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Capital Management

The Silver Bullet | The Anti-Goldilocks Era

Goldilocks is over

The last twenty years were a period of low inflation, few geopolitical frictions, free-trade, and neoliberal policies. We believe this stable, goldilocks environment is over. Record high inequality, persistent inflation on higher fiscal spending, rising geopolitical risks and climate polarisation will shape the future investment environment. Here's how we think investors should get ready for this challenge.

Regime-change across Macro, Policy and Geopolitics

Since the post-war period and the end of the Bretton Woods system, western governments engineered a multi-decade period of stable growth and low inflation. Demographic growth, the rise of private credit, and globalisation have boosted growth - but generated long-standing imbalances.

This goldilocks period with a low-tax, low-interest rate policy mix boosted short-term growth at the expense of declining productivity, leading to a rise in inequality: for the first time in over a century, the word *inequality* is used more than *revenues* and *profits* in books and magazines, according to Google Ngram data. Over the next decade, millennials will become the median voter across most developed economies. The policy mix is likely to change, as a result.

Increased polarisation in politics has contributed to the rise of populism over the past few years. Both left-wing and right-wing populism ultimately result in more fiscal spending, rising geopolitical tensions and a segmentation in global trade.

In this context of supply constraints and market frictions, loose-for-everyone monetary policy becomes an unfit and untrustworthy instrument. Recent research by the BIS shows that once inflation becomes persistent and structural, market participants increasingly use that one number to re-price goods. Put differently, entrenched inflation becomes the one coordinating device for pricing decisions across markets.

After a glorious decade rescuing global economies from the Lehman crisis with *quantitative easing*, central bankers are therefore facing a day of reckoning. Their one-size-fits all anaesthetic is no longer enough to boost growth, and in some cases, the negatives outweigh the positives.

Fiscal policy, too, will need to adapt: in some cases, fiscal spending will only boost short-term growth. Other, *post-populist* governments, are attempting to implement long term reforms. Still, what's on the table is too little to boost long term growth and help us exit secular stagnation.

When domestic policy is not enough to improve growth, some governments will inevitably turn to external threats to maintain consensus. The recent rise in geopolitical tensions is in part due to sluggish growth and in part due to the looming confrontation between China and the US. On the one hand, China benefits from the ability to implement long-term planning, and its *common prosperity* model attempts to provide an alternative to the failures of western capitalism. On the other hand, the United States continues to be resilient in the short run, but are accumulating increasing social divisions and internal tensions, which might destabilise domestic policy and politics. The result is likely to be a rise in tensions over the coming years.

What does regime change mean for investors?

1. Persistent inflation. Higher inflation will be persistent, as its widespread nature reinforces behavioural changes.

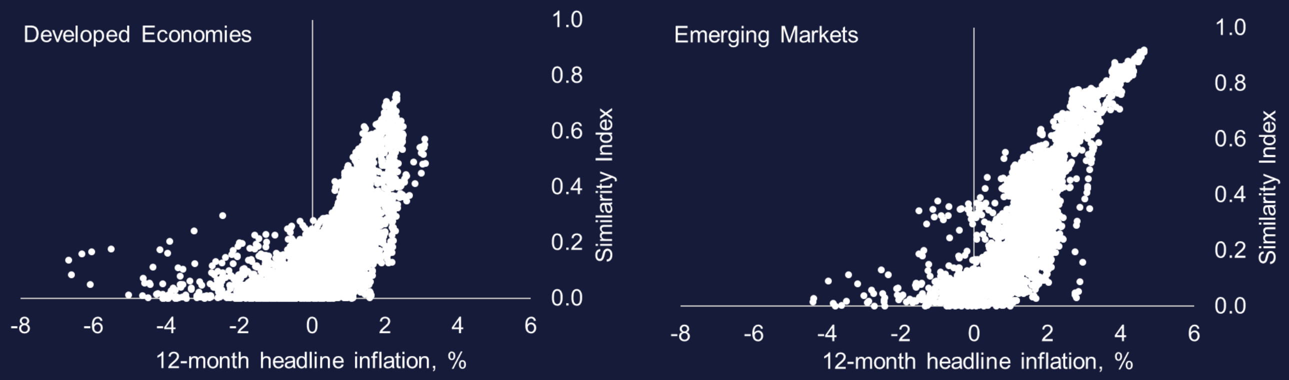
Globalisation reduced inflation by almost 0.25pp, since 2000 according to OECD research. As geopolitical fricitions and trade barriers rise, companies will likely shift production onshore, losing access to cheaper labour. According to a recent survey, almost one in four US and European companies are considering moving part of their China operations outside the country.

The unwinding of these global supply chains, compounded by the war in Ukraine, initially had an impact only on goods inflation. This has now spread across all components. In advanced economies, almost half of all CPI components have price increases over 5%, while in EM economies it's almost 70% of CPI components.

This widespread nature of inflation, reinforces behavioural changes and persists higher inflation, according to a recent BIS report. The BIS finds that higher inflation, especially during periods of tight labour market, influences structural features of wage and price setting. For example, having suffered decades of stagnant or declining real wage growth, workers are incentivised to unionise and demand higher or inflation-indexed wages.

This wage-price spiral is seen in an increasing number of countries. In the short term, this may be broken by aggressive rate hikes inducing a recession. However, in the long term, the conditions for persistently higher inflation remain - central bankers will need to adjust monetary policy more often and more aggressively than before.

When inflation is high, it becomes a coordinating device to set all prices



Source: BIS June 2022

2. Monetary volatility. With persistent and more volatile inflation, central banks will have to choose: raising rates aggressively and risking a mild slowdown, or, keeping policy loose for longer and risking an entrenchment of inflation, with deeper long-term costs.

In a paper from earlier this month, Federal Reserve economists argue that an inverted yield curve might not be as good an indicator of recession risk today as it was in the past. In our view, the Fed will keep hiking interest rates above the current market-implied peak of 3.5% over the coming quarters, bringing real rates into net positive territory vs inflation expectations and despite the risk of a mild recession.

Other central banks, like the Bank of England or the ECB, remain well behind the curve. The Bank of England is the least prepared to bring real rates back to positive, in our view, given the accumulation of private debt in the UK, coupled with supply bottlenecks. With inflation running at nearly double digits, rising social unrest and labour markets constrained by Brexit rules, the UK could become the first country with entrenched inflation. Recent discussions about a five percent public sector pay rise are consistent with this risk.

The ECB is likely to keep hiking rates to above one percent over the coming quarters. Unlike in the UK, Eurozone household and corporate balance sheets are in better shape and with less indication of a wage-price spiral. However, grey clouds loom over the periphery and Italy in particular, with Mario Draghi's tenure getting close to an end. At the same time, the ECB's spread compression tool is far from ready. This will likely mean more volatility in periphery spreads and Eurozone financial conditions.

Overall, inflation volatility will likely lead to monetary policy volatility and errors: the Fed might hike too much, generating a credit crunch across weak US consumers and emerging economies. The Bank of England and ECB might wait too long and end up over-depreciating their currencies, which eventually might lead to a painful u-turn in policy to regain credibility.

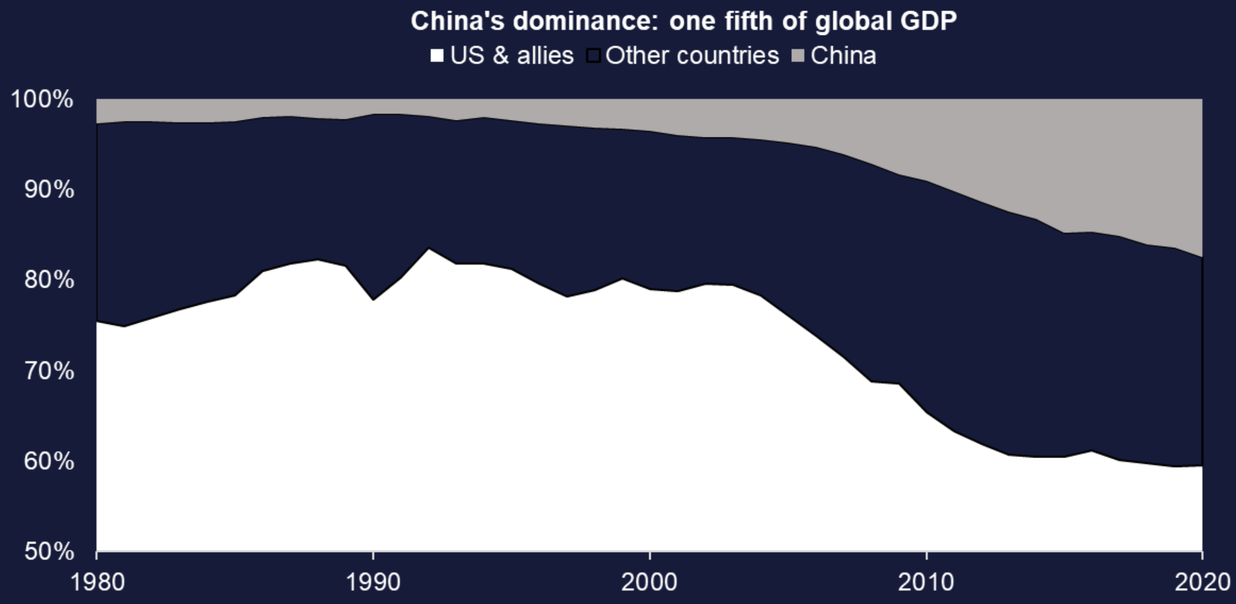
3. Greater geopolitical uncertainty. We are moving from a unipolar to a multipolar world. With the Russia-Ukraine war in context, China's relative strength is now a destabilising factor for geopolitics.

Since 2000, China's weight of GDP to global GDP has risen from around 5% to nearly 20%. China's rise is worrying in the context of President Xi's recent policies, which appear to isolate China's growth from that of the West. For example, aggressively reducing domestic leverage and China's reliance on foreign capital markets. These policies could be preparatory steps for China's economy to withstand many years of an antagonistic relationship with the West.

In the short run, President Xi's policies will hurt growth. China will most likely be in a balance-sheet recession over the next few quarters, despite official CCP data showing that the country has thus far narrowly avoided negative growth. The good news is that by absorbing imbalances in the construction sector, these policies might make the country ready to move to a consumer-led economy, albeit with lower growth rates and more *common prosperity*. The bad news is that they could also be preparing China's economy to withstand a period of economic isolation and conflict for example over Taiwan.

A prolonged slowdown in China, coupled with higher real interest rates in the US will likely make many sovereign debt structures in emerging economies unsustainable, especially those that are dependent on China's strong growth and China's funding.

With a higher degree of China and IMF loans senior to bondholders across many emerging economies, we see more downside in EM debt. Almost one-in-five hard-currency EM issuers are trading at distressed levels today. EM countries on average spend ten percent of their revenue on interest, while the IIF estimate this will rise to twelve percent by 2025. This is just shy of 1990s levels when multiple EM countries defaulted due to external vulnerabilities. Emerging markets bond spreads have widened, but we believe more restructuring events are on the way. We remain especially cautious on countries with weak governance, a reliance on commodity-imports and complex debt structures, like Egypt, Turkey, Kenya and Pakistan.



Conclusions

The last decade was a boon for buy-and-hold carry strategies. Central bank policy was the only game in town for investors, volatility was low, and correlations between risky and risk-free assets were stable and negative.

The future looks different.

Politics, policy and geopolitics are no longer stable. Governments and central banks around the world are taking different policy paths, some leading to policy errors. The Fed might end up hiking more than people think, hurting consumers and emerging economies. The Bank of England, instead, might lag behind common sense until inflation becomes entrenched, leading to stagflation.

In the words of veteran bond investor Dan Fuss, in a recent FT article: “The world is changing. The management of fixed income portfolios has to change with it.”

Future bond strategies need to be able to gain from volatility, to optimise convexity on the upside and downside, and to take advantage of the disruptions in sovereign and corporate capital structures which will come with higher yields.

For active, long/short investors, what’s coming is as exciting an opportunity set as you can get. And this is why after ten years of joint experience, the last six of which managing a top-rated credit opportunities fund, we set up Andromeda.

We are ready for the challenge.

Alberto Gallo
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Andromeda Capital Management (ACM) is a global strategy focused on regime-changing themes and investing primarily in fixed income and credit. For more information, please contact info@andromedacm.com or visit www.andromedainvestors.com

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