ANDROMEDA
Capital Management

The Silver Bullet | The Most Important Question

Dreams make good stories. But everything important happens when we're awake.

- Dune, 2021

The most important question

Will the world come back to where it was before the pandemic?
This is the most important question for investors today.

Ten-year US Treasuries are near their peak over the past decade of between 3 to 3.5%. Equity risk premia and implied volatility are near their tightest levels. Markets are cheering.

Are we back to goldilocks, or are we dreaming?

The broad consensus calls for a soft landing, with falling inflation and at worst, a mild recession in Europe. And the consensus recommendation is long investment grade bonds and long rates, on expectations that central banks will begin to cut, sometime in H2 2023.

In other words, markets are assuming the world will steer clear of persistent inflation. We believe recession risk is low, but that inflation will stay persistent.

A reversion to the goldilocks, low inflation, high global growth normal is unlikely to happen, in our view. The changes in policy and geopolitics we have experienced post pandemic are structural.

Fiscal policy is one key driver. Milton Friedman used to say *nothing is more permanent than a temporary government programme.*

Wth millennials becoming the median voter across the West, fiscal policy is likely to stay expansionary over the next few years. As the Financial Times recently showed, millennials have shattered the oldest rule in politics: *if you are not a liberal at 25, you have no heart. If you are not a conservative at 35, you have no brain.* Contrary to history, millennials remain liberal and pro-spending even as they age. And in addition to that, workforce participation is unlikely to go back up.

Geopolitics is another source of structural change: foreign policy will keep government spending up.

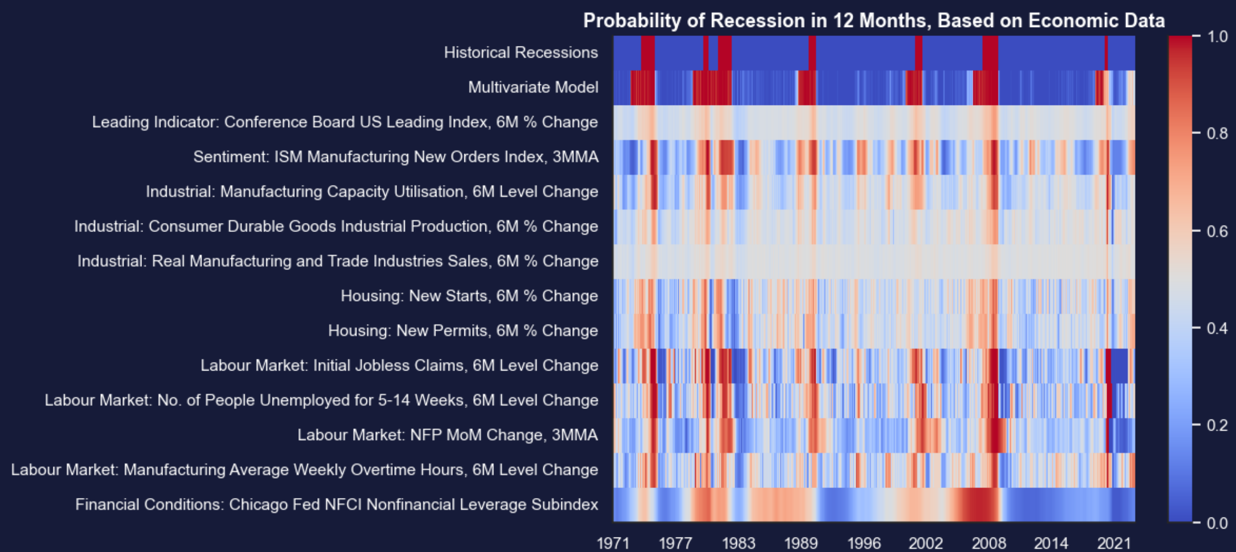
For decades, western governments have relied upon cheap energy from Russia and cheap goods from China. Both the US and Europe are now rushing to diversify their energy sources and strengthen their defence forces. Europe, in particular, is behind on energy security as well as fiscal integration. Global manufacturing is gradually moving from just-in-time to just-in-case supply chains, through reshoring and onshoring.

What do these developments have in common? They create persistent imbalances, producing more inflation per unit of output. And high inflation historically goes in tandem with populism, which is pro-people, pro-spending and anti-capital. History shows this type of state capitalism is frequent in a post-pandemic, wartime economy. Goldilocks might have been the exception, after all.

US and Eurozone recession risk is lower than you think

Our models show around a 50% probability of a US recession in the next 12 months – slightly lower than the 65% Bloomberg consensus, and much lower than near certainty priced into rates markets, today.

As we show below, some segments of the economy are at greater risk, in particular the US housing market, manufacturing new orders and industrial production. However, while the labour market has started to weaken, it is far from recessionary levels yet. Non-financial leverage tracked by the Chicago Fed is also still at lows.



Source: FRED, Bloomberg, Bureau of Labor Statistics. *Each row represents recession probabilities estimated by a univariate model based on the respective economic variable, except row 1 which represents actual historical recessions and row 2 which represents recession probabilities estimated by a composite model covering all economic variables.

The combination of these signals suggests that a recession will likely be shallow. That is, while companies are reporting weakened activity, generally strong corporate balance sheets mean the risk of mass layoffs is relatively low. Furthermore, households' financial situations are in a stronger position than in the past, given the stock of excess Covid savings. Finally, governments continue to push back against a slowdown. Unlike pre-pandemic, there is no mention of austerity now.

DM Central Bank Balance Sheets
12-month difference as of Dec, $bn

	2018	2019	2020	2021	2022	2023
Fed	-385	115	3161	1431	-249	-961
ECB	231	-31	2342	1605	-218	-983
BoJ	213	146	901	147	-64	90
BoE	32	-11	367	258	-25	-118
BoC	4	3	323	-37	-66	-83
RBA	-7	0	99	215	-2	-82
RBNZ	1	-3	32	11	7	-8
Total	**88**	**219**	**7224**	**3631**	**-618**	**-2145**

Source: JPM

Government Fiscal Budget
% of GDP

	2018	2019	2020	2021	2022	2023
US	-4.2	-4.7	-15.6	-10.8	-5.5	-4.5
UK	-2.4	-2.3	-12.9	-7.3	-7.0	-5.5
DE	1.9	1.5	-4.3	-3.7	-2.6	-2.7
FR	-2.3	-3.1	-9.0	-6.5	-5.1	-5.3
IT	-2.2	-1.5	-9.5	-7.2	-5.5	-4.9
ES	-2.6	-3.1	-10.1	-6.9	-4.9	-4.4
JP	-2.5	-3.0	-9.0	-5.5	-6.7	-4.9
CN	-4.1	-4.9	-6.2	-3.8	-5.7	-5.0

Source: Bloomberg Economists' Consensus as of Jan 2023

Core inflation to stay above 3% in 2023, in the US and Europe

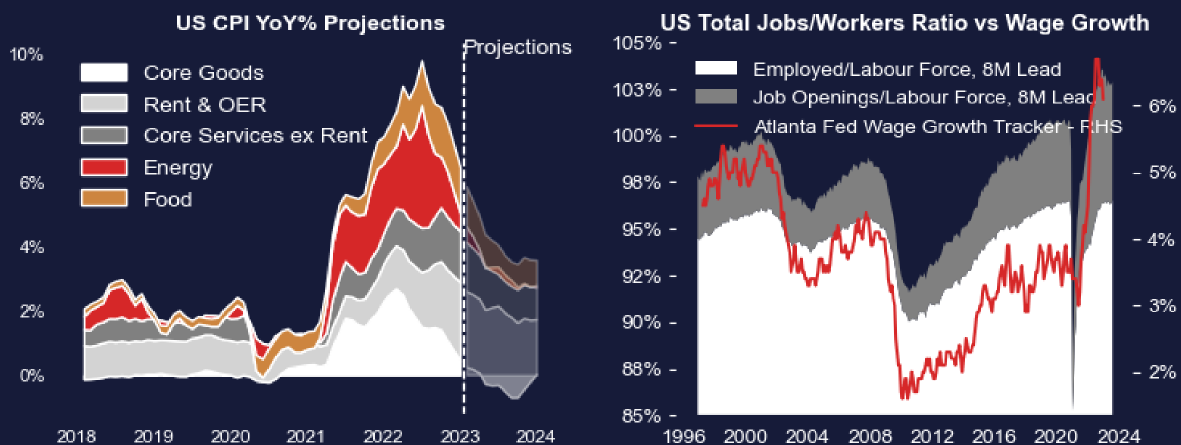
We estimate US and Eurozone inflation to moderate from last year's highs but remain above central bank targets by the end of 2023. In our base case, we see US headline inflation at 3.6% and core inflation at 3.5% by December 2023. This is above consensus market expectations of 2.5-3%, and in line with Fed forecasts of 3.5%.

Rent and other core services inflation are likely to remain sticky, given a still tight labour market and a slow transmission channel from lower house prices to rents. It is well understood that the core goods disinflation will be a significant but one-off relief as supply chains normalise from pandemic-related disruptions. As a result, policymakers are likely to focus primarily on core services inflation, which can be directly influenced by tighter financial conditions, a weaker labour market and lower wages. The key to understanding where inflation will stabilise, as well as the Fed's response is, therefore, the labour market.

Despite some signs of slowing wage growth, US labour demand in terms of total available jobs (employed + job openings) still significantly outstrips labour supply, i.e. the total labour force. Part of the rebalancing is likely to happen with declines in unfilled job openings, with companies trimming their staffing needs as the economy slows. But we think labour supply will remain scarce and that the participation rate will likely stay low. Recent Fed research shows the shortfall in the labour force is largely explained by a surge in retirements since the start of the pandemic, across the older age cohorts. It's hard to imagine many retirees, now in their 60s, easily coming back to work a few years later. This means any rebalancing in labour markets is going to be gradual, and so will the slowdown in wage growth.

Eurozone inflation will start slowing six months later than the US peak, given the later peak in natural gas prices vs oil prices. At the same time, China's reopening is likely to lift demand in Europe, keeping pressure on the ECB.

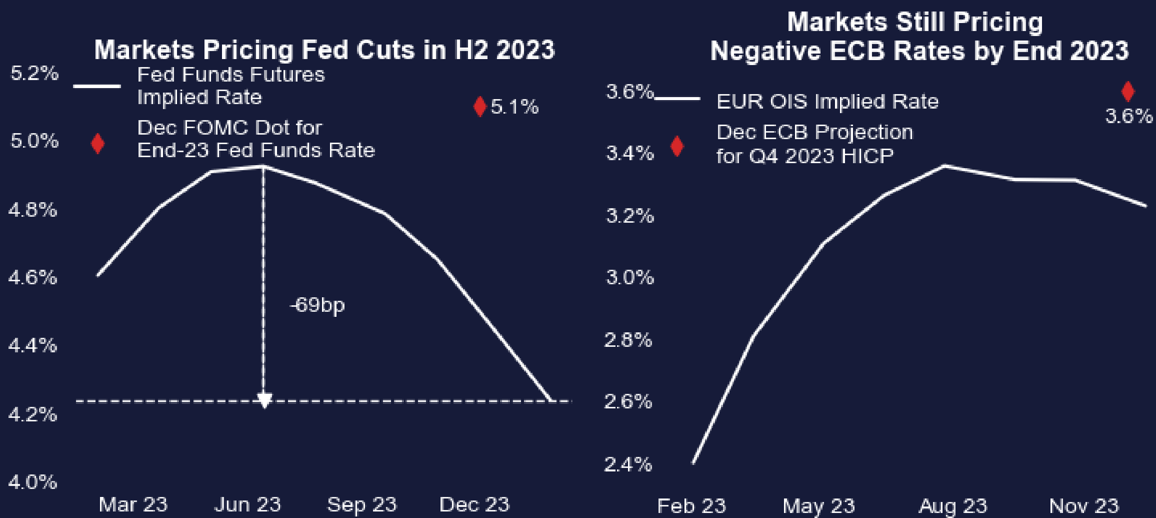
The risk of entrenched inflation is highest in the UK, which faces a combination of an energy crisis, like in the Eurozone, and an overheated labour market, like in the US. Broadening price pressures are eating into real wages and fuelling a cost-of-living crisis, which carries social costs – there has been a visible rise in strikes over the past six months. That said, the BoE remains behind the curve, putting the UK at a real risk of continued currency depreciation and a wage-price spiral.



Source: FRED, Bloomberg, Bureau of Labor Statistics, Atlanta Fed

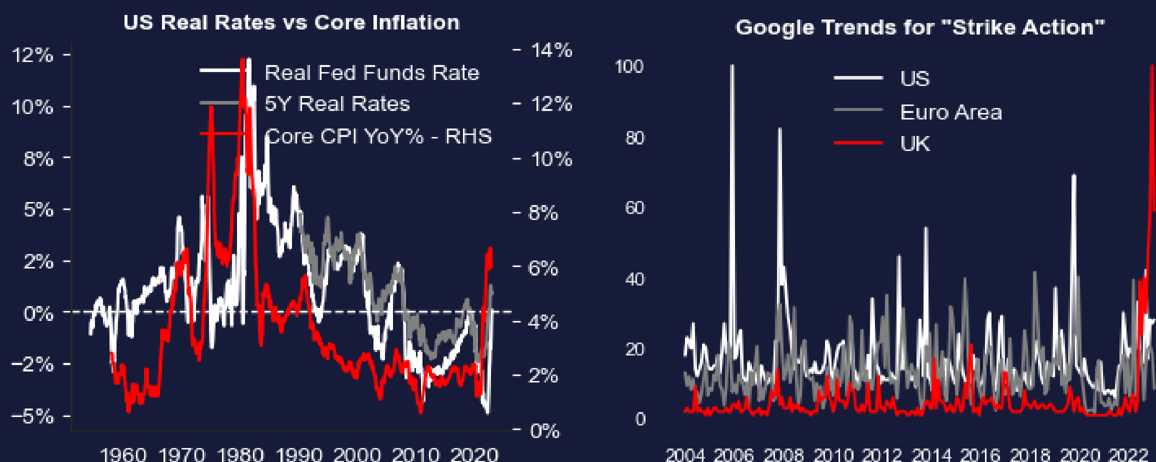
Central banks will not cut rates this year

Markets are pricing Fed rate cuts to start around mid-2023, betting on an imminent economic recession to force a sharp policy turn. Historically, a risk of substantial damage to the economy or to the financial system has pushed the Fed to cut rates. This time round, however, we see neither of the two on the horizon. Labour markets remain strong, despite the decline in house prices and activity. Consumer savings rates have fallen, but their stock of savings remains above pre-pandemic levels. Some financial bubbles, like crypto, have deflated - but so far without systemic spillovers. Real rates are also just starting to go into positive territory.



Source: Bloomberg, FOMC, ECB

For these reasons, we believe the Fed is unlikely to revert to monetary easing just after reaching peak tightening. Conversely, sticky wage growth/core services inflation might keep the Fed's policy focused on prices. Fed voting members have repeatedly highlighted that they want to avoid the mistake of the 70s: a decade of rate hiking/cutting cycles, which only made inflation more entrenched and ultimately led to the Fed raising rates to 20% to bring inflation under control.



Source: FRED, Bloomberg, Google Trends. *Real Fed Funds Rate calculated as Fed Funds Rate – Michigan 1Y Median Inflation Expectations. 5Y Real Rates calculated as 5Y UST Yield – Michigan 5Y Median Inflation Expectations. Google Trends for Euro Area calculated as an average of Germany, France, Italy and Spain.

No Fed cuts in 2023 and a hawkish ECB and BoJ are the big risk to markets

There's lower inflation and lower recession risk. But central banks are still in the fight. And as Raghuram Rajan recently argued, it won't be easy for them to restore credibility.

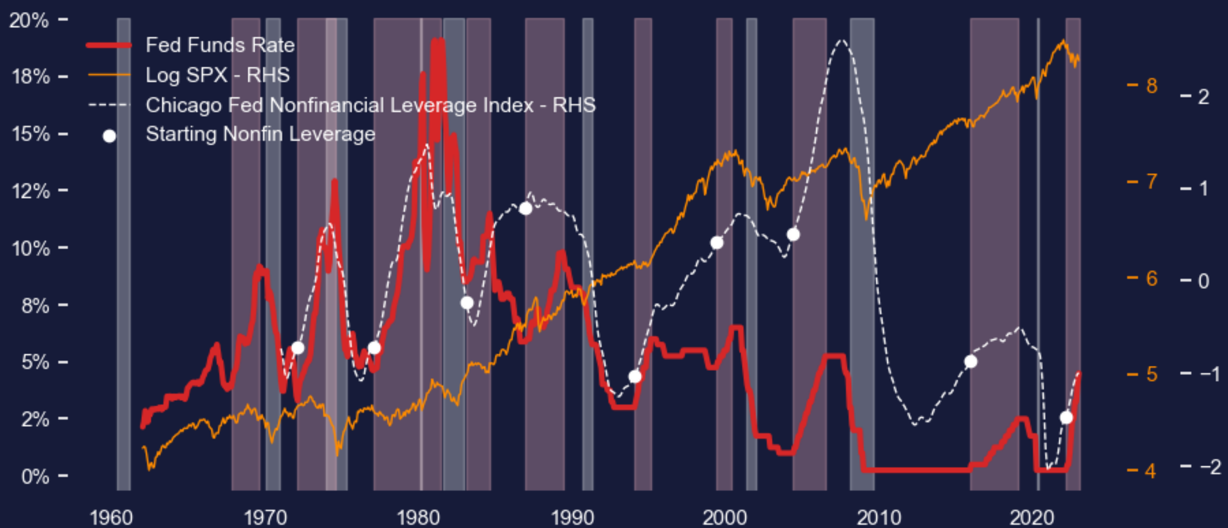
The risk to markets, in our view, is that the Fed might stick to its hawkish stance for most of 2023 to get its inflation job done. While most tightening in financial conditions has already taken place in 2022, markets might be unprepared for a prolonged period of high rates, let alone a resumption of hikes, which would be a tail scenario.

Similarly, we think markets' pricing of the ECB's policy trajectory this year is too dovish. At the December meeting, ECB staff projected headline and core HICP to average 6.3% and 4.2% in 2023, with headline HICP remaining high at 3.6% in Q4. That means markets are pricing real rates to stay negative throughout 2023. This is clearly not in line with the ECB's intention to keep interest rates at "sufficiently restrictive levels" to return inflation to target. In addition to higher rates, the ECB is also withdrawing liquidity through the end of its TLTRO operations, as well as with quantitative tightening, set to start in March.

Finally, the BoJ is likely to come under more pressure to exit its yield curve control strategy.

Continued central bank hawkishness means more stress for risk assets. In our analysis of past hiking cycles since the 1960s, we found that the most significant determinants of subsequent risk asset performance are the speed of hikes and non-financial leverage at the start of the hiking cycle, which far outweigh the importance of duration of hikes and terminal rates.

While this time round the hiking cycle started with relatively low non-financial leverage across corporates and consumers, the historically fast pace of hikes calls for caution.



Source: FRED, Bloomberg, Chicago Fed

ANDROMEDA
Capital Management

China's re-opening rebound and its long-term deleveraging challenges

We think China is likely to see a strong cyclical rebound in 2023, thanks to supportive policies combined with base effects. The Chinese economy was held back in 2022 by its rigid zero-Covid policy in the face of the omicron variant. The government took a u-turn at the start of December with a more abrupt than expected exit, which led to an explosion of infections across the country and a further decline in economic activity. Nevertheless, we think growth will recover more meaningfully this year after the initial disruptions. The central government also promised to prioritise growth in 2023, including measures to support property demand.

Analysing the dynamics underneath the CCP's u-turn is highly speculative. The 20th Party Congress in October confirmed the further consolidation of power by President Xi. It marked a departure from the collective leadership model and consensus-based decision-making approach which underpinned China's rapid growth over the past decades, since Deng Xiaoping's economic reform.

Without checks and balances, policymaking is likely to fall into errors. The recent tensions across China suggest discontent has already risen across the country, and perhaps even across the CCP's ranks. It is possible that President Xi's Beijing pro-government faction might have come under increasing pressure from Shanghai's pro-business faction. Whether Xi's grip on power will remain as solid as before, it remains to be seen.

Reopening is likely to boost growth this year - but we remain cautious on China's long-term outlook. An ageing population, rising inequality and over-reliance on the property sector continue to haunt the economy. At the same time, we expect tensions between China and the US to persist, as the two countries face issues concerning trade tariffs, technological primacy, and Taiwan.

Source: Bloomberg, NBS

Conclusions: populism and inflation are here to stay

Hope clouds observation.

- Frank Herbert

If you are hoping for a return to a goldilocks, low-inflation, low-rate world, then today's markets provide a comfortable lull. But if you are scratching your head, then it's time to re-think your capital allocation. The political and geopolitical shifts happening today are structural, not transitory.

Geopolitical schisms, high commodity prices and persistent inflation go hand-in-hand. True, the supply chain disruptions that came with the pandemic are normalising, and so is goods inflation. But demand remains strong, on combined consumer and government spending. And further ahead, political preferences give the government's *visible hand* a stronger weight over markets' invisible hand. This means either state capitalism, or populism. State capitalism comes with higher taxes, more redistribution and more regulation. Populism is pro-people, pro-spending and anti-capital.

For asset allocators who have enjoyed decades of good returns on equities and government debt, this shift calls for a re-think of investment portfolios. Government debt is likely to give little upside above inflation over the coming decades. Central banks are fighting for their credibility, but not all will be able to keep real rates up for a very long time. At the same time, developed countries continue to spend. Who benefits? Corporates and banks, especially in strategic sectors, helped by subsidies and bailouts. A de-globalised world also means a race to secure strategic resources and onshore production.

Today, credit offers unusually high upside, with selective protection from public balance sheets. We see substantial upside in Eurozone credit, and significant opportunities for alpha across vulnerable cyclical sectors in the US and UK.

Alberto Gallo	Aditya Aney	Tao Pan
Chief Investment Officer	Portfolio Manager	Head of Research

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@andromedacm.com or visit www.andromedainvestors.com

ANDROMEDA
Capital Management

Bibliography

Central banks can’t win when it comes to credibility on inflation, R. Rajan, Financial Times, 2023

Lessons from the Past: Can the 1970s Help Inform the Future Path of Monetary Policy?, F. Mandelman & B. Meyer, 2022

Millennials are shattering the oldest rule in politics, Financial Times, December 30, 2022

National Policies to Shield Consumers from Rising Energy Prices, Bruegel, 2022

On Taming Inflation, C. Evans, 2022

“The Great Retirement Boom”: The Pandemic-Era Surge in Retirements and Implications for Future Labor Force Participation, J. Montes, C. Smith & J. Dajon, 2022

Stagnation Nation: Navigating a Route to a Fairer and More Prosperous Britain, Resolution Foundation, 2022

ANDROMEDA
Capital Management

Disclosure

This publication expresses the views of the author as of the date indicated and such views are subject to change without notice. Andromeda Capital Management LLP ("ACM") has no duty or obligation to update the information contained herein.

This publication is being made available for professional investors only and for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources.

ACM believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.

This memorandum, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of ACM.