive to economies.

**Fiscal austerity**
Cutting spending in an attempt to stimulate economies is rarely politically palatable—especially in the US.

**Financial repression**
Politically easy to implement and historically proven to be effective, we believe it’s currently the only viable solution for governments around the world.
Financial Repression 101

What is financial repression?
Financial repression has historically involved a number of government actions to reduce debt—including lowering interest rates, increasing regulations and restricting capital movements—all while maintaining inflation. The goal is to create negative real (after-inflation) returns and inflate away public debt by forcing real rates below GDP growth.

Why does it matter?
Unfortunately, financial repression also functions as a “stealth tax” on individuals from whom it systematically strips wealth, since their investments no longer generate the income they expect. It’s a policy that rewards debtors and punishes savers—especially retirees.

How do we know it’s happening globally today?
In today’s slow-growth, highly leveraged environment, many governments worldwide are trying to reduce their debt by actively taking measures like these:

- **Keeping interest rates at record lows.** Globally, central bank rates are hovering near record lows in most major developed markets. In the US, the Federal Reserve will continue to suppress interest rates until it sees evidence of sustainable economic growth.

- **Buying bonds.** Until “tapering” began in early 2014, the Fed had been purchasing record amounts of Treasuries to drive down 10-year bond rates. Central banks in other regions around the world—including the European Union and Japan—have implemented similar bond-buying programs to stimulate their economies.

- **Intervening in markets.** To get access to capital, Austria has restricted capital flows to foreign subsidiaries in central and eastern Europe. Select pension funds have also been transferred to governments in France, Portugal, Ireland and Hungary, enabling them to re-allocate toward sovereign bonds.

Does financial repression work?
As the chart below shows, financial repression has been used successfully in the past to reduce government debt. By keeping real government yields below 1% for two-thirds of the time between 1945 and 1980, the US was able to inflate away the enormous debt left over from the Great Depression and World War II.

“Rate hikes are inevitable, but that doesn’t mean the end of financial repression. We’re entering a new phase that will continue to shift the risk landscape for investors.”

**Kristina Hooper**
US Investment Strategist, Allianz Global Investors

Financial Repression Can Last a Long Time

After WWII, the US debt-to-GDP level was 122%; it took decades of financial repression to reach 30%. Today, debt to GDP is at 106% and rising, and the US has instituted financially repressive policies that may last for years to come.

![Debt-to-GDP Ratio (%)](image)

*Past performance is no guarantee of future results. Sources: IMF, Datastream and Allianz Global Investors Economics & Strategy Group. Note: Years 1900–2011 are actual; years 2012–2017 are projections.*
Traditional Income Sources Fall Short Today

CDs, Treasuries and cash are now yielding significantly less than they were in 2006, as shown in this chart of annual income generated from a hypothetical $100,000 investment. Today, stocks and high-yield bonds are more likely to be able to deliver the income your clients need.

Sources: Bloomberg and Factset. Past performance is no guarantee of future results. Based on yields for the indices as of 12/31/06 and 6/30/14.
A Word About Risk: Investing involves risk and you can lose money. Equities have tended to be volatile and, unlike bonds, do not offer a fixed rate of return. Dividend-paying stocks are not guaranteed to continue to pay dividends. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. Foreign markets may be more volatile, less liquid, less transparent and subject to less oversight, and values may fluctuate with currency exchange rates; these risks may be greater in emerging markets. Investments in commodities may be affected by overall market movements, changes in interest rates and other factors such as weather, disease, embargoes and international economic and political developments. Bond prices will normally decline as interest rates rise. Investing in a limited number of sectors may increase risk and volatility. The impact may be greater with longer-duration bonds. The value of real estate and portfolios that invest in real estate may fluctuate due to: losses from casualty or condemnation, changes in local and general economic conditions, supply and demand, interest rates, property tax rates, regulatory limitations on rents, zoning laws and operating expenses. US government bonds and Treasury bills are guaranteed by the US government and, if held to maturity, offer a fixed rate of return and fixed principal value.

Optimal allocations relative to the Smart-Risk Spectrum will vary over time depending on macroeconomic conditions and an individual’s investment time horizon, financial status and risk-tolerance level. Investors should consult with a financial advisor when determining an asset allocation suitable for their investment needs. Unlike cash and fixed-income securities, equity securities do not offer a fixed rate of return and entail a greater risk to principal.

Past performance is no guarantee of future results. This is not an offer or solicitation for the purchase or sale of any financial instrument. It is presented only to provide information on investment strategies and opportunities. The article contains the current opinions of the author, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Forecasts and estimates have certain inherent limitations, and are not intended to be relied upon as advice or interpreted as a recommendation.

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A Three-Step Plan for Fighting Financial Repression

Investors’ financial goals are still the same, but today’s environment and risks are drastically different. To overcome the four headwinds facing investors today, you may consider moving out on the risk spectrum and taking advantage of today’s most compelling opportunities.

1. **Consider moving some assets out of cash**
   Cash can be a helpful component of a portfolio, but putting too much in “low-risk” investments like cash could mean the big risk of missing long-term goals. A dynamic multi-asset allocation strategy can put more of your money to work.

2. **Look beyond traditional income sources**
   With government-bond yields near record lows, investors are not only getting insufficient income potential; they may be risking a shortfall in future purchasing power. In this environment, fixed-income flexibility is key, so consider corporate bonds (both investment grade and high yield) as well as emerging-market bonds.

3. **Pursue pockets of opportunity to boost return potential**
   To cope with financial repression, investors should consider asset classes that can help generate positive after-inflation returns and growth potential:
   - **Dividend-paying stocks** can provide key income potential when interest rates are low. They also contribute significantly to total return during times of low GDP growth.
   - **Non-government taxable bonds**, like the ones discussed above, may help provide substantial real yields.
   - **Asia-Pacific currencies** may be undervalued and poised to outperform thanks to their growing economies.
   - **Commodities and real estate** can function as an inflation hedge, since they generally don’t move in lockstep with inflation.
   - **Emerging-market stocks** have offered significant growth potential when domestic economic growth has been low.

There is no guarantee that any of the strategies above will be successful.