The Silver Bullet | Paradise City

Take me down to the Paradise City
Where the grass is green and the girls are pretty
Take me home, yeah-yeah
- Guns n' Roses

2024 won't be the year central banks win against inflation. That was last year's story. This year will be a test for democracy – and governments will keep over-spending to pass this test. From the developed world to emerging markets, over half of the world's population will head to the polls in the next twelve months. The most important vote is undoubtedly the US presidential elections. With growing political polarisation, what Americans vote for this year will shape the future for the nation and the rest of the world.

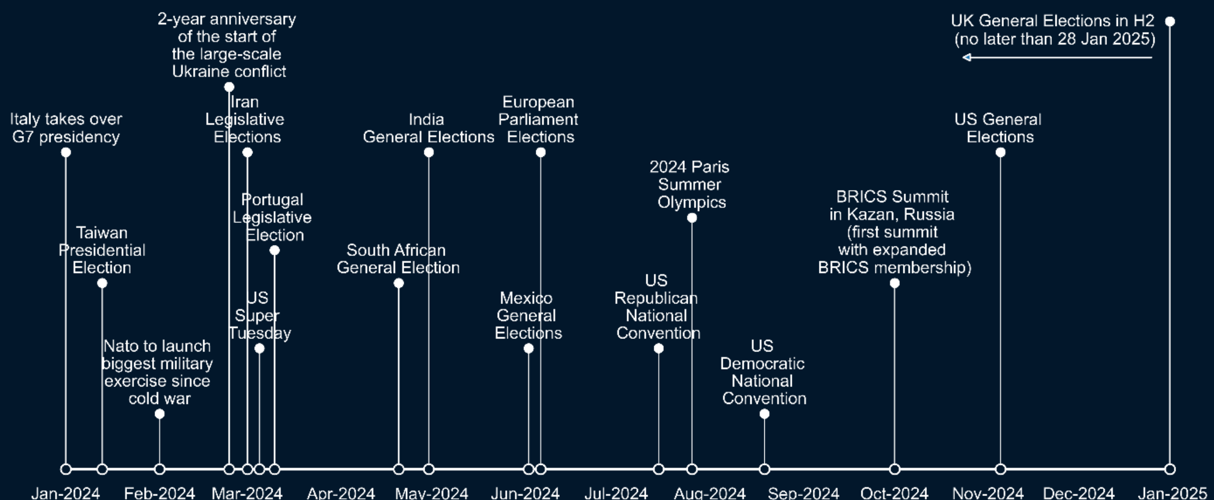
Will the Biden administration become a pause in history's global populist trend? And what are the economic and geopolitical implications of the potential return of Donald Trump?

Trump's strong performance in the early primaries means a repeat of the standoff between him and Biden is likely. While it's still too early to make any call, the race currently appears skewed in Trump's favour, with him leading in five out of seven swing states' polls and Biden's approval ratings near the lows at 38.9%.

Even corporate America is aligning itself with the change in political winds. JP Morgan CEO Jamie Dimon made an unusual endorsement at Davos: *"Take a step back, be honest. Trump was kind of right about Nato, kind of right on immigration. He grew the economy quite well. Tax reform worked. He was right about some of China. He wasn't wrong about some of these critical issues."*

A second Trump administration means more fiscal stimulus, higher tariffs, rising economic fragmentation, and faster de-globalisation.

2024: Year of Key Elections



Looking at the statistics, the Biden administration roughly kept its 2020 electoral promises to boost domestic growth through large spending programmes and to restore the US's leadership in international geopolitics. Yet, despite the improvement in overall growth statistics, President Biden's administration is suffering from record low approval ratings.

Why are voters not liking the current policy mix and its results?

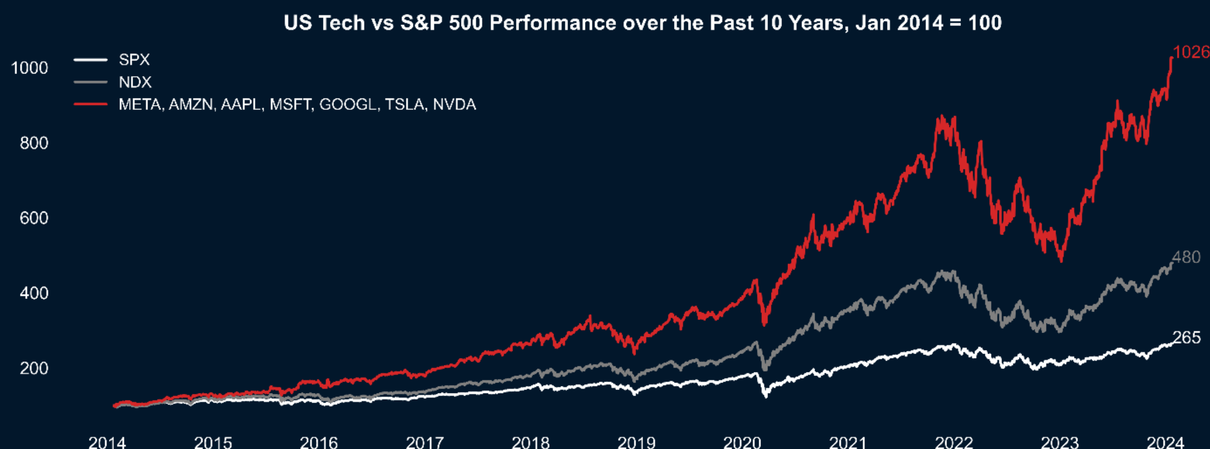
The short answer is – the liberal capitalist system is failing. The post-war policy framework centred around liberal capitalism and multilateralism has worked well for Western governments, supplying their electorates with cheap goods from China and cheap energy from Russia, which kept inflation anchored. This meant central banks could use monetary stimulus freely to boost growth and with relatively limited consequences on inflation.

The key problem with this policy framework, however, is corporate monopolism and social inequality. Years of low interest rates have allowed large firms and wealthy households to term out their debt and stay resilient against rate hikes. High inflation over the past two years has hurt low-income groups. The Fed's response to hike short-end policy rates, while necessary, inadvertently made things worse for small businesses and weaker households, in relative terms. As we show in our analysis, by focusing on short-end rates and with limited quantitative tightening, the Fed has put more pressure on small and lower income borrowers who rely on short-term funding.

This has resulted in an even greater concentration of wealth and a lopsided equity market performance, reflected by the fact that the top seven stocks have outperformed the broad US market by nearly 800% over the past 10 years.

And this is why the average man and woman on the street are still voting for Trump.

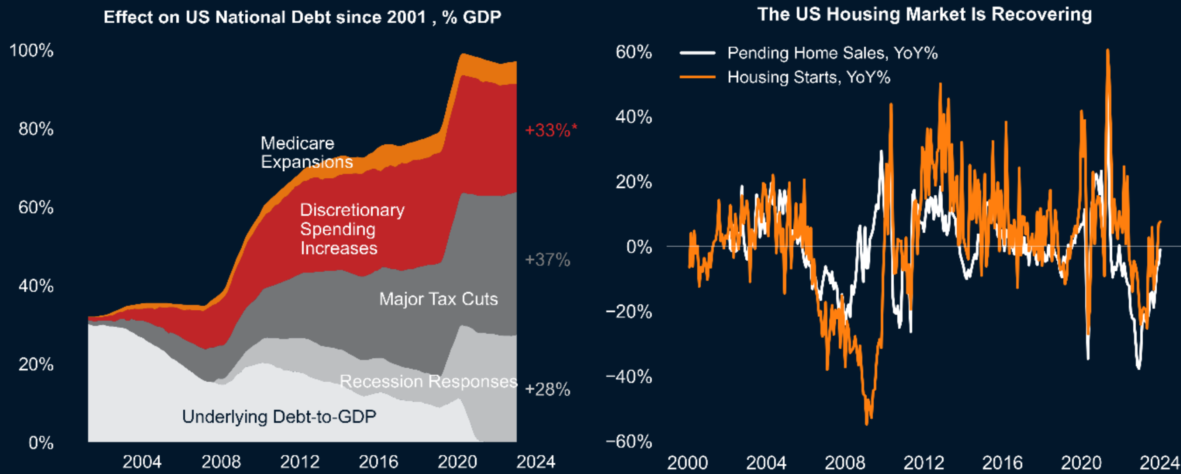
What is the impact of populism? Typically, a populist leader is one who proposes a political or economic dream, polarises the voters' anger on external enemies, and implements unsustainable economic policies to perpetuate that dream – the work of Edwards and Dornbusch on this topic is invaluable. Initially, a populist government generates an economic *boost*, before its fiscal and monetary policies reach any limits and/or other countries react to tariffs and trade policy. The stronger the economic starting point, the longer the honeymoon period lasts.



Source: Bloomberg

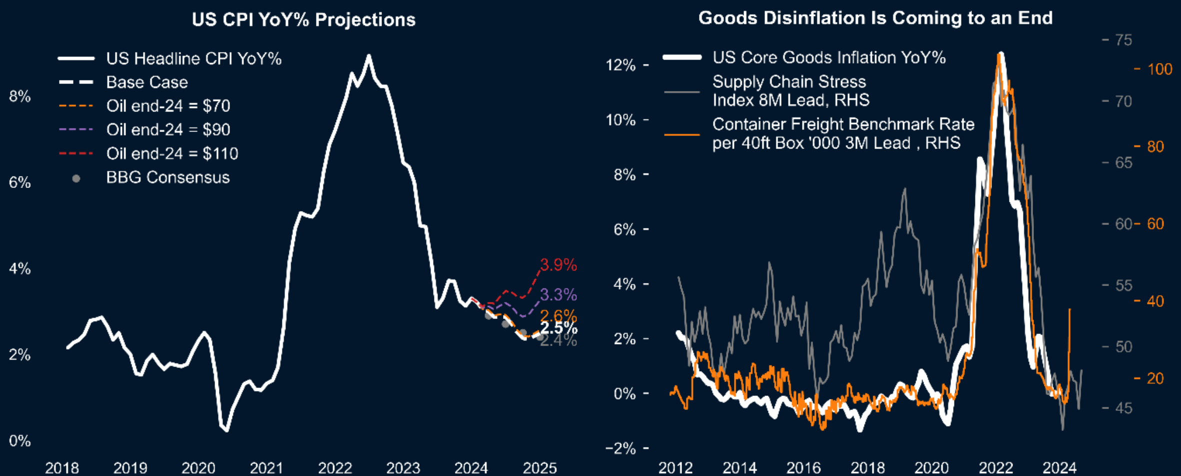
What would be Trump's policy mix in his second administration?

Based on his first term, President Trump's answer will likely be to ride on the populist drift: increase tariffs, build more walls to stop immigrants, cut taxes and turn on the spending tap. Even in the case of a second Biden administration, following a very tight election, fiscal deficits are likely to stay high.



Source: Bloomberg, Congressional Budget Office and Committee for a Responsible Federal Budget. The graph accounts for policy changes enacted since 2001, and not existing built-in changes such as the automatic growth in Social Security and Medicare. *+33% refers to net discretionary spending increases and major Medicare expansions combined.

The result is likely to be inflationary, just at a time when we are seeing some progress on bringing inflation back under control. The current downward trend in inflation means the Fed has a window to cut rates right now – not because they need to, but because they *can*. In other words, the Fed could soon start with 1-2 *insurance cuts* in the second quarter, in order to shield the economy from a slowdown, into elections. At the same time, more stability in yields would also shield the regional finance sector from duration volatility and help boost lending to small businesses. Today, financial markets have already discounted the easing to come, with over 150bp of rate cuts priced in over the next twelve months.



Source: Bloomberg, FRED, Bureau of Labor Statistics, Drewry World Container Index

What if the Fed is just about to cut rates before a Trump win?

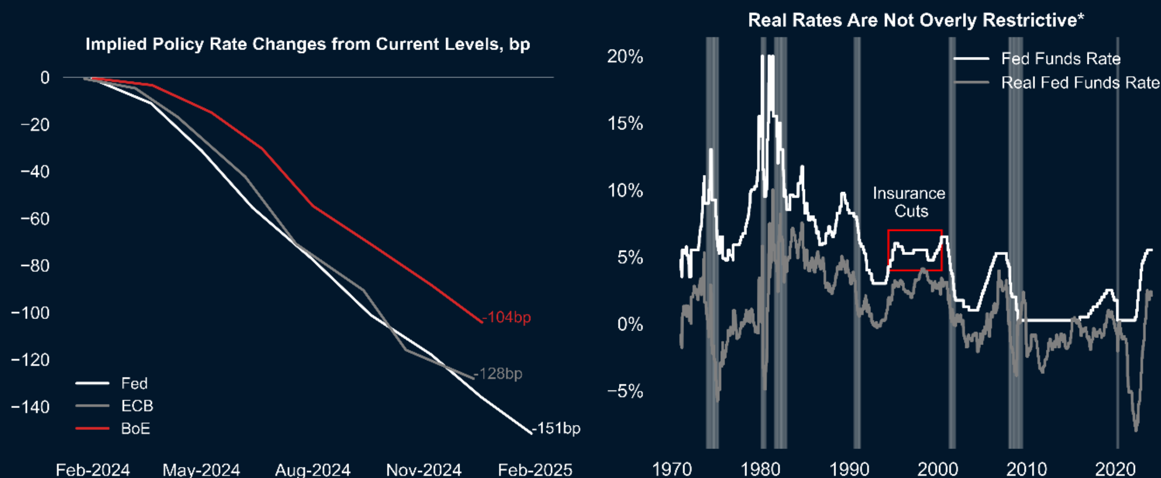
Financial conditions have been easing at the fastest pace in a decade since the Fed's pivot last November. Stocks are making new highs, and credit spreads for investment grade and high yield firms are at multi-decade lows. Financing markets are open. The liquidity in financial markets is spilling over into the real economy: the housing market is recovering, and consumer spending has remained solid.

While inflation continues to moderate, we expect the pace of declines to slow mid-year, with headline and core inflation staying above target into year-end. The risk of a re-acceleration in growth and inflation are currently underestimated by rates markets, which have focused on the scenarios of hard vs soft landing. A *no-landing* scenario will make it harder for the Fed to cut rates further later in the year. A pause of cuts in the second half of the year could pose a surprise to rates and risk markets.

	Projections in Jan 2023 for End-2023			**Projections in Jan 2024 for End-2024**	
	Andromeda	BBG Consensus	Actual	Andromeda	BBG Consensus
US Headline Inflation YoY% at Year-end	3.4%	3.0%	3.4%	2.5%	2.4%
US Core Inflation YoY% at Year-end	3.5%	3.0%	3.9%	2.7%	2.4%

Source: Bloomberg, Bureau of Labor Statistics

In contrast to the US, the Eurozone economy faces more challenges given its higher exposure to geopolitical shocks and China weakness. We see no recession in the Eurozone, and ECB cuts coming mid-year. The ECB is perhaps looking at the rear-view mirror and doing what the Fed should do – holding a restrictive policy stance. However, forward indicators are improving, including the latest bank lending survey. This means we could see a tepid cyclical recovery, helped by continued domestic fiscal stimulus, by the recent China stimulus actions as well as by higher real incomes, but constrained by the ECB's slow policy adjustment.



Source: Bloomberg, FRED. *Shaded Area = Recessions

The Bank of England is stuck in a lose-lose stagflation. Core inflation is still above 5% with wage growth near 7%. However, faltering growth and the general election to be held later this year means the BoE is under pressure to cut rates. Meanwhile, the Conservatives' weak polling suggests the government could prioritise spending for short-term political gains rather than on long-term productivity-enhancing initiatives. The result could be sticky inflation and persistent low growth.

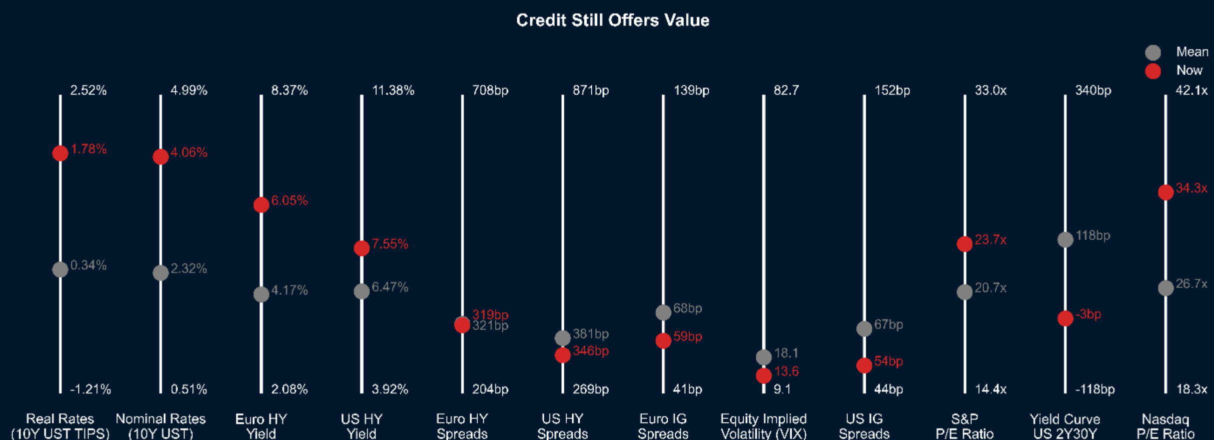
The Bank of Japan signalled an exit from negative rate policy in January, with higher confidence in underlying inflation reaching the price stability target. We think the BoJ has a window of opportunity to start policy normalisation around March/April, in tandem with the Shunto spring wage negotiations. Waiting longer to act might make a move harder, as the effects of import-led inflation fade, and political uncertainty rises with sinking approvals for the current government.

China is slipping further into a balance sheet recession with a prolonged property market downturn and international businesses' ongoing onshoring/reshoring efforts. The government has been under pressure to step up policy stimulus, with reported plans to issue ultra-long special bonds to fund fiscal spending and a 2tn Yuan rescue package to shore up the stock markets. These measures, while helpful in capping near-term downside, do not address the structural issues faced by the Chinese economy. As a result, we remain sceptical over China's long-term growth outlook.

Conclusions: No landing. There's alpha in credit, not duration

Last October, we called to buy credit and flagged the attractive risk premium in Europe particularly, in a context of no recession and stable growth. Today, we see investors and markets have swung from fear to greed, and with central bankers signalling rate cuts, stocks, credit and bonds have become priced for perfection.

Long-end rates will determine what happens to risk assets. So far, central bankers have tightened financial conditions only briefly and for short-term borrowers. A traditional Taylor rule approach does not consider the lengthening of maturities households and institutional investors have achieved thanks to more than a decade of near-zero yields. Raising the short end rate to 5% for a year alone has not affected the marginal funding cost for large firms. As a result, ample liquidity continues to support risk assets. In credit, private debt is looking increasingly frothy as funds compete to lend to firms and to deploy over $500bn in undeployed capital.



Source: Bloomberg. *10-year range; ranked by percentile rank of valuations from low to high.

The combination of rate cuts, together with pre- and post-election fiscal stimulus is likely to generate faster growth and extend the economic cycle further, in our view.

We expect no slowdown and no economic landing. We believe the current narrative discussing soft/hard landing is misguided and corresponds to traditional late-cycle economics. Since the first Trump administration and post-Covid, fiscal policy has become pro-cyclical, and economic cycles over-extended. We expect above-average growth and above-target inflation in the US, and more outperformance between the US vs Europe/Asia.

With volatility and risk premia at record lows, risk assets are vulnerable to both a too-hot as well as a too-cold economy. We believe the risk of a too-hot economy is the one most underestimated by markets today. A disruption in supply chain as well as oil markets, together with fiscal deficits and the potential return of a Trump administration, might eventually derail the current low rates equilibrium. Credit still offers alpha opportunities, but it’s time to focus on alpha and reduce beta. We see the largest consensus longs and the least value in US investment grade credit. CDX IG spreads are trading at 54bp today, just 10bp above their all-time lows, while DTCC data shows an all-time-high long positioning in the index. Non-US assets remain unloved and attractive. We see value in European credit, in energy, industrial and bank debt and in companies with a proven ability to withstand the impact of a higher rate and inflationary environment.

Captain America's been torn apart, now
He's a court jester with a broken heart
He said, "Turn me around and take me back to the start"
I must be losin' my mind, "Are you blind?"
"I've seen it all a million times"

Alberto Gallo
Chief Investment Officer

Aditya Aney
Portfolio Manager

Tao Pan
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@andromedainvestors.com or visit www.andromedainvestors.com

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