The Silver Bullet | The Great Catch

"He always thought of the sea as la mar, which is what people call her in Spanish when they love her. Some times those who love her say bad things of her but they are always said as though she were a woman. Some of the younger fishermen, those who used buoys as floats for their lines and had motor-boats, bought when the shark livers had brought much money, spoke of her as el mar which is masculine. They spoke of her a contestant or a place or even an enemy. But the old man always thought of her as feminine and something that gave or withheld great favours, and if she did wild or wicked things it was because she could not help them."

- The Old Man and the Sea, E. Hemingway

As we embark on our journey at Andromeda, the opportunity set across markets and global events appears exciting and scary at the same time. Like experienced sailors and fishermen, the key to a successful catch is having the right preparation, respecting the waves, and being patient enough to capture opportunities when they finally arise.

It's exciting, because for the first time in decades, markets are no longer dominated by central bank policy, forward guidance and buy-the-dip herding. This is an ideal environment for alpha and for monetising inflection points.

It's scary as well, because the exit out of goldilocks will likely make the world a more dangerous place to live in. The recent crisis across LDI investors in the UK is an early warning sign. But there's more to come, in our view, after *QE Infinity* fuelled years of capital misallocation across public and private assets. The Dutch pension system alone, for instance, is over twice as large as GDP, vs the UK one at 1.2x. We expect more volatility in the Eurozone too, as the ECB catches up with persistent inflation, as well as in emerging markets, hurt by the double-punch of a strong dollar and high funding costs.

Lower growth across emerging economies, higher unemployment and geopolitical shocks will come with social unrest. Perhaps, this is the price to pay for years of delayed economic adjustment. Understanding policymakers' approach to the upcoming shocks will be key to distinguishing value from value traps.

The tightening in rates markets will spill-over into higher credit volatility over the coming months, in our view. This will bring opportunities in value assets. At the same time, many capital structures will become unsustainable, in a context of high funding costs. It is a great time to invest in credit markets. Overall, policy normalisation will be a good thing - a long, artificial calm induced by quantitative easing has made our financial system more fragile, and market participants more complacent. The return of volatility is welcome.

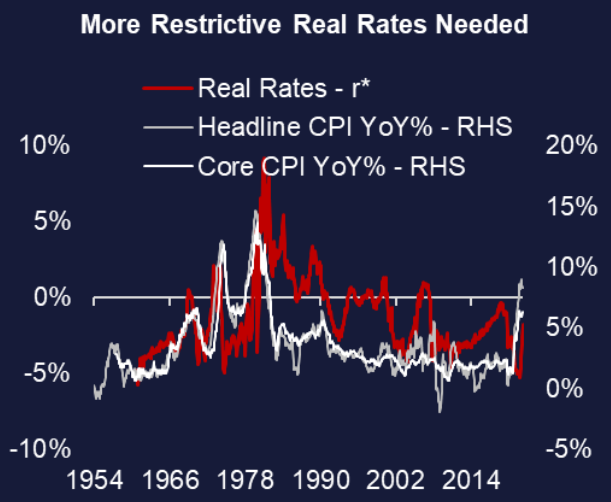
No Dovish Pivots in Sight: It's Just a Bear Market Rally

We warned investors against the risks of persistent inflation and monetary volatility in July. Since then, we have seen several upside inflationary surprises, the **Fed** significantly revising up its policy rate projections, and a further tightening in financial conditions. With the markets now pricing a terminal rate of 4.9% and growth data showing weakening signs, here are the key questions: has the Fed reached peak hawkishness? If so, are we going to see a dovish pivot soon?

The short answer is no: it is too soon to expect policy accommodation.

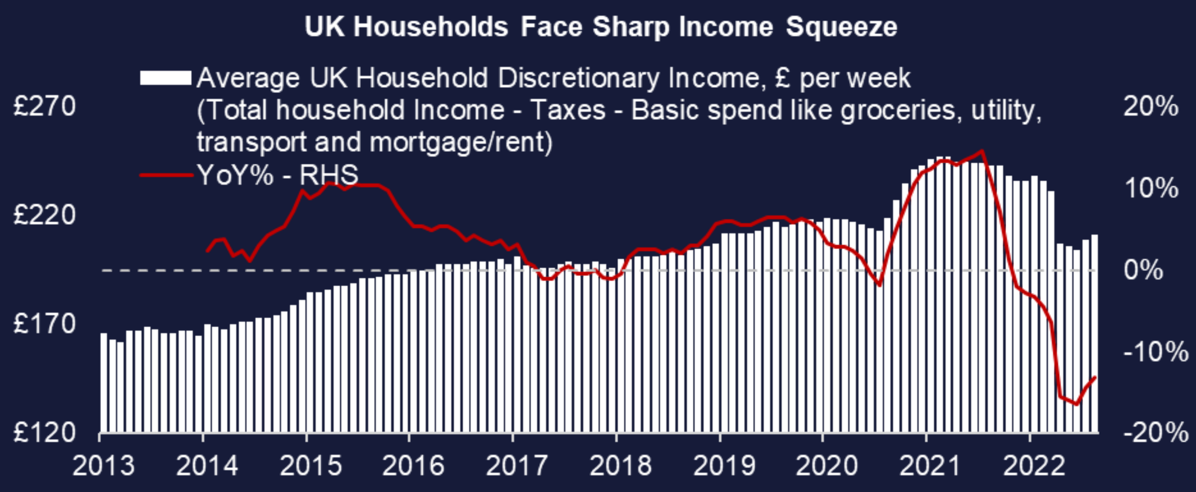
On the one hand, more signs show headline inflationary pressures may have peaked. Energy inflation is moderating with gasoline prices dropping near 40% from the peak in June. Continued easing in supply chain stress and a consumption rebalance from goods to services mean core goods inflation will decline further, after falling from 12% in February to 6.6% in September. Looking at the relationship between peak inflation and terminal rates in past hiking cycles since the 1960s, we estimate that the Fed Funds Rate may need to reach the range of 4.3-5.8% to bring headline inflation within target this time, considering the structural decline in r* over the years. In other words, the terminal rate of 4.6% outlined by the Fed in its September dot plots could be restrictive enough in this inflationary cycle, as shown by estimations from Chicago Fed President Evans.

On the other hand, the bad news is that inflation outlook into next year is still subject to significant uncertainty, which leaves no room for the Fed to relax and risk its own credibility. While headline inflation is coming down, the US labour market remains tight with wage growth running above 6%. Adding to that is a shrinking workforce, with participation numbers constrained by the pandemic as well as demographics. For the Fed to be confident that inflation has been brought down on a sustained footing, further cooling of the labour market is needed. As Chair Powell made clear at his Jackson Hole speech, price stability is now the critical target within the Fed's dual mandate, as "the employment costs of bringing down inflation are likely to increase with delay". In a historical study the Atlanta Fed also argued that given monetary changes take longer to affect prices than output, it is important to avoid a "step-and-go" approach. That means when the Fed reaches its outlined restrictive level, it is more likely to hold for policy tightening to take effect on prices, rather than ease prematurely on the first signs of rising unemployment.



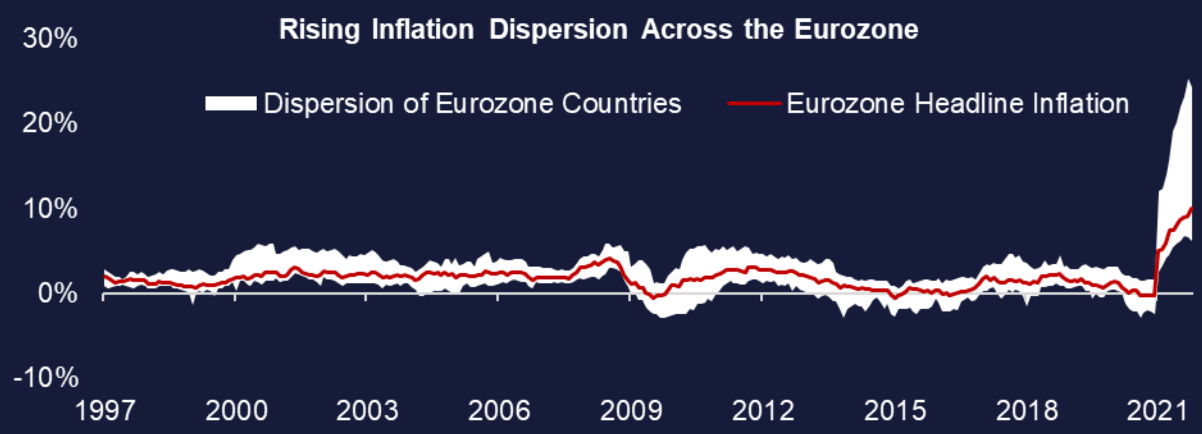
Source: FRED, New York Fed, Atlanta Fed

In Chair Powell's words, bringing down inflation will also "bring some pain to households and businesses". The price is worth paying. Doing otherwise means entrenching inflation expectations and putting the central bank's credibility at risk: the UK is a case in point on the downside risk of reckless policy. The UK government's September "mini" Budget has proven a clear policy mistake, triggering a run on the currency and a pensions crisis. It also puts the **Bank of England** in a lose-lose situation, forcing it to embark on emergency asset purchases while RPI inflation is running above 12%. We think the emergency QE is just a temporary fix. With doubtful government competency and inconsistent monetary policy, the pound is likely to suffer a permanent downward re-rating, further entrenching the UK's inflation problem. This, coupled with stagnant productivity growth means workers' real wages continue to fall, putting pressure on discretionary spending.



Source: Asda Income Tracker, Centre for Economics and Business Research ltd

The **ECB** is catching up on its fight against inflation. We think they will hike another 75bp this month and start tightening TLTRO terms to reduce the balance sheet. That said, Eurozone inflation is driven more by supply constraints with no clear short-term solution. This means bringing inflation down will likely require more demand destruction and more economic pain. At the same time, a lack of coordination in fiscal support for energy subsidies or price caps is creating dispersion in inflation and growth across member states. With a one-size-fits-all monetary policy, countries with less fiscal space are likely to suffer in a rising rates environment, leading to higher fragmentation risks.

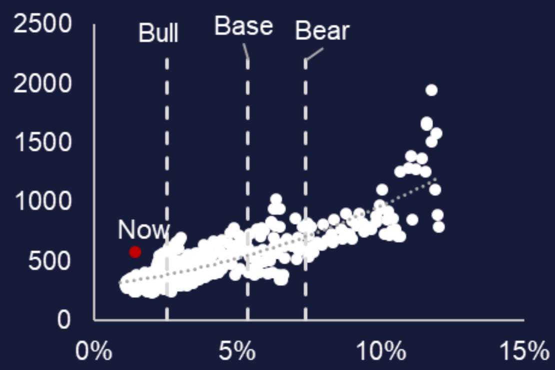


Source: Eurostat

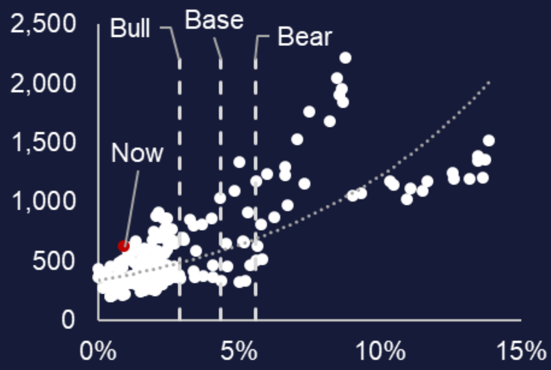
More Volatility Ahead and Rising Default Rates

As the reversal from the past decade's easy monetary policy continues, more fragile hotspots will come to the surface, in our view, similarly to what happened with the UK LDI crisis. Over the coming months we could see more spread widening, as rates volatility spill into higher credit volatility and default rates start rising on persistently higher funding costs and slowing growth momentum. Currently US and European high yield spreads are pricing in around 5.7% and 4.8% of forward default rates respectively, which are close to our base-case model projections. However, they do not provide additional compensation for substantial left-tail risks.

US HY Spread, 11-Month Lead vs Default Rate



Euro HY Spread, 11-Month Lead vs Default Rate

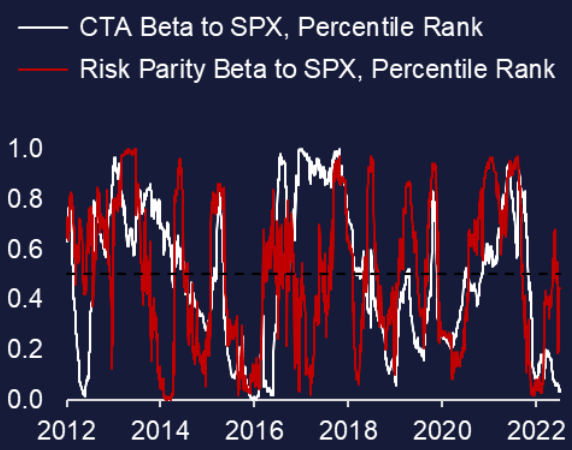


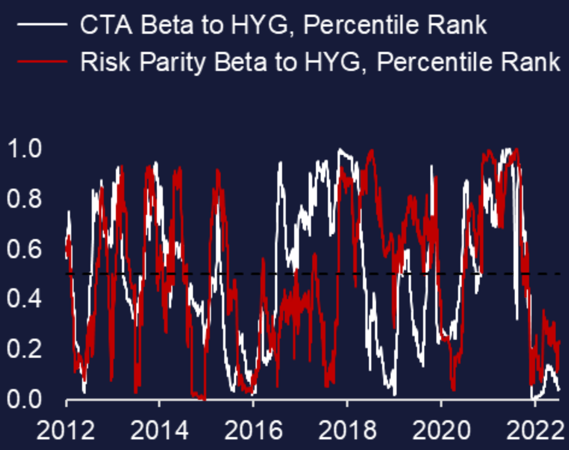
Source: Proprietary Default Rate Models, S&P, Bloomberg. US data: 1982-2022; Europe data: 2001-2022.

Short Squeezes Unlikely to Turn into a Sustainable Rally

Despite still elevated inflation, risk assets had a surprising rally after the September US CPI release. In our view this is more likely a short squeeze caused by already bearish positioning, and will struggle to turn into a sustained rally without more significant improvements in the inflation and policy outlooks. So we take this as a repeat of the July rally, with even less fundamental tailwinds.

Bearish Positioning Means Short Squeezes Are Possible





Source: Bloomberg. *3-month rolling beta.

"The economy of imaginary wealth is being inevitably replaced by the economy of hard assets"

- Vladimir Putin

Conclusions: Volatility Unlocks Value

Like ocean waves, the upcoming volatility is going to be both exciting and scary. Our models show inflation will remain persistent, with core inflation continuing to rise in the Eurozone next year and staying above target in the United States. Monetary policy dominance is fading, and more repricing is overdue across public and private asset markets: after the first risk-off stage driven by rising interest rates, we expect a second one driven by risk premia in equities and credit.

Overall, monetary normalisation will be a good thing, even though they might come with unexpected consequences. Setting the *price of time* to zero for decades, central bankers fuelled an economy of *imaginary wealth*, with rising asset prices, high corporate profits and stable inflation. But this goldilocks, high-profit and low-inflation environment was only sustainable thanks to cheap energy from Russia and cheap goods from China. At the same time, low interest rates encouraged capital flows into placeholder assets, like real estate or crypto currencies. This asset-based growth model is now under question.

As the tide goes out, firms with unsustainable business models and capital structures will find themselves in need to restructure their debt. Others, however, will become great value investments. Our top-down process focuses on harvesting the best convexity and on capturing the volatility from upcoming market stress. We still see negative catalysts hitting US housing, UK consumers and commodity-importing emerging markets. There is no dovish Fed pivot in sight, until employment, earnings and financial stability are at risk. Our strategy has gone live on October 7th. We are ready to capture the opportunities that will arise across solid firms with sector leadership as well as public or private backing.

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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 IR@andromedainvestors.com or visit www.andromedainvestors.com

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Disclosure