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**Capital Management**

# The Silver Bullet | Stuck in the Middle With You

*You can't always get what you want*
*But if you try sometimes, well, you just might find*
*You get what you need*

- Mick Jagger & Keith Richards, 1969

## Price Stability against Financial Stability

Central bankers are stuck. After over a decade of free money, monetary policy has come to a breaking point. Policymakers will soon have to choose between price stability and financial stability.

The role of financial stability in central banking has been underestimated since the Greenspan approach of 'stimulate today, deal with the consequences later'. But a handful of central bankers flagged the risks of inflating bubbles in the name of stimulus. In 2015, ECB member Benoît Cœuré wrote about *rational bubbles*: "In the short-term, it may indeed generate a temporary boost to the economy. [...] But this boost would ultimately be very costly. Not only does it come with welfare-decreasing macroeconomic instability, but it also brings about an arbitrary redistribution of wealth that may, in the worst case, undermine social cohesion and trust that the central bank is acting within its narrow price stability mandate." "The problem [of bank failures] is that the costs do not fall on those who enjoy the benefits.", wrote Mervyn King in 2010.

And yet, the lessons learned during the 2008 crisis seem to have been forgotten. With prolonged Quantitative Easing, *QEinfinity*, monetary policy helped to inflate asset bubbles in and outside the banking system, from crypto to real estate. These bubbles now threaten the normalisation of policy.

Today, the financial system is dealing with the long-term consequences of rational bubbles, including increased wealth inequality and increased social and geopolitical tensions. Central banks claim to have the right tools to both defuse asset bubbles and achieve a soft landing, as ECB President Lagarde argued in her latest speech. But data shows inflation is more persistent than forecasts. The research team at the BIS elaborated a two-regime view of inflation in a recent research note. Once expectations de-anchor, headline inflation becomes a device for price-setting for the majority of goods, regardless of supply chain dynamics. Put differently, central banks have a lot of room to manoeuvre when inflation is low, but once the economy falls into a high inflation regime, it becomes difficult to bring it back to normal.

This means policymakers won't get all they want this time around. On the one hand, tightening too little could leave the economy drifting into a high inflation regime. On the other hand, tightening too much might push the financial system into a credit crunch and economy into a recession. Some central banks are choosing price stability. The ECB is a case in point, having spent years stress-testing banks and defusing the sovereign-bank nexus, which contributed to the 2011-2012 banking crisis. Other central banks won't be able to do the same: with rising government and household debt, the Bank of England continues to keep its bank rate deeply below inflation, which recently climbed back above ten percent. And what will the Fed do? These are our key takeaways.

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Outlook

- Our estimates show inflation is still persistent and likely to stay above target at 3.4% in the US by the end of this year.
- The financial system is in better overall health than in past crises.
- In the US, mid-tier banks are vulnerable because of low margins. We believe policy action will stem fears around First Republic and other weak banks. That said, more consolidation is needed.
- European banks have been stress tested thoroughly for longer. While Credit Suisse was a special case of bad governance, we see fears around other major lenders not justified by fundamentals.
- The recent events around Silicon Valley Bank and Credit Suisse should serve as a warning. Financial markets and investors are still benefiting from ample capital and liquidity, and therefore organising a rescue is economically viable and politically possible.
- That said, financial fragility does not mean that a broad-based shift in policy is imminent. Our models estimate that the current amount of cuts priced by Fed fund futures markets is excessive: unless financial contagion deepens over the coming weeks, we estimate a moderate decline in credit availability, not a sudden stop.
- We do not see Fed cuts ahead over the coming months. Inflation will remain persistent and should be the major concern for central bankers. In the Eurozone and the UK, rising social unrest threatens to create a wage-price spiral. The UK is a case in point, where the Bank of England has been asleep at the wheel, letting inflation run far into double digits.

Market opportunities

- This is a volatile but alpha-rich environment. There will be more rounds of volatility, more indiscriminate sell-offs and more opportunities to pick the right assets.
- Across asset classes, there are wide dislocations in the pricing of tail risks. Equity volatility is still near record-lows and equity valuations near highs. Credit is pricing mid-cycle spreads and elevated volatility. Rates markets are pricing in a large probability of cuts, while rates volatility and skew are at record highs.
- We see the best longs in Europe, where the ECB has been working to strengthen bank balance sheets over the past several years, and where corporates in many sectors benefit from government support.
- The weakest areas in the financial system are outside of banks, in our view. Our best shorts are in emerging markets, US housing and European REITs, and across business models and capital structures which rely on high leverage and low-cost funding.

Over the past few months, we adopted a cautious stance in credit and flagged that persistent inflation and higher-for-longer rates had to eventually spill over into wider spreads.

This turning point in the credit cycle is happening now.

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## The Credit Cycle Is Turning

*You used to be so amused*
*At Napoleon in rags and the language that he used*
*Go to him now, he calls ya, ya can't refuse*
*When ya ain't got nothin', you got nothin' to lose*

- Bob Dylan, 1965

The rapid increase in rates has taken its first casualties: the recent wind-down of Silicon Valley Bank and acquisition of Credit Suisse have led to a sell-off in risk assets.

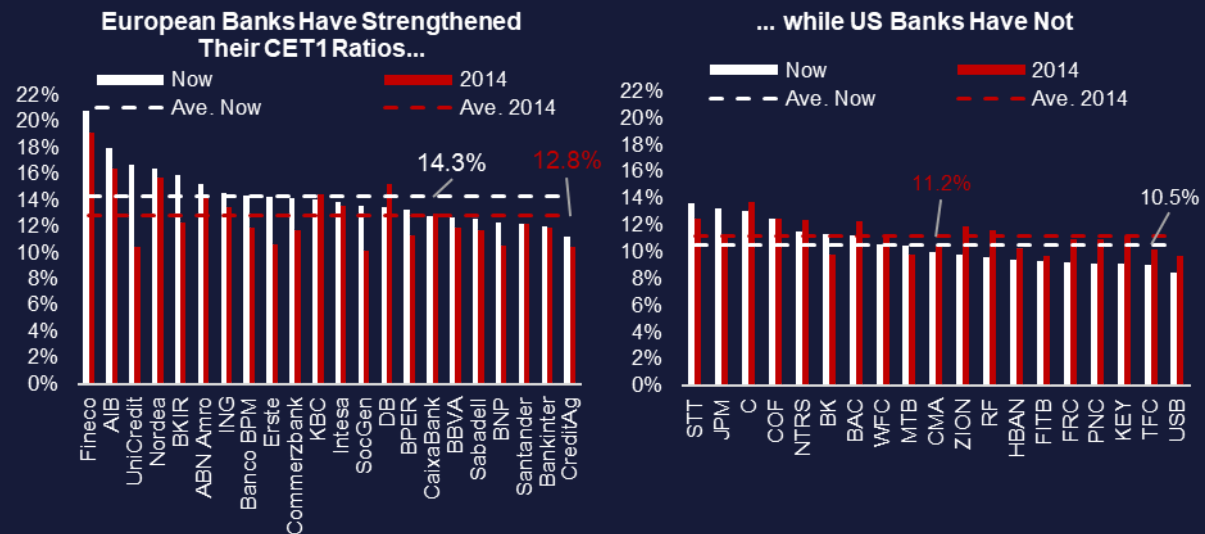
We previously warned that aggressive central bank tightening would expose fragilities in financial markets, leading to higher credit spreads. Financial conditions and bank lending standards have already tightened significantly over the past year and will likely tighten further following the latest bank failures. In response to recent market volatility, ECB President Lagarde said “there is no trade-off between price stability and financial stability”. This is wishful thinking.

For now, the ECB and the Fed are prioritising price stability. But inflation is likely to remain persistent. From Berlin to Paris to London, social unrest is rising. A generation of millennials, left out by asset-focused policies of the past decade, is now the median voter across western economies, demanding more fiscal stimulus. Geopolitical fractures continue to deepen. This means rates remaining higher for longer, with heightened volatility and more bubbles yet to be burst.

## Buy When Everyone is Fearful

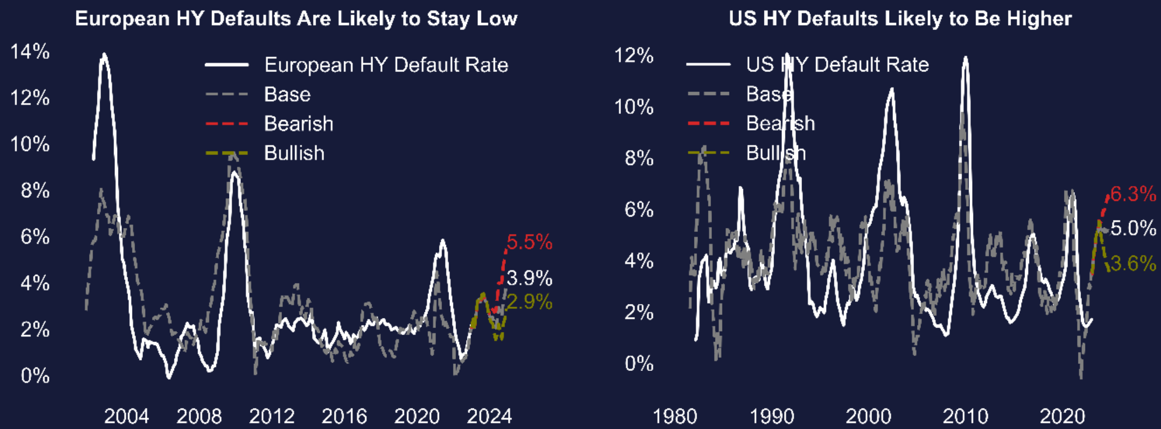
Contrary to most investors and current market pricing, we think Europe is better placed to weather the credit storm than the US.

We expect both European and US default rates to rise, but the tail of high risk credits is weaker in the US, for three reasons: faster Fed rate hikes, more leveraged balance sheets, and weaker banking oversight following the loosening of Dodd-Frank regulation in 2018.



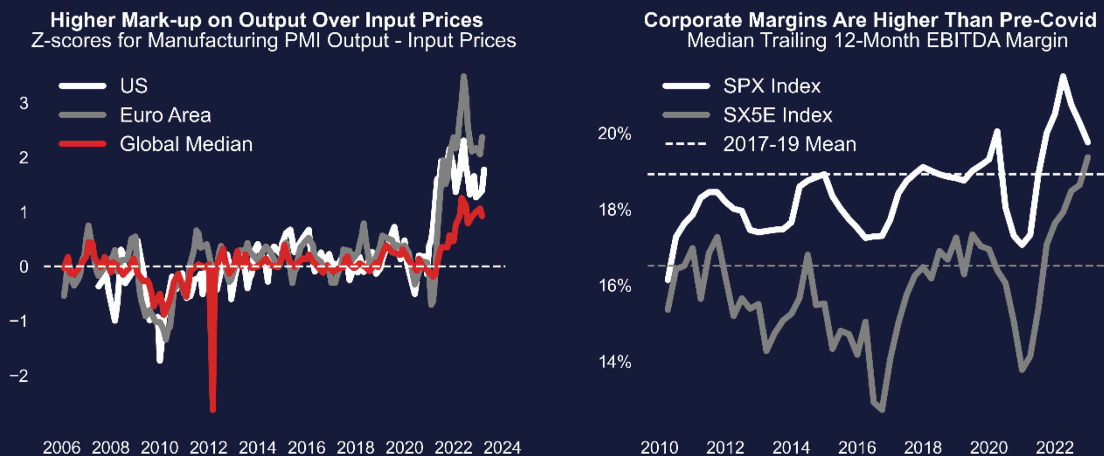

Source: Bloomberg

We see greater resilience in Eurozone credit, as default rates are likely to rise only modestly thanks to still healthy corporate fundamentals and continued state support to strategic sectors. As per the ECB's reported study, one often ignored factor behind the post-Covid runaway inflation is rising margins as companies have been able to raise prices in excess of their rising costs. While such a fast pace of margin expansion will not go on forever, it helps to partially shield corporates from central bank tightening and buys time for them to adjust to a higher interest rate regime. Thanks to this, net leverage has continued to improve for European high yield, returning to pre-pandemic levels of ~4.5x.




Source: S&P, Bloomberg

We therefore find value in pockets of European credit today. These include state-champion corporates and banks as well as counter-cyclical sectors like alarm companies. We also see value in structured credit, especially in the equity tranche which is overpricing default risk, and senior mezzanine tranche which would need 25% default rates before being impaired yet trades wider than most credits.




Source: IIF, Bloomberg

US corporates face higher risks of a credit crunch driven by bank weaknesses. Losses on hold-to-maturity securities and deposit outflows remain concerns for US banks. In addition, US banks are exposed to contagion risks from their commercial real estate (CRE) lending. Out of

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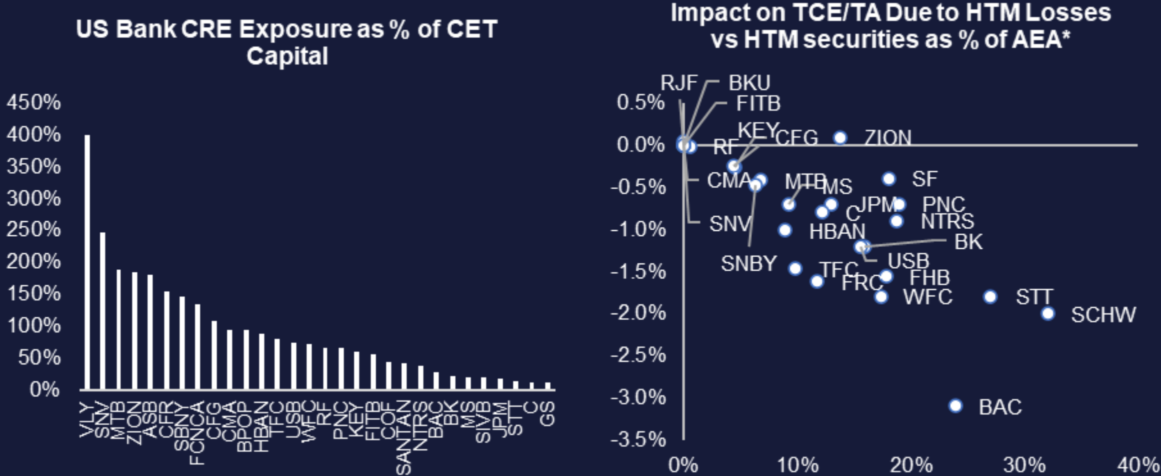
~$4.5tn of outstanding CRE debt, banks account for a 38% share, as estimated by Morgan Stanley research. The risks are particularly acute for regional banks, which are playing an increasingly bigger role in credit intermediation - small banks account for 41% of total loans and 21% of total credit outstanding in the US now vs 31% and 15% a decade ago. Our model estimates that the recent decline in US bank capitalisation is likely to reduce loan growth to low single-digit by year-end from around 10% YoY now. According to GS research the GDP growth drag could be around 0.3-0.5pp. A pullback in bank lending will increase financing difficulties for US firms, leading to higher default rates.




Source: GS Research, JPM Research. CRE Exposure = CRE (exc owner-occupied and multi-family) + Construction, Land Development, and Farm. *TCE: Tangible Common Equity; TA: Tangible Assets; AEA: Average Earning Assets.

## Where are the Next Bubbles? Shorting Zero-Rate Addicted Sectors

As funding becomes more selective, the most vulnerable businesses are those that are overleveraged and have used the leverage to buy overvalued assets. Put simply, businesses that now cannot afford expensive debt and don't have the asset value to pay down their debt.

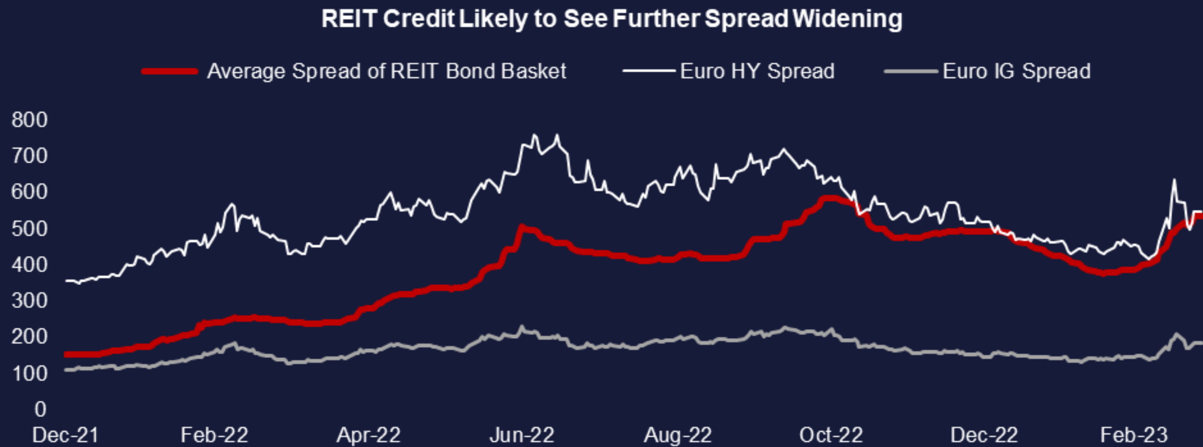
While this definition covers sectors ranging from low-beta utilities/telecoms to high-beta tech/private equity, not all are equally or imminently vulnerable. For instance, telecom companies, especially those in more oligopolistic European markets, have been able to pass on inflation, are strategic and therefore could receive support from governments if needed. Likewise, while private equity is highly levered, the day-of-reckoning may be further in the future, as firms delay restructuring decisions.

The more imminent bubbles are likely to be in those sectors which have a near term maturity wall and have limited or declining support from capital markets and governments.

One clear example is the real estate sector, especially in northern Europe.

In northern Europe, property yields have declined since 2010 and now average around 2-3% for residential and 4-5% for office/retail. REITs and property companies bought these assets and debt funded them at 1-2% yield, making for a profitable arbitrage. With higher for longer rates, this game is now up. In response, companies have begun to cut dividends, hurting equity valuations - but credit spreads are still tight at around 400-500bp. This tightness is partly as valuers have been slow

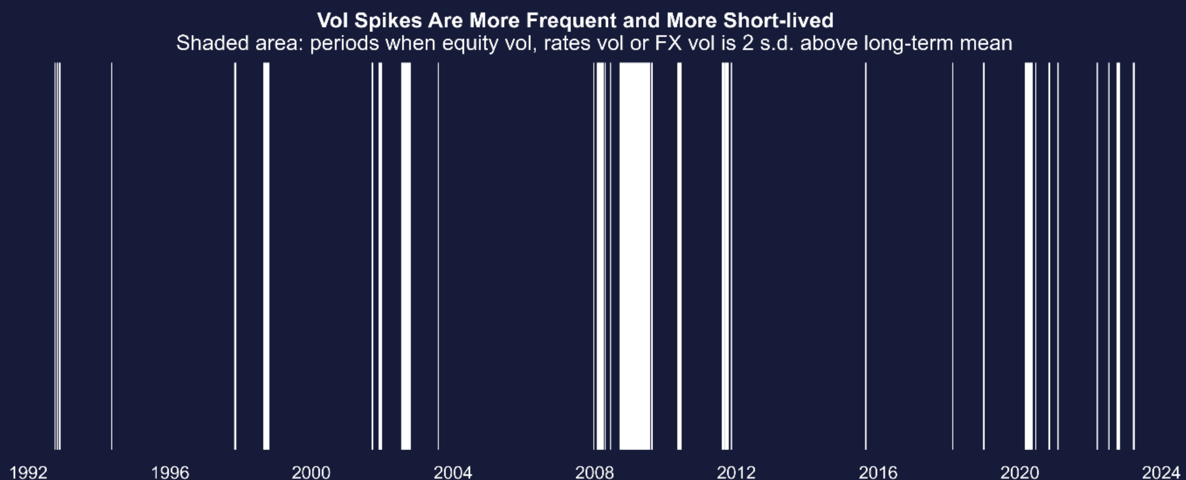
to reflect the higher interest rate environment in property valuations, and as such LTVs have officially remained near 40-55%, which has comforted creditors. However, we think a more realistic revaluation could push LTVs to as high as 70-80% for many issuers, thereby increasing the possibility of restructurings, absent an equity raise. Names we see significant downside risk include Aroundtown, Unibail, Castellum and Balder.




Source: Bloomberg

Another example, albeit less imminently vulnerable than REITs, is Softbank Group.

Softbank Group is unlikely to be a default candidate, but its spread trades too tight to fundamentals. Firstly, the Group's LTV at 20% is likely understated and masks the correlation-risks in the portfolio. Around 80% of the assets are in the technology/e-commerce sectors, whose valuations are negatively correlated to higher interest rates. Also, around 40% of the assets are in the Softbank Vision Funds (SVF), which were marked down by only -5% in 2022 vs -30% for the NASDAQ. Secondly, there have been reports of lax corporate governance standards, also noted by CEO Son. This is further exacerbated by senior leaders leaving within the last two years including the head of the SVF and the COO.




Source: Bloomberg

## Conclusions: Volatility, Liquidity and the Next Crisis

*Clowns to the left of me*
*Jokers to the right*
*Here I am, stuck in the middle with you*

- Stealers Wheel, 1973

Central bankers are stuck between inflation and financial fragility. But while policymakers face a difficult challenge, this environment creates more opportunities for investors than goldilocks weather. How will policymakers navigate this trade-off between price and financial stability? And is a soft landing still possible?

Our macro models estimate the recent distress across mid-tier banks in the US and Credit Suisse in Europe is not enough to push the economy into credit contraction, let alone causing a fully fledged recession. As a result, we are fading recession fears in credit and rates markets.

This balancing act between price and financial stability, however, might eventually become untenable. Persistent inflation might force some central banks into a Trichet-style policy error, while others are likely to let the economy drift too long into a high inflation regime. As that happens, we are likely to see more frequent volatility spikes.

Many capital allocators have stayed cautious into the hiking cycle, putting capital in cash in anticipation of a big risk repricing. With the return of volatility, staying on the side-lines waiting for a 2020-type selloff  is understandable, but might mean missing attractive entry points today.

Our strategy looks to benefit from spikes in volatility and credit dispersion. Our top-down process focuses on identifying vulnerable names with negative catalysts, as well as firms in strategic industries with solid backing. We think it is still too early to call a recession. While we are positioning for potentially larger moves ahead, we believe the current opportunities are already too good to be ignored.

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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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The Silver Bullet | The Anti-Goldilocks Era, July 2022

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