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The Silver Bullet | Alea Iacta Est

Alea iacta est

- Julius Caesar

Investors entered this year worrying about imminent recession risk and hoping for declining inflation and a pivot from central bankers. The consensus view called for a reversion to the mean – back to a world of stable inflation, stable interest rates and stable profits.

We are no longer in that world. The Rubicon has been crossed. The goldilocks equilibrium of low interest rates, rising asset prices and global trade is breaking before our eyes.

The increase in oil prices, in geopolitical tensions and in interest rates over the past few weeks confirm we are reaching a point of no-return across politics, geopolitics and markets.

First, the geopolitical equilibrium based on American dominance is faltering. A transition to a multi-polar world means continued geopolitical friction and the emergence of regional power brokers, like Turkey, Saudi Arabia, Brazil and Russia. Ultimately, China poses the biggest long-term threat to the United States – but China is no longer alone.

Second, geopolitical tensions go together with domestic political change. Cheap goods imports from emerging economies to developed market consumers were only a band aid against a multi-decade stagnation in real wages. Cheap flat-screen TVs cannot fix a lack of access to education, declining social mobility and rising inequality. Bargaining power has now shifted from employers to workers. The combination of lower demographics, post-pandemic labour supply and migration curbs will likely continue to lead to a global repricing of labour.

Third, fiscal spending remains the most likely government response. Governments in developed economies have been unable to implement long-term action plans to boost productivity and wages, with a few exceptions. Politicians will continue to respond with blunt fiscal expansionary tools, especially in the run up to next year's elections.

These structural changes have made the job of central bankers more difficult. Three quarters into the year, core inflation remains above four percent across most developed economies.

Sticky inflation calls for higher interest rates. Research work from the Bank for International Settlements shows clearly that after a year above target, inflation can become entrenched and self-reinforcing.

Raising interest rates too quickly, however, could unveil economic and financial fragilities accumulated after decades of loose policy. Credit Suisse and Silicon Valley Bank are a case in point. Yet, more fragilities exist across public and private markets. Raising interest rates too slowly, too, could lead to a de-anchoring in long-end yields, exposing regional banks and insurers to further losses on their bond holdings.

In this catch-22 situation, Fed Chair Jerome Powell did something he had never done before: commenting against fiscal policy. It was a mistake, especially given recent volatility in yields. Saying that the US deficit is unsustainable is a sign of Powell's frustration: both the Fed and the ECB have been vocal against sustained spending. They are unlikely to get much concrete action from governments, ahead of elections.

What does this mean for investors?

Central banks have navigated the path between a too hot and a too cold economy relatively gracefully, so far. But the first half of the inflation normalisation journey was the easy part. What lies ahead is a tougher choice between price stability and macro/financial stability.

How far will central banks go in their fight against inflation, and which parts of the financial system are likely to break?

Some central banks will choose to prioritise growth and let inflation run hot, at the cost of losing credibility and/or making inflation more entrenched. Others will stay hawkish for longer, at the cost of hurting the economy. The Bank of England, for example, has already kept policy rates too low for too long. A lack of labour supply combined with energy and goods import dependence in the UK will likely keep inflation above target for several years. The ECB, instead, has taken a persistently hawkish stance, considering periphery spreads are rising and Germany is already on the edge of a technical recession. Eventually, the ECB will have to decide between defending its inflation target and the Euro, vs keeping growth positive and suppressing centrifugal forces in periphery spreads.

In our previous SIlver Bullet | No Free Lunch for the Fed, we argued that a goldilocks soft landing was the equivalent of a policy free lunch: a rare, if not impossible proposition.

Today, the Fed continues to portray a soft landing as a possible scenario, but this is gradually fading from its base case. Following the September Fed press conference, risk assets have been waking up to the reality that higher-for-longer rates are here to stay. Short and long-end yields have broken new highs. The multi-decade bull run in bonds is over, and "the year of the bond" consensus proved wrong. But the ripple effects go well beyond bond markets.

What does the new world look like, and which assets are attractive in this new environment?

There are plenty of risks out there. Many assets and capital structures which have survived a long era of low yields, are still not priced for persistent interest rates. This year's repricing in real estate debt is a case in point. But more repricing is due in private markets too, including private equity and debt.

There are also more opportunities. In the first half of the year, investors flocked to investment grade bonds on the idea that all-in-yields would compensate for most risks – despite low spread levels – and that once inflation would stabilise, a rate cut cycle would come. Our stance on duration, as discussed also in our latest investor webcast, remains more cautious. It is still too early to buy government debt.

Credit, instead, is becoming attractive. Volatility will persist and default rates will rise. Unlike during the buy-the-dip decade, firms without pricing power or with too much leverage will no longer be able to kick the can. But investors will get paid handsomely to pick the right credits.

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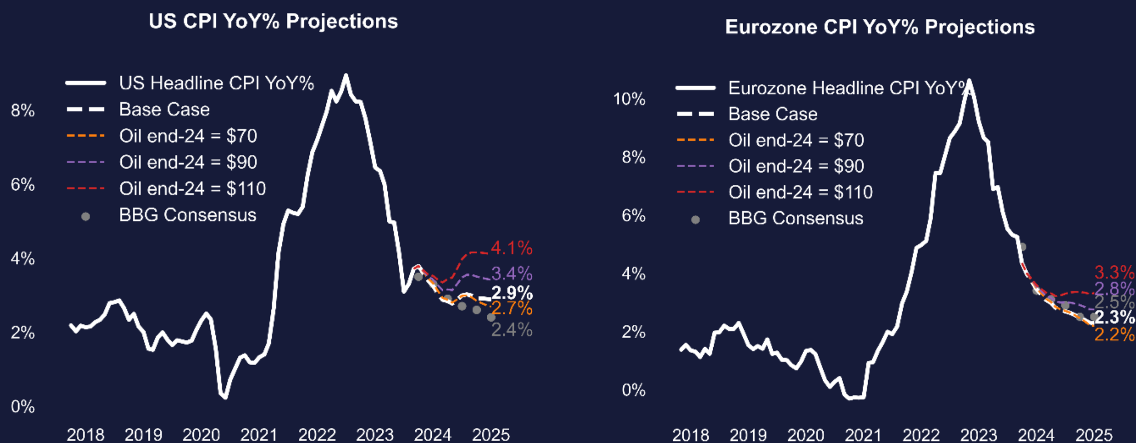
Higher-For-Longer Is Here to Stay

Why haven't rate hikes worked? This has been the biggest puzzle for investors this year.

In our view, the explanation lies in the long-end. Central banks have so far done only half of their job, by focusing on raising short-end base rates, while keeping long-end yields inverted. As we show in our analysis, an inverted yield curve reduces the impact of higher base rates on asset valuations, leading to uneven tightening across income groups. The lower income groups who rely more on short-term credit bear most of the pain from monetary tightening, while high income groups are largely unscathed. As a result, consumer spending remains robust, lending to sticky core inflation. This is one reason why even after the latest moves, long-end yields have more room to rise.

As shown by BIS research, high inflation can become entrenched and self-reinforcing, becoming a coordinating device across economic agents. This feedback loop is likely already under way in the UK, while signs are emerging in other regions too. In our model base case, we expect inflation to continue its gradual decent but remain above central bank targets by the end of 2024 at 2.9% in the US and 2.3% in the Eurozone.

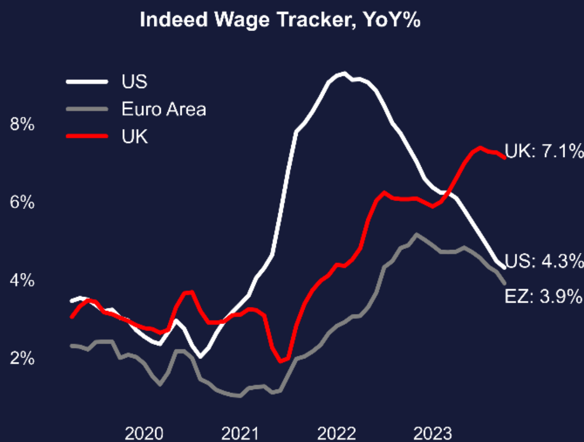
There is upside risk to these projections next year, given uncertainty over commodity prices and fading base effects. To avoid getting entrenched in a high inflation regime, central banks not only need to maintain restrictive base rates, but also need long-end rates to rise and stay high.

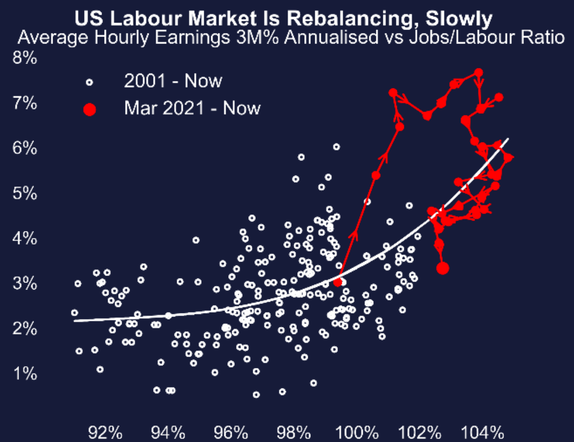


Source: Bloomberg, FRED, Bureau of Labor Statistics, Eurostat, ECB

This means central banks will need to do what they have not done enough of so far: balance sheet reduction. This is particularly true for the Fed, which cut its balance sheet only by -11% from its peak, compared to -20% by the ECB (including TLTRO repayments) and -16% by the BoE. An acceleration in quantitative tightening could drain liquidity from the financial system and add demand headwinds to the treasury market. J.P. Morgan research estimates the ownership of US Treasuries by price-insensitive investors including the Fed, US banks and foreign holders has fallen from almost 75% at the peak to 55% as of Q2 2023. This means demand for treasuries will rely more on marginal buyers like asset managers, levered funds, and pension funds, who are generally more price and flow sensitive.

Despite weaker demand, we are likely to see an increase in treasury supply. The US is currently still running a deficit above 7%, while strong fiscal spending is likely to continue with rising geopolitical tensions and the approach of elections next year. Based on J.P. Morgan estimates, treasury gross duration supply is projected to rise by 30% next year. With an increasingly unfavourable demand-supply mix and uncertainty over inflation, long-end rates will likely face more pressure as investors demand more term premia.





Source: Bloomberg, FRED, Bureau of Labor Statistics, Indeed.com

No US Recession, Moderate Rises in Defaults

Higher-for-longer rates and steeper yield curves will tighten financial conditions, which is desirable in the fight against inflation and will inevitably lead to softer growth. However, we see a low probability of a US recession in the next 12 months (<20%). The labour market remains in solid shape with the total jobs-to-labour gap shrinking slowly, thanks to higher labour force participation rate, increased immigration, and continued normalisation in job openings. Strong employment and healthy balance sheets for most except the lowest income households will continue to support consumption. Fiscal spending will continue to act as a tailwind too.

We also expect the US to continue outperforming other developed economies. The Eurozone faces more challenges given its proximity to geopolitical hotspots, greater reliance on external trade and energy imports, as well as less fiscal space for government spending. As a result, growth could remain low or flat next year. However, we do not expect a sharp rise in unemployment as industrial activity are likely to see a cyclical recovery and private sector leverage is still low.

The UK still faces substantial stagflation risks. Despite some recent encouraging signs of slowing sequential inflation, wage growth remains elevated, increasing the risk of an entrenched wage-inflation feedback loop. There is also no clear supply side solution to the tight labour market given restrictive immigration rules post-Brexit. Moreover, there is limited room for policy manoeuvre as rising government and household debt makes it hard for the BoE to hike further, while market scrutiny over the government's budget discipline rules out substantial fiscal easing. Putting all factors together, the risk is a loss of credibility by the BoE and a de-anchoring of inflation expectations. The ultimate victim here is likely to be the pound.

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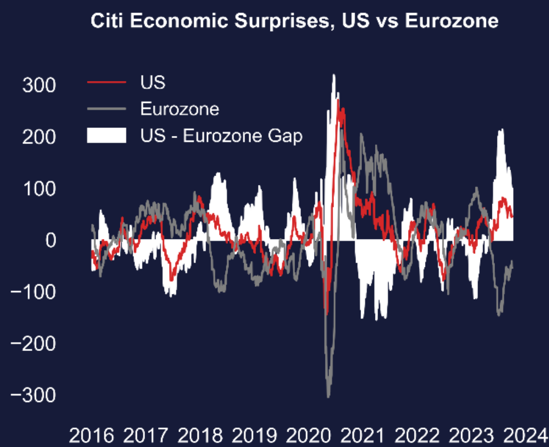
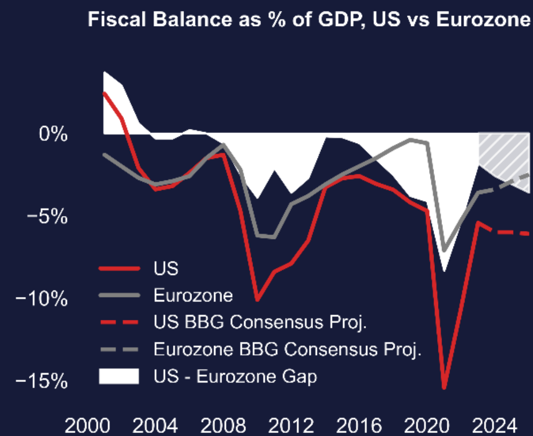
The Bank of Japan is preparing the ground for an eventual exit from its yield curve control (YCC) strategy, which could happen early next year. The end of YCC should pave way for a return to positive rates and normalisation in monetary policy for Japan, after decades of quantitative easing. This change in policy regime will likely remove another anchor to global long-end yields.

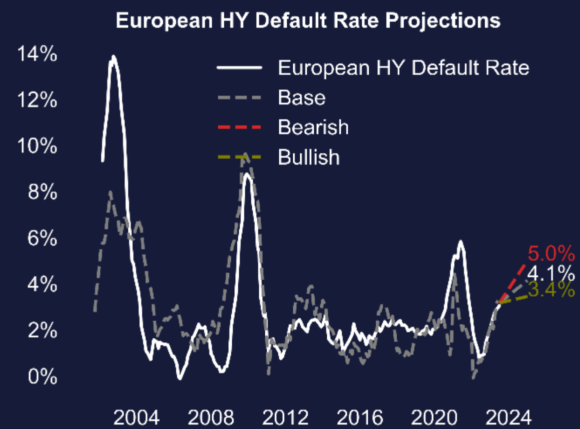
In contrast to other major economies, China is likely to step up policy easing as it battles against a domestic balance sheet recession. However, we expect any further easing to be moderate and targeted, which should stabilise growth in the short-term but will not be enough to kick start a new robust growth cycle. We remain cautious on China's long-term outlook given its property market imbalances, ageing demographics, and increasingly opaque policy-making.

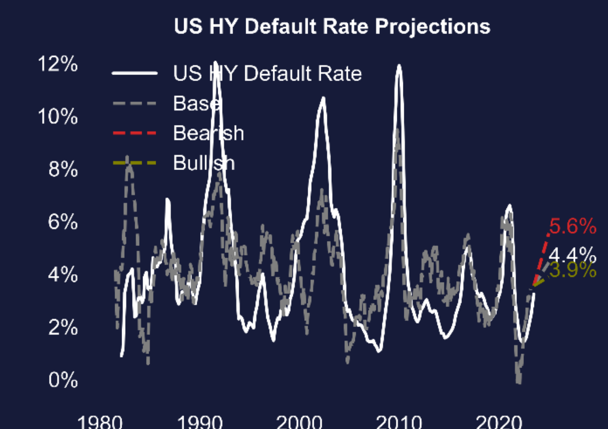




Source: Bloomberg, US Treasury, Eurostat

Against this macro backdrop of higher-for-longer rates and softening growth, we expect high yield default rates to pick up moderately, thanks to still healthy corporate fundamentals and relatively termed-out debt. In our base case, we expect high yield default rates to rise to 4.1% in the Eurozone and 4.4% in the US in 2024 – higher than during quantitative easing, but lower than peaks in previous cycles.





Source: Bloomberg, S&P

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The Good, the Bad and the Ugly

In a world of persistently higher funding costs, we look for firms that are able to maintain margins by passing on costs to consumers, and given their strategic importance, have supportive stakeholders.

These are *the good credits:*

High-coupon bonds in defensive sectors: certain corporates in traditionally 'cyclical' sectors offer value in this environment as they are accustomed to paying high coupons, have de-leveraged their balance sheets, and have management teams with ready plan-Bs if capital markets remain closed. These include gaming, energy, security, and luxury auto makers.

National champion commercial banks: spreads have remained wide since the CS event, amongst select T2 and AT1 bonds in large commercial banks. Greek banks have rallied since the start of the year following PM Mitsotakis' victory and rating upgrade, but still trade cheap relative to European peers.

Junior and Senior Mezzanine high yield tranches: CDS indices can outperform cash bonds in a systemic widening, as they are currently crowded hedging instruments. In addition, the names within the iTraxx Xover and CDX HY indices are larger firms – many of them enjoying implicit or explicit government support. At the same time, mezzanine tranches offer a solid margin of safety against losses: up to 10% for the junior mezzanine and 20% for the senior. Credit losses on a five year horizon exceeded 10% only a few times over the past twenty years.

The bad credits are sectors or firms that can survive higher funding costs through asset sales, but trade too tight relative to their fundamentals.

US BBB/ BBs vulnerable to lower spending among weaker consumers: US IG has been a favorite long amongst managers and is a crowded position according to DTCC data. Amongst BBB/BBs retail, casinos/hotels, autos and auto parts are the tightest sectors against fundamentals.

EM sovereigns: Large EM sovereigns like South Africa and Brazil, trade tight despite weak fundamentals including populist politics, close to 100% debt/GDP and dual fiscal / current account deficits. South African spreads are particularly vulnerable to a widening heading into 2024 spring elections, which may likely see the ANC promote deficit-funded policies.

The *ugly* sectors and single names are those with SPV-like business models that only survive in a low rates environment:

REITS, especially European REITS, have been funding themselves at 2-3% yields and buying assets with portfolio yields under 5%. With rates near 5%, LTVs have risen from 40-50% to 70-90%. These REITS have assets they can sell to reduce debt. However, valuations are likely to be lower and execution slower than estimated given the number of REITS looking to de-lever at the same time.

Debt collectors: Debt collectors, who buy unsecured consumer loans funded through debt, have the double-whammy of lower IRR on their NPLs and higher funding costs on their bonds, which significantly weakens cash flow generation. They are especially exposed to weaker consumers, who were struggling to pay bills even before the current stagflation, and are worse off now.

Conclusions: Credit is Now Attractive

Volatility is change, and the world is changing. A multi-decade bull run in bonds is over. Money is no longer free. Liquidity is no longer flowing to cash-park assets and negative cash-flow firms. Politics, geopolitics and markets have crossed the Rubicon. Central banks and governments are managing this change. There will be more spending, more taxes and eventually more financial repression. Even at higher rates, staying in cash is no longer an option.

This is a tough environment for long-only strategies in most asset classes. Real rates on sovereign debt could still rise further, and higher inflation and taxes are likely to squeeze equity margins.

It is an exciting time for us.

After over a decade of volatility suppression by central banks, the price of fear is going back up. Some parts of the financial system will eventually break. Default rates will rise. But volatility and positive real rates mean investors are paid to deploy capital in good credits, while unsustainable firms with bad governance can no longer kick the can.

Change is scary, but today fear pays a pretty good premium.

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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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