The Silver Bullet | No Free Lunch for the Fed

"We wouldn't just raise rates and try to crash the economy and then clean up afterward."

- J. Powell, November 2022

Immaculate disinflation. To succeed in fighting inflation, at the same time keeping the economy from financial instability: this is the central banker's dream.

This month, the Fed will talk hawkish and act dovish. In a two-step dance with markets, central bankers have been targeting inflation, while at the same time keeping an eye on market volatility.

"There is no trade-off between price and financial stability", said ECB President Lagarde at her press conference in March.

History suggests the opposite. With interest rates climbing, several cracks have opened across the financial system over the past few quarters, including the LDI pension fund crisis in the UK, Silicon Valley Bank and Credit Suisse to name a few. The Fed's reaction will be to pause and wait.

Yet, 500bp of hikes later, the economy and the job market remain solid, and inflation is still sticky and above target.

If hikes aren't working, then what are central bankers *not doing*?

And can the dream of a soft landing without financial instability become a reality, or is it just a policy free ride?

To answer these two questions we need to understand whether inflation will remain sticky. The short answer is yes, inflation will stay above target.

Our models estimate a softening in demand, but not enough to trigger significant job losses this year. We still see US inflation above 3% at year-end. Recent research from the Kansas Fed shows that bank failures have limited impact on lowering inflation. The Silicon Valley Bank and Credit Suisse failures were a bump, not a systemic crisis. In fact, consumer data shows delinquencies on auto loans, credit cards and mortgages have improved over recent months, not deteriorated. And while consumers keep on spending, governments are leaving the taps open too, with the US leading at a projected deficit of 7% of GDP.

Financial conditions remain loose: what central bankers are not doing is *quantitative tightening*, and that's resulting in record-inverted yield curves. For someone trying to tighten liquidity, an inverted yield curve is a self-defeating proposition: quantitative teasing, not tightening.

Today, Microsoft or Apple can borrow below 4% and park their cash in T-Bills at over 5%. The majority of mortgages are set below current rates, according to Goldman Sachs research: wealthy households are still paying 2-4% interest and can invest at higher rates.

Who is bearing the burden of high interest rates? Cash-strapped businesses and consumers borrowing short term. For the top-50% of households and the firms listed in the S&P 500 or rated investment grade, the good times are still rolling. Both credit spreads and equity risk premium are back to the lowest levels of the year. Put simply, heavily inverted yield curves keep long-term capital into risky assets, which defies the marginal impact of higher short-term rates.

A Job Half Done

With higher short-term rates but lower long-term yields, the Fed is doing only half its job.

If central bankers are serious about bringing inflation down back to target, then they need to combine higher rates with balance sheet reduction, or quantitative tightening.

The combined size of developed market central bank balance sheets stands at $31tn. So far, the Fed has stopped full reinvestments of its holdings, reducing the balance sheet by up to $95bn a month. The ECB will increase its balance sheet run-off rate to about €25bn a month from July, and has made it more expensive for banks to borrow through its long term TLTRO funding. But the projected pace of balance sheet reduction is mild, with 2023 running at half the pace than last year.

After a steep series of hikes in 2022, the tightening impulse on financial conditions has faded in 2023. Central bankers are pausing, to assess the health of the financial system in light of the recent crises.

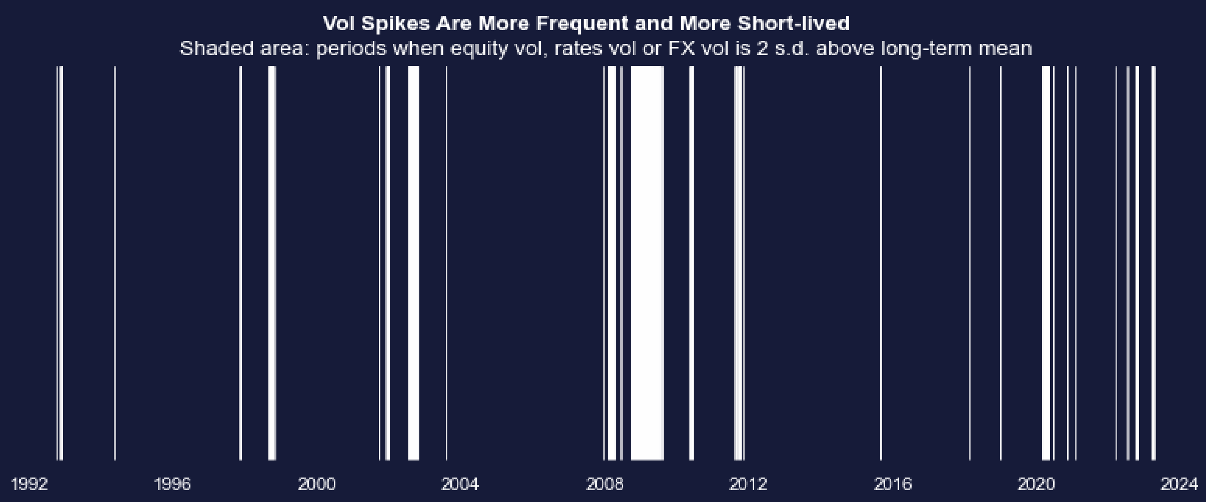
However, over the second half of the year and probably after Jackson Hole, the balance sheet question will come back to haunt central banks.

Reducing balance sheet holdings and yield curve inversion has one side effect that has policy makers quivering: the substitution from risky to risk-free assets, reversing the pro-risk substitution effect induced by a decade of quantitative easing. In its latest Financial Stability Review, the ECB explicitly mentioned an exit from yield curve control from the BoJ as a financial stability risk.

In a speech at the LSE, ECB board member Schnabel said that monetary stability could be achieved without causing financial instability, *"if financial disturbances are caused by market dysfunction and liquidity issues rather than solvency concerns"*. However, after over a decade of ultra loose monetary policy, it is likely that raising yields might reduce valuations and perhaps trigger insolvencies in weak, over-leveraged sectors. Real estate investment trusts across Europe and commercial real estate in the US have already repriced.

So far, this repricing of risky assets is happening in slow motion. But volatility events across financial markets are becoming more frequent, even if still short-lived. Put differently, cracks are opening, but there's still plenty of liquidity on the sidelines.

Eventually, central banks might have to choose between stable prices vs stable markets.



Source: Bloomberg

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No Recession, No Cuts, No Free Lunch

We see growth softening, but no significant job losses and no Fed cuts into year end.

On the one hand, sentiment is softer and some banks are tightening credit conditions as the latest Fed and ECB lending surveys have shown. Jobless claims are rising, but slowly. On the other hand, inflation is still persistent. Despite some recent moderation, our models show that headline inflation will likely stay above 3% in the US by the end of this year, with core inflation likely stickier at around 3.5%.

The Eurozone is a few months behind in the inflation cycle and has just started to see peaking signs in core inflation, while the UK is flirting with a wage-price spiral. Even Japan is seeing accelerating wage growth for the first time in decades, increasing the chance of sustaining at-target inflation.

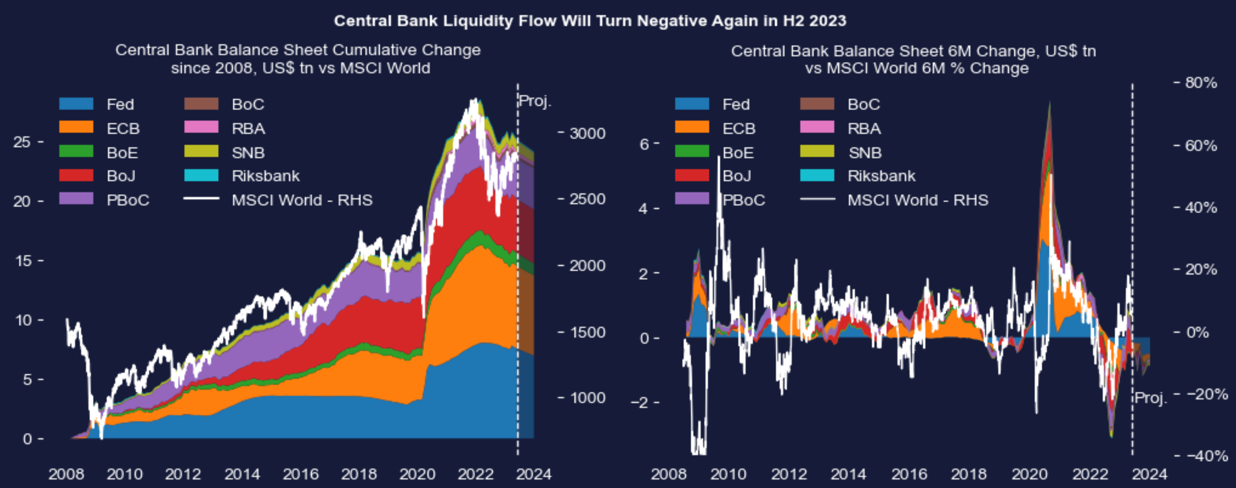
As a result, we do not see Fed cuts over the coming months and think both the Fed and the ECB still have a few more hikes to go.

The Bank of England is at risk of losing credibility: real rates have remained deeply negative, but rising government and household debt are limiting how much it can hike. We believe the central bank will not be able to deliver against market expectations of 100bp of hikes into year-end, nor will it be able to substantially reduce its balance sheet.

The Bank of Japan is likely to adjust and eventually exit its yield curve control strategy, albeit it has signalled that plans to do so are not imminent.

A weakening macro backdrop combined with higher-for-longer rates mean more volatility ahead in the coming months. Liquidity flows are likely to turn from a tailwind into a headwind just as growth softens. Since the UK LDI pension fund crisis last September, central banks have injected around $1tn of liquidity through balance sheet expansion. This flow is likely to fully reverse in the second half of the year.

After over a decade of quantitative easing and loose monetary policy, immaculate disinflation is nothing short of a free lunch for central bankers. The Reserve Bank of Australia and Bank of Canada tried to pause their hiking cycles: it did not work, and both returned with surprise hikes.



Source: Bloomberg, Central Bank Websites

Conclusions: Opportunities in Credit and Europe

One of the oldest lessons in economics is that free lunches don't exist. Financial markets are pricing in a policy free lunch: rates markets are overpricing the probability of cuts, while equities price record-high multiples. We expect higher-for-longer rates to expose fragilities in the financial system and hurt unsustainable capital structures across credit and sovereigns.

It will be a slow rise in defaults, not a wave. We expect high yield default rates to rise up to 3.8% in Europe and 5% in the US, up from 2.8% and 2.5%.

The most vulnerable sectors are the ones which relied upon low rates for a long time and/or holding interest-rate sensitive assets. Non-bank financials including real estate firms, for example, or debt collectors are a case in point. We see more downside across European REITs as well as Intrum, a levered buyer of unsecured credit across Europe.

Emerging markets will bear the brunt of higher-for-longer rates too. Egypt is a case in point: faced with twin deficits, the country has avoided reforms and relied on IMF support and one-off asset sales. This strategy is unsustainable. Another example is Turkey. President Erdogan's victory likely signals another five years of unpredictable policies. Sovereign spreads have tightened on a shift back to orthodoxy, but large imbalances remain: the Turkish central bank just asked local banks to buy the country's dollar bonds to shore up the market before the runoff election.

Where do we find value? *"Long high quality credit"* remains the most popular consensus trade. US investment grade offers little spread and substantial risk, given its large share of triple-B cyclical credits. Eurozone high yield markets instead are still priced for an above-average default rate, while many borrowers benefit from stakeholder or even government support. There is value in European banks, which trade at a large premium following the Credit Suisse fallout, but are enjoying record-high profits. Greece outperformed all Eurozone countries over the past quarters, and we believe that after PM Mitsotakis' confirmation in May's elections, the country is positioned for further upside and for an upgrade to investment grade. Ukraine offers upside, too, as we get closer to US presidential elections which put future support into question.

Our portfolio focusing on value niches, positive convexity and liquid trades is constructed for the upcoming volatility and dispersion.

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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@andromedacm.com or visit www.andromedainvestors.com

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