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SPECIAL REPORT

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A Radical Rethinking Of Fiscal Policy

There is a deeply entrenched belief that sustained increases in public sector debt and budget deficits inevitably lead to fiscal ruin, and that governments must act to rein in deficits to avoid disaster. In the U.S., for instance, warnings about fiscal unsustainability have grown louder, with the federal budget deficit averaging 6.1% since 2010 and public debt reaching $36.2 trillion, or 122% of GDP.

Yet, similar warnings have been issued for decades – first about Japan in the 1990s, then China in the 2010s, and now the U.S. Despite these dire predictions, economic reality has unfolded quite differently. Public debt and deficits have soared globally, but interest rates have plummeted, defying conventional wisdom.

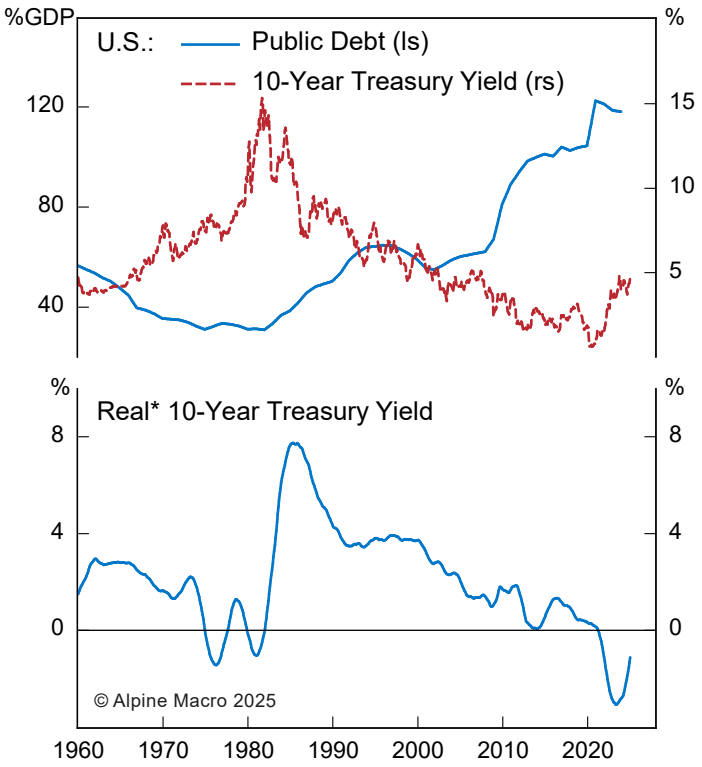
In This Report

The Evidence

Overwhelming evidence suggests that higher public debt and deficits correlate with lower interest rates. The much-feared "bond market vigilantes" have failed to materialize. Consider the U.S.: since 1980, the public debt-to-GDP ratio has quadrupled, rising from 31% to over 120% today. Yet, long-term bond yields have fallen sharply in both nominal and real terms during this period (**Chart 1**).

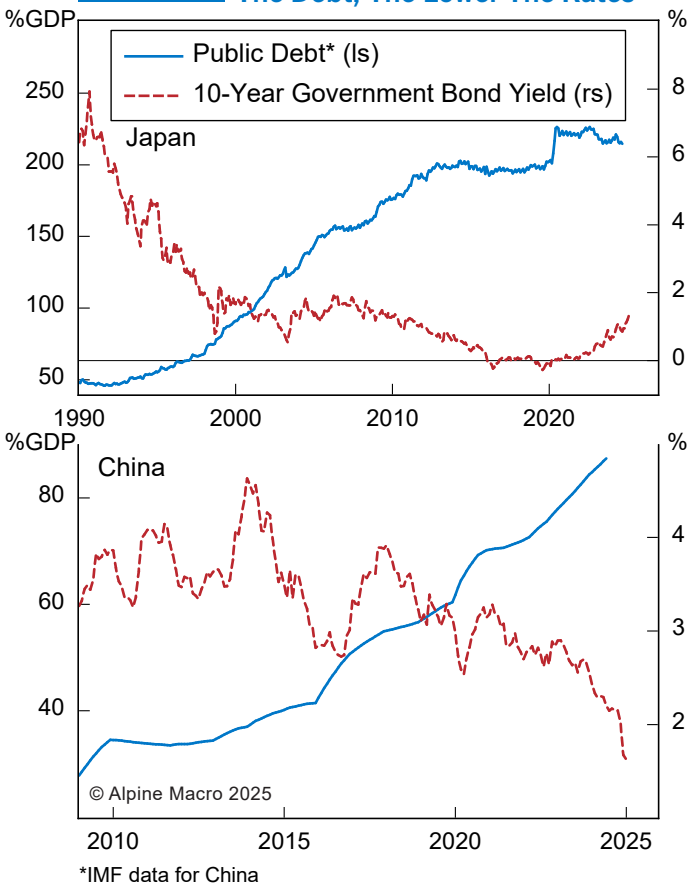
This phenomenon is not unique to the U.S. Japan's public debt-to-GDP ratio has almost quintupled since 1990, now standing at 215% (**Chart 2**). Despite this, Japanese bond yields remained near zero for most of the last decade and are only 1.3% today. Similarly, China's public debt has surged from 35% of GDP in 2010 to nearly 90% today. Yet, its 10-year bond yields have fallen to 1.6%, down from 3-4% a decade ago.

Chart 1 U.S.: What Fiscal Risk Premium?



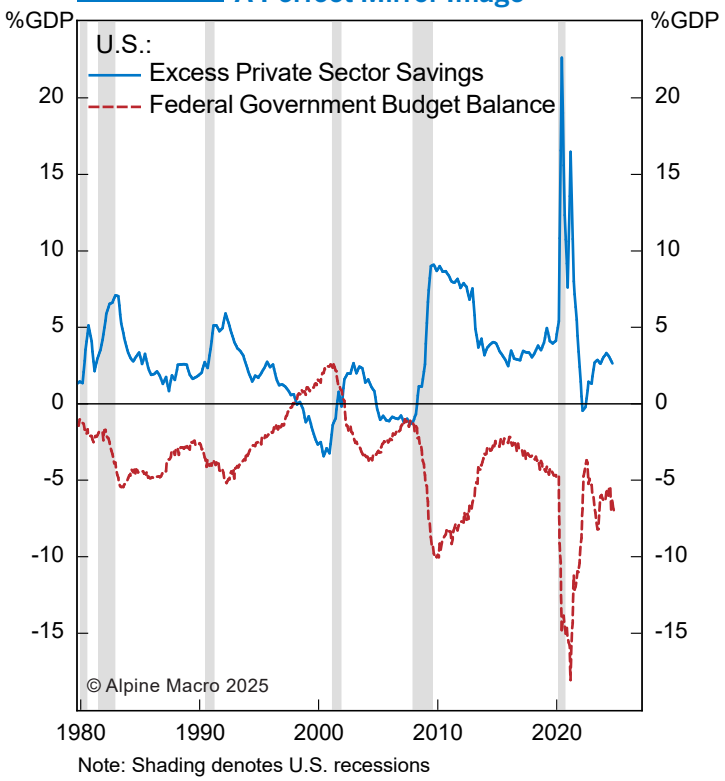
*Deflated by CPI inflation; shown as 3-year moving average

Chart 2 Japan & China: The Higher The Debt, The Lower The Rates



*IMF data for China

Chart 3 Deficit Versus Excess Savings: A Perfect Mirror Image



Note: Shading denotes U.S. recessions

Why have ever-rising debt levels and deficits not triggered financial disasters as many have predicted in these major economies? Instead, why have they coincided with declining interest rates or thriving bond markets?

Causality, Confusion, And Policy Reactions

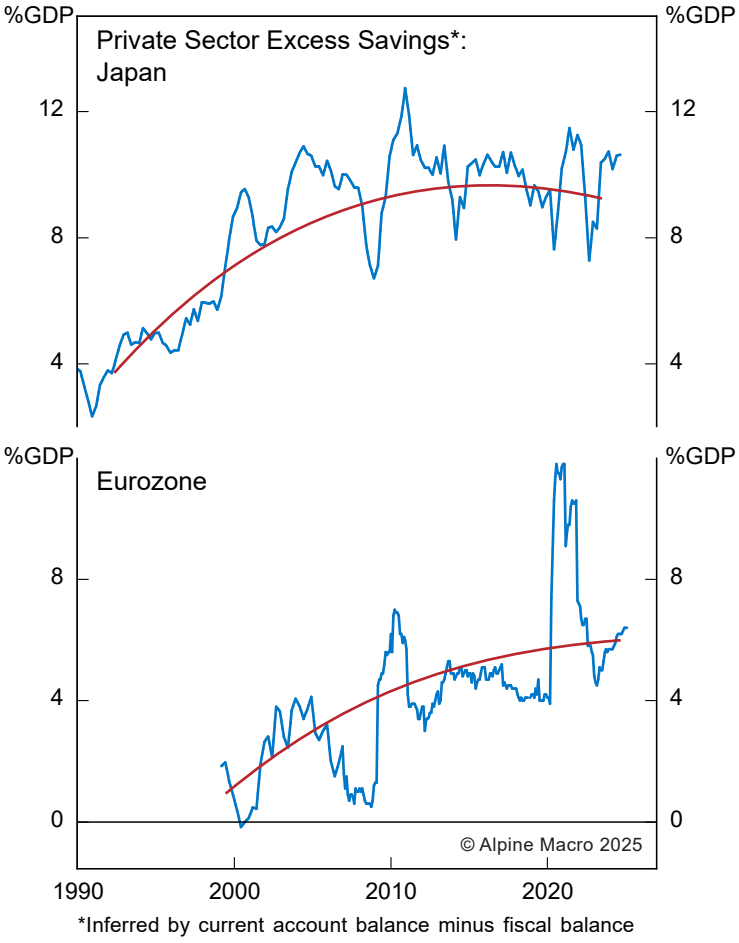
The relationship between debt, deficits, and interest rates is often misunderstood, leading to widespread confusion.

First of all, interest rates are not solely determined by inflation expectations; they also reflect the relative scarcity of savings. Rates tend to fall when inflation declines, but they also drop when savings grow faster than investment demand. Crucially, when inflation is contained and inflation expectations are stable, interest rates are primarily driven by the savings-investment balance. Specifically, if the private sector saves more than it invests, interest rates tend to decline, and *vice versa*.

Meanwhile, fiscal policy plays a direct role in shaping aggregate demand, making it a critical tool for governments to maintain macroeconomic stability. During economic recessions, for example, excess savings rise, weakening aggregate demand. In such cases, the government must step in to dissave – running deficits – to boost demand and mitigate the recession's impact.

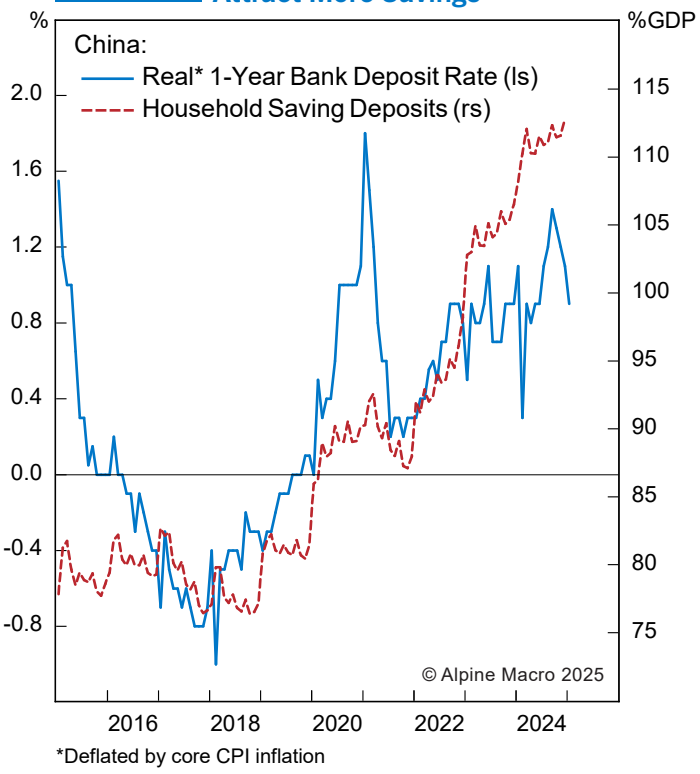
Chart 3 shows that the U.S. budget deficit always soars during economic recessions, and public sector

Chart 4 Japan & Europe: Excess Savings Are Structural



*Inferred by current account balance minus fiscal balance

Chart 5 China: Real Interest Rates Attract More Savings



*Deflated by core CPI inflation

dissaving has almost been perfectly matched by excess savings in the private sector. Obviously, if excess savings become chronic, sustained government dissaving is necessary to prevent the economy from falling into a deflationary trap.

Japan was the first industrialized economy to face chronic excess savings, beginning in the early 1990s. Continental Europe followed in the 2010s, and China has since joined this trend in the current decade.

In Japan, the collapse of the property bubble in the late 1980s and an aging population sharply reduced investment demand, but rising life expectancy has kept savings rates high. On average, Japan's private sector savings have exceeded investment by 9.8% of GDP annually since 2000 (**Chart 4**).

In Europe, over-regulation and high taxes have likely suppressed investment demand. Yet, savings rates across the eurozone – particularly in Germany – have remained elevated.

China's story is similar to Japan's. A bursting real estate bubble, slowing economic growth, and rising policy uncertainty have weakened business confidence and investment demand. At the same time, the national savings rate – already high before the pandemic – has climbed further as consumers save more amid a weakening job market, falling income growth, and declining household net worth (**Chart 5**).

Regardless of the underlying causes, the result is the same: falling interest rates, both nominal and real. The large deficits and rapid accumulation of public debt are a net result from policy responses to these fundamental imbalances. This is why debt and deficit are inversely correlated with levels of interest rates.

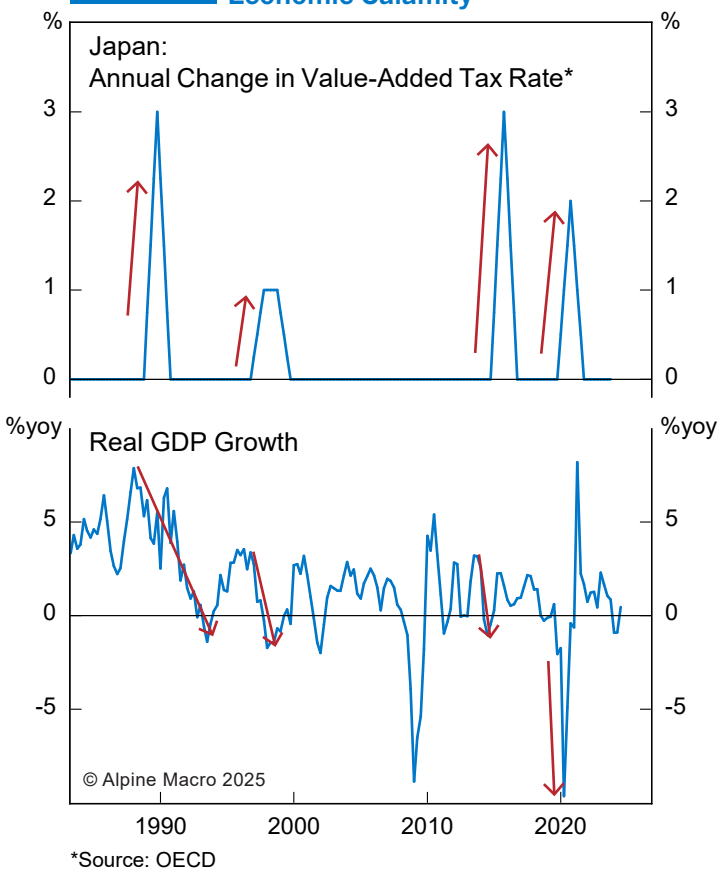
Different Policy Reactions, Different Results

Although the over-saving problem is common to many countries, government reactions have varied widely, leading to vastly different economic outcomes. Europe and Japan have experienced growth stagnation, while China has seen a sharp economic slowdown. Over the past two decades, these economies have spent far more time battling deflation than inflation. This poor economic performance is largely due to the fact that Japan, Europe, and China have been either unwilling or unable to provide sufficient fiscal stimulus to offset the demand gap, fearing that excessive debt could lead to financial instability.

Take Japan as an example: it has run large budget deficits for more than three decades, yet the economy remained stuck in deflation and growth stagnation between 1990 and 2020. Persistent price declines indicate that fiscal stimulus was still insufficient relative to the scale of excess savings. Notably, the Japanese government raised value-added taxes four times since 1990 to rein in fiscal deficits. Predictably, the last three tax hikes pushed the economy back into recession (**Chart 6**).

In Europe, the Maastricht Treaty acts as a fiscal straitjacket, preventing eurozone members from

Chart 6 Fiscal Tightening Versus Economic Calamity



*Source: OECD

pursuing proactive fiscal policies, even during periods of growth stagnation and rising deflationary risks. **Chart 7** shows that the German economy has stagnated since 2021, yet the government continues to tighten fiscal policy. In our view, fiscal austerity has significantly contributed to Germany's economic pain.

China's policy response to its sharp economic slowdown during the COVID-19 crisis, the collapse of its real estate market, and mounting deflationary pressures has been grossly inadequate. Beijing provided limited fiscal and monetary support during the pandemic-induced economic shutdown and has continued to restrain fiscal and monetary expansion, even as the economy teeters on the brink

Chart 7 Germany: Recession And Fiscal Austerity

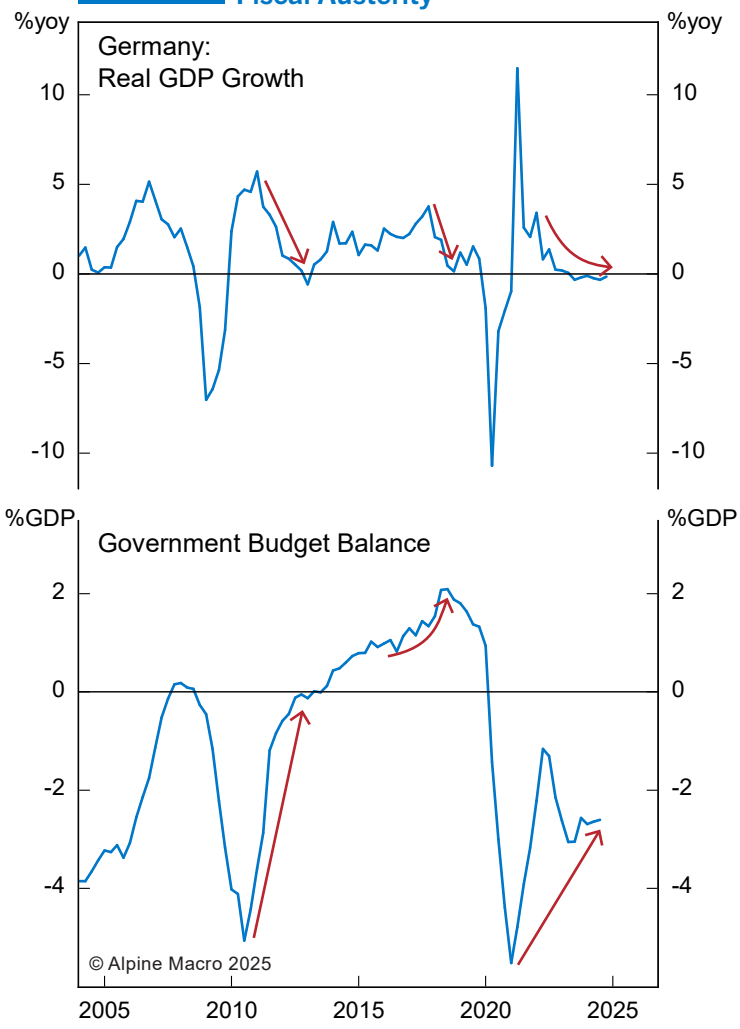
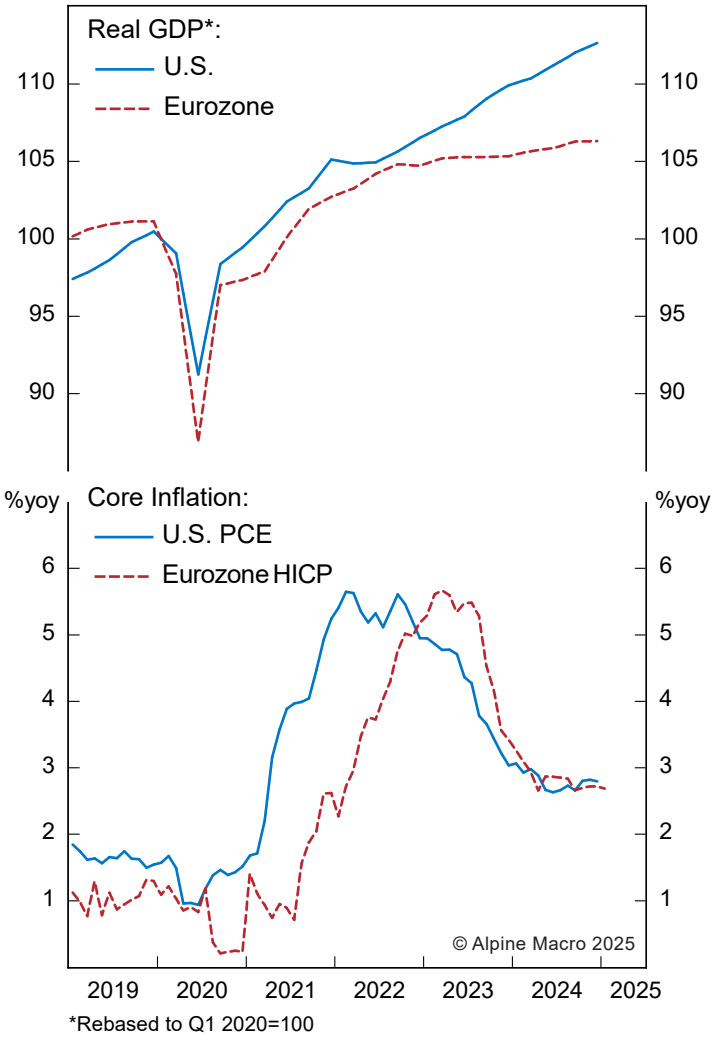


Chart 8 Is U.S. Fiscal Stimulus Excessive?



of deflation. The fear of rising debt accumulation and a potential debt crisis is the key reason Chinese leaders have hesitated to reflate the economy more aggressively.

Among the major economic blocs, the U.S. stands out as the only one that has consistently taken decisive policy actions to counter recessionary pressures whenever the economy faces stress. This is evidenced by its ever-increasing fiscal expansion since 2001. Critics argue that U.S. fiscal and monetary authorities have overdone their expansionary policies, risking a potential debt crisis or a major inflation outbreak. However, the U.S. economy has consistently outperformed other high-income economies since 2000, with inflation undershooting the Federal Reserve's 2% target – at least until the COVID-19 pandemic, which caused global supply-side disruptions and drove inflation higher worldwide.

Even today, core PCE inflation in the U.S. is on par with core CPI inflation in the eurozone (**Chart 8**), despite the U.S. economy vastly outperforming

Europe in terms of growth since the pandemic ended two years ago. This suggests that America's policy responses have been both adequate and effective in navigating recessions and crises in an era of abundant savings.

Debt Crisis Versus Monetary Regimes

Can a public sector debt crisis ever occur? Under a fiat currency system, the answer is no. In such a system, the central bank has unlimited capacity to expand its liabilities by issuing money. Crucially, central bank liabilities (money supply) and government liabilities (debt) are identical in quality, differing only in maturity. This interchangeability makes the central bank the ultimate guarantor – or buyer of last resort – for sovereign government debt, ensuring that a debt crisis cannot happen even under extraordinary circumstances.

However, a sovereign debt crisis can occur under three specific conditions:

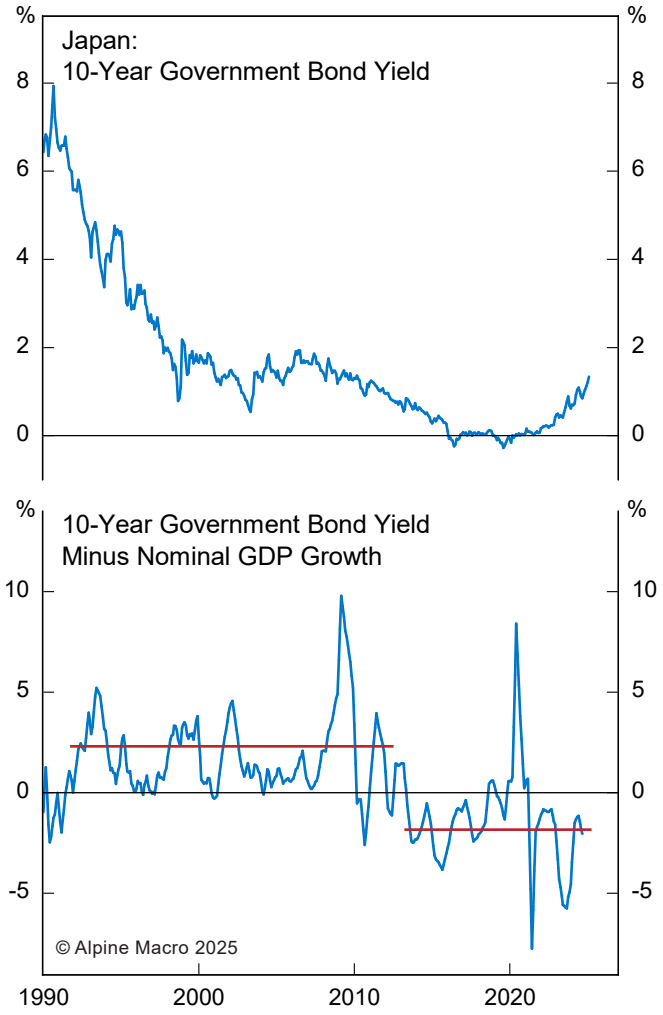
1. **Excessive Foreign Currency-Denominated Debt:** A crisis can arise if a government borrows too much in foreign currency and faces a creditor strike. In such a scenario, the government may default on its foreign liabilities once it exhausts its foreign currency reserves. This was the primary cause of the emerging market crises in the 1990s, when excessive foreign currency borrowing led to defaults.
2. **The Gold Standard:** Under the gold standard, governments faced the risk of running out of money because the money supply – and thus the size of the central bank's balance sheet – was constrained by gold reserves, production, and international flows. Central banks could not "print" gold to buy government bonds, leaving no lender of last resort to underwrite sovereign debt. This created the possibility of sovereign default.

   The U.S. experienced *de facto* sovereign defaults during the 1933 suspension of gold payments to bondholders and the 1971 closure of the gold window. In both cases, the U.S. government failed to honor its promise to pay bondholders in gold, instead offering paper dollars with significantly reduced value relative to gold.
3. **Quasi-Gold Standard Systems:** A currency union or currency board system operates similarly to the gold standard, albeit without gold. In such a regime, a sovereign nation relinquishes discretionary monetary policy, leaving no buyer of last resort for its debt. Such a monetary regime effectively transforms sovereign bonds into something akin to corporate bonds, making default a real possibility.

The eurozone debt crisis of the 2010s is a prime example. By 2009, Greece, Portugal, Spain, and Italy were running large twin deficits, but the European Central Bank (ECB) initially refused to purchase their bonds, plunging these markets into crisis. However, the crisis ended suddenly after then-ECB President Mario Draghi's famous "whatever it takes" statement, which signaled the ECB's willingness to act as a lender of last resort.

The ECB's eventual intervention underscores the critical role of central banks in underwriting sovereign debt. In this light, the eurozone debt crisis can be considered a man-made disaster.

Chart 9 The Fallacy Of Debt Arithmetic: Where Is The Crisis?



What Does All This Mean?

- **Forget About The Debt/GDP Ratio:** The debt/GDP ratio is merely an accounting metric that tracks how much private sector savings – both domestic and foreign – have been channeled into public sector spending. It is not a meaningful indicator of a nation's debt sustainability. In essence, this ratio is no different from the money supply/GDP ratio. Ironically, while many obsess over the debt/GDP ratio, few raise concerns about a rising M2/GDP ratio.
- **Debt Arithmetic Is Flawed:** The conventional argument that debt dynamics become unsustainable when bond yields exceed nominal GDP growth – especially with a debt/GDP ratio above 100% – is empirically flawed. Japan's debt/GDP ratio has surpassed 100% since 2001, and its bond yields consistently exceeded nominal GDP growth throughout the 2000s (**Chart 9**). Yet, the bond market remained robust, with no signs of stress.
- **Fiscal Policy Should Focus On Macro Imbalances, Not Balancing The Books:** The goal of fiscal policy should never be to "balance the books". Instead, it must be calibrated to counteract macroeconomic imbalances in the private sector. Tight fiscal policy is necessary to curb excess demand and prevent economic overheating and inflation. Conversely, fiscal stimulus is essential to combat deflationary pressures and growth stagnation. Governments must prioritize addressing emerging economic imbalances over obsessing about deficits and debt.
- **The Eurozone's Structural Challenge:** The design of the eurozone's common currency regime poses a significant challenge to economic growth and price stability in the region. The Maastricht Treaty, signed over three decades ago, was crafted for an era of excess demand and high inflation – conditions vastly different from today's environment of weak demand and deflationary risks. Despite some modifications, the core framework of the monetary union remains unchanged. As long as fiscal policy remains constrained by the treaty, the eurozone will continue to experience subpar growth, recurring deflationary threats, and sporadic bond crises. This is because the private sector saves way more than it invests.

- **No Need For Serious Fiscal Retrenchment In The U.S.:** It remains to be seen whether the U.S. fiscal expansion is excessive or just about right, but one thing seems certain: there is no need to dramatically reduce America's budget deficit and debt in the age of relative abundance in private sector savings. Doing so could only inflict undue damage on economic growth and cause stock prices to fall, though such an effort could trigger a sharp rally in bonds.

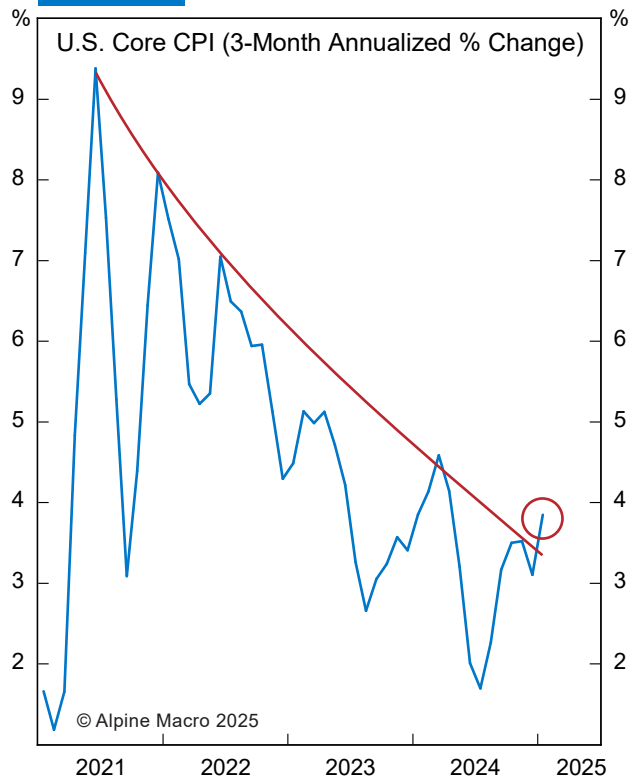
The bottom line is that in a world shaped by technological advances and aging populations, fiscal policy will play a pivotal role in determining economic growth. While technological progress enhances capital efficiency, an aging population tends to reduce investment demand. In this context, countries that adopt more proactive fiscal policies are likely to achieve higher economic growth, rising stock markets, and stronger exchange rates.

A Market & Investment Update

The January CPI print disappointed the bond market last week, triggering a spike in Treasury yields. However, the surge in core services inflation (excluding rent) appears suspect and likely an aberration. Last week's PPI report came in better than expected, suggesting disinflation may continue. Importantly, the quarterly rate of change in core CPI continues to trend downward (**Chart 10**), though any further spikes would be concerning. Regardless, nothing has changed the case for the Fed to maintain the current rates for longer.

Our *2025 Annual Outlook* outlined a roadmap summarized as "lower first, new highs later".[1] This narrative seems to be unfolding. Since December, U.S. stocks have virtually flatlined. The U.S. equity market pause will likely persist, as much of the positive news has already been priced in.

Chart 10 Core CPI: Testing The Downtrend



1 Alpine Macro *Macro Outlook 2025* "Boom Or Bust? An Investors Playbook For 2025 & Beyond" (December 9, 2024).

Chart 11 China Techs: Good Growth On The Cheap?

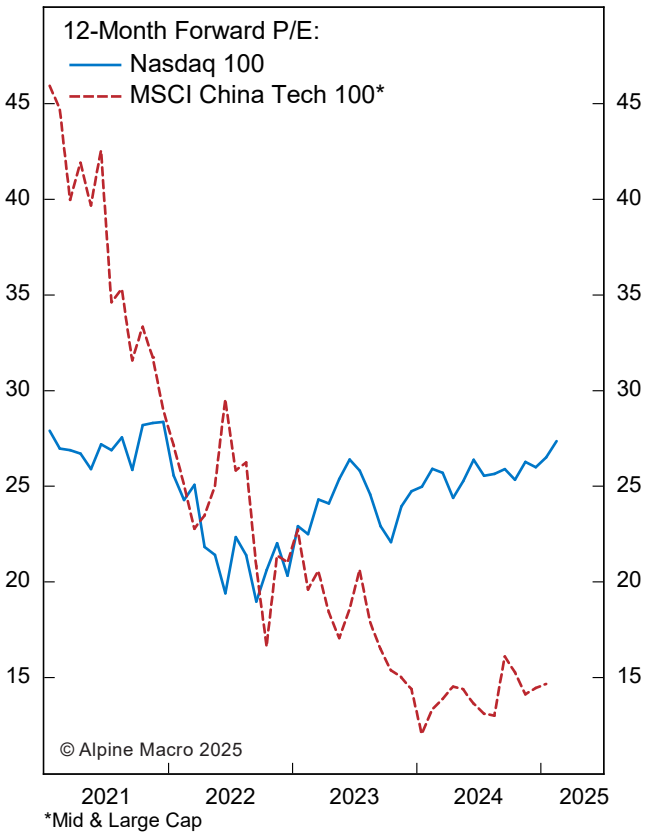
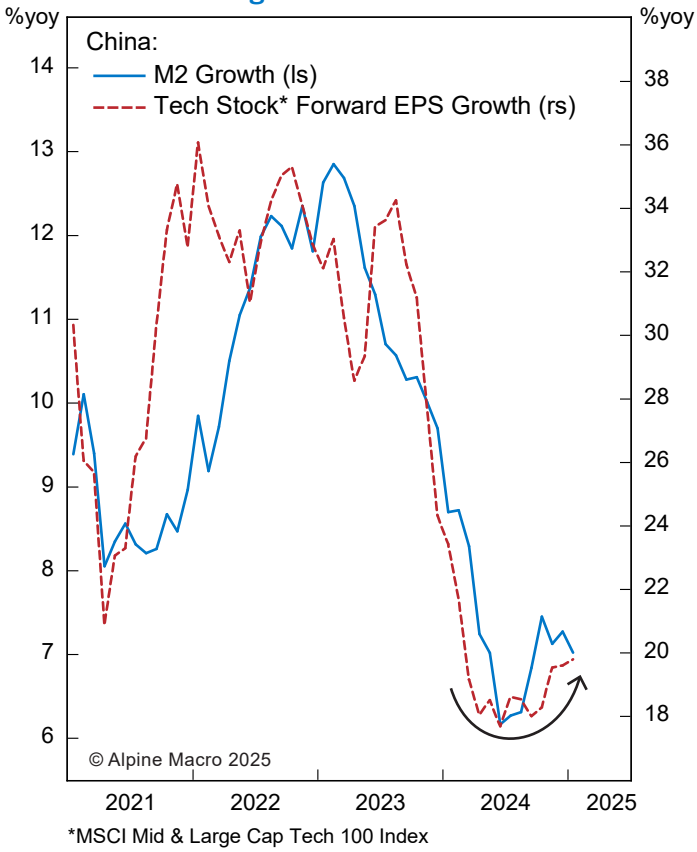


Chart 12 China's Economy: Signs Of A Rebound



While the U.S. equity market may be in a consolidation/corrective mode, investors could look for growth stocks on the cheap. The revelation of the Chinese OpenAI app, DeepSeek, has shocked Chinese tech shares back to life. The MSCI China Tech 100 Index seems to have bottomed last February, and the advance in prices has progressed by leaps and bounds in recent months.

The Chinese tech index has outperformed the Nasdaq 100 Index in the last 3 and 6 months significantly, and yet is still trading at a substantial discount to their U.S. counterparts (**Chart 11**).

Although the outlook for Chinese tech stocks is clouded by geopolitical strife, their valuation looks attractive. BYD, a Chinese EV maker, had total revenue of US$95.7 billion, up 12.7% from a year ago. Tesla, however, generated $97.7 billion in revenue for 2024, up just 1% from a year ago. Nevertheless, Tesla's forward P/E is 120.5 times, while BYD's is 20 times.

Of course, these could be isolated cases, and no one should generalize the story. But from a macro perspective, the Chinese economy seems to have turned a corner and EPS growth for Chinese tech companies has begun to pick up, along with M2 growth (**Chart 12**).

Bottom line: It is not too late to buy some Chinese tech stocks, at least for tactical reasons. Go long Chinese tech stocks (ETF: CQQQ).

Housekeeping

We are switching from long S&P 600 Industrials/ short Mexican equities to an outright long S&P 600 Industrials. Meanwhile, put a stop loss at -10%.

Chen Zhao
Chief Global Strategist

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long U.S. Financials ($IYF)	08/19/2024	101.30	101.3	-	-	17.9%
Long 10-Year German Bunds/ Short 10-Year JGBs	10/07/2024	2.3%/0.93%	-	-	-	9.1%[1]
Long Gold ($GLD)	12/09/2024	245.36	-	-	-	27.4%[2]
Short EUR/JPY	12/11/2024	160.00	-	-	-	-0.3%
Long S&P 500 Energy ($XLE)/ Short WTI Crude Oil ($USO)	01/13/2025	90.3/82.2	-	-	-	7.6%
Long S&P 500 Energy ($XLE)/ Short Dow Jones Alternative Energy Index	01/13/2025	90.3/257	-	-	-	12.8%
Long S&P 600 Industrials ($PSCI)[3]	01/27/2025	140.03	-10%	-	-	-8.6%[4]
Long Chinese Tech Stocks ($CQQQ)[5]	02/17/2025	-	-	-	-	-

Note: P&L is calculated using daily closing prices.

[1] Return is calculated based on a continuous Long 10-Year German Bunds/Short 10-Year JGBs position, first initiated on 08/07/2023 and stopped out on 08/05/2024.

[2] Return is calculated based on a continuous Long GLD position, first initiated on 04/01/2024 and stopped out on 11/11/2024.

[3] We are removing the short end of our Long S&P 600 Industrials ($PSCI)/Short MSCI Mexico ($EWW) trade, and adding a stop point at -10%.

[4] Return is calculated based on a Long S&P 600 Industrials/Short S&P 500 Specialty Retail position, first initiated on 01/13/2025 and closed on 01/24/2024.

[5] We are initiating a Long Chinese Tech Stocks ($CQQQ) trade.