ANDROMEDA
CAPITAL MANAGEMENT

The Silver Bullet | Buy the Tails

Keep your eye on one thing and one thing only: how much government is spending, because that's the true tax. There is no such thing as an unbalanced Federal budget: you are paying for it. If you are not paying for it in the form of explicit tax, you're paying for it indirectly in the form of inflation.

- Milton Friedman

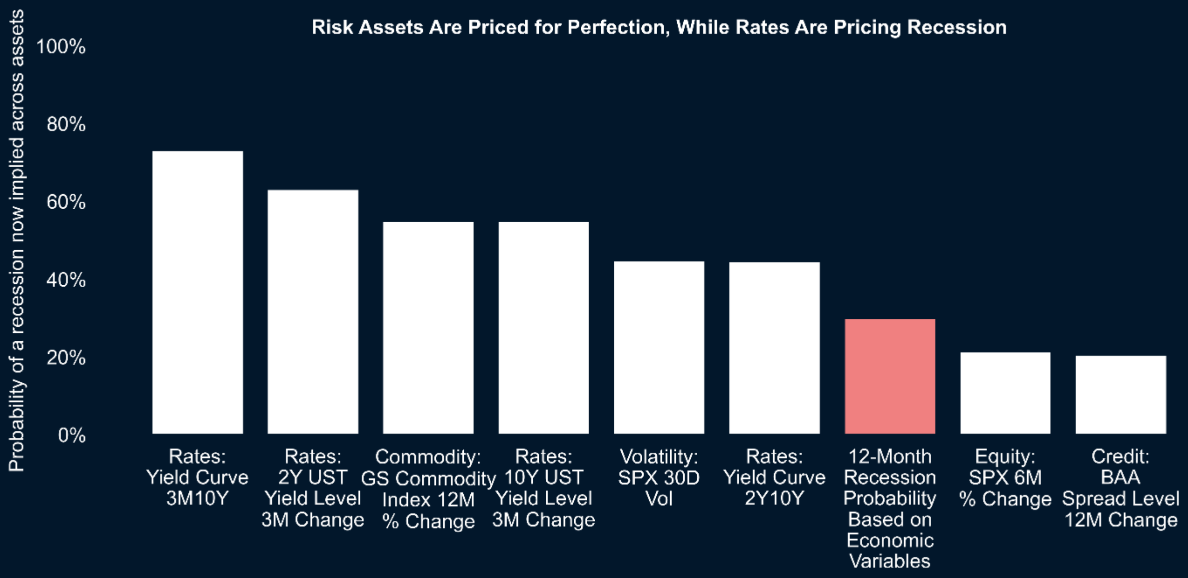
An emergency cut without an emergency. The Fed shifted its reaction function to the extreme dovish side, as it cut in the face of stable jobless claims, and near record market valuations.

Investors cheered the Fed reaction, as valuations increased further. The logical conclusion is: if the Fed cuts 50bps during good times, that means they are ready to support markets during the bad.

Put simply: the goldilocks party is on, and everyone's invited. The problem is, the party's a bit crowded and the music might stop, eventually. A soft landing is the consensus view amongst nearly 80% of investors and is now nearly fully priced into risk assets. What's mispriced are the tails.

Starting from the current situation of a soft landing, with disinflation and resilient growth, the scenarios for the next year can be widely divergent. On the one tail, both Democrats and Republicans have promised to keep spending. A Republican sweep could deliver a rapid fiscal boost to the US economy, boosting inflation together with tariffs on imports. But the Democrats, too, are likely to continue fiscal handouts to the poorest consumers, which have proven to be more inflationary than tax cuts. On the other tail, a divided Congress could fail to deliver enough stimulus to extend the cycle, pushing growth lower and increasing the probability of a recession.

In today's new geopolitical environment, low inflation and solid growth are a fragile equilibrium that will be tested over the coming months. The clock is ticking.

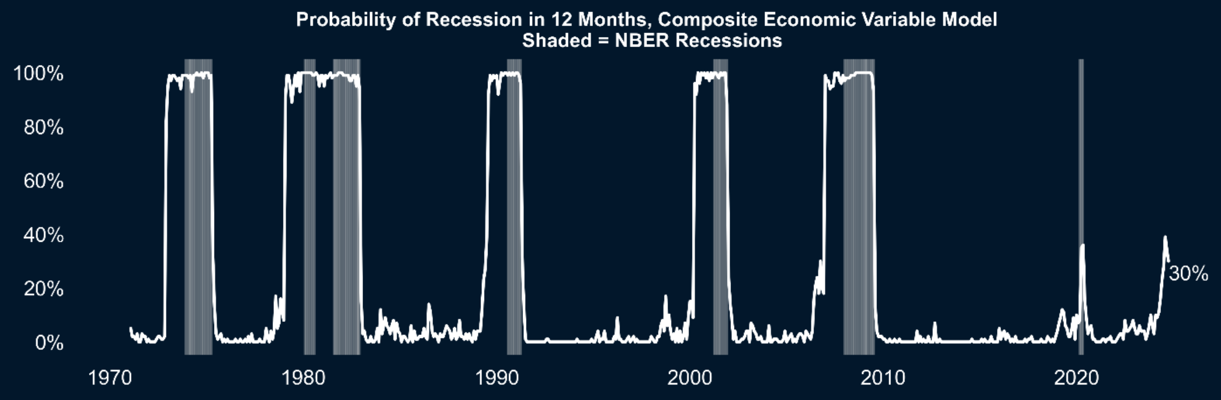


Source: Andromeda Capital Management, FRED, Bloomberg. Data as of 25 September 2024.

1. Are we entering a recession?

The short answer is no. The risk of a recession has risen, but it is still not our base case.

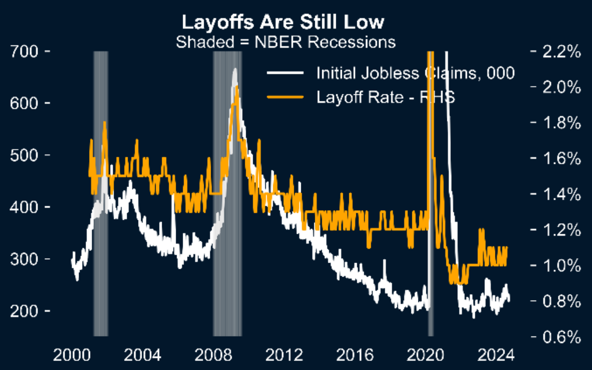
Undoubtedly the US economy is showing more cooling signs, with manufacturing activities shrinking and unemployment rate rising. Our recession model based on a range of economic variables suggests that the probability of a recession in 12 months has increased to around 30%, up from below 20% at the start of the year. However, a probability of 30% is just slightly above the unconditional probability historically and does not decisively point to an imminent recession.

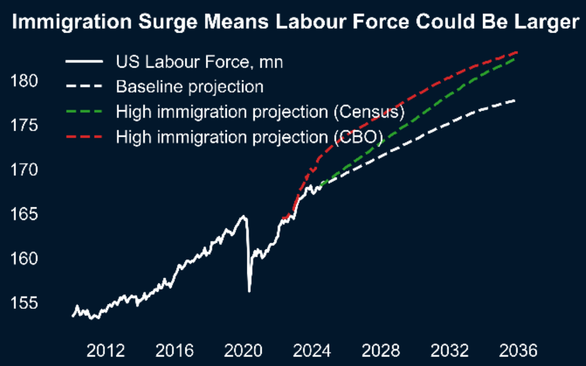


Source: Andromeda Capital Management, FRED, BLS, BEA, Bloomberg. Data as of 25 September 2024.

In our view, the key to understand the risk of a US recession lies in the labour market. Over the past six months, payroll growth has averaged +164k per month, much higher than the +98k monthly average in pre-Covid non-recessionary periods since 2000. Nevertheless, unemployment rate has also been rising, reaching 4.2% in August vs 3.7% at the start of the year.

Why is unemployment rate rising despite strong job growth? A major factor is likely due to the post-Covid immigration surge. According to estimates by the San Francisco Fed, the actual labour force could be growing faster than official data suggested given the immigrant inflows. As a result, the latest short-run breakeven employment growth rate – the pace needed to keep the unemployment rate stable - could have risen to 130-220k per month, compared to past estimates of 70-90k. In other words, the rise in unemployment rate so far was more due to an expanding labour force and more available workers, but less due to firms cutting labour demand and firing workers. In line with this view, the layoff rate and initial jobless claims are still relatively low.

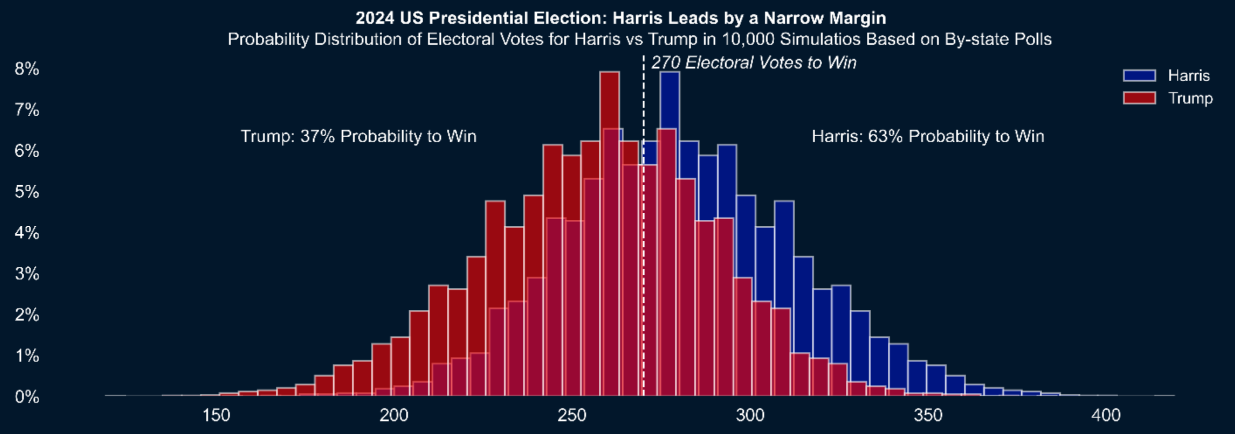




Source: Andromeda Capital Management, FRED, BLS, US Department of Labour, Bloomberg, Petrosky-Nadeau & Steward (2024), Federal Reserve Bank of San Francisco

2. How will economic policy change in the different US election outcomes?

The odds for the US elections have become more even and overall outcomes more uncertain after Vice President Harris entered the race with strong momentum. Latest polls show that she leads former President Trump by around 2.5pt nationally and is ahead in more swing states. Our models based on by-state poll data suggest that Harris enjoys a slight advantage at the moment, with a 63% probability to win over 270 electoral votes and become the next president. However, her leading margins in the key swing states are narrow and have lost some momentum compared to late August. This means the race remains tight and subject to sentiment shifts.



Source: Andromeda Capital Management, FiveThirtyEight, RealClearPolitics. Data as of 25 September 2024.

A Trump presidency is generally believed to mean more fiscal spending. However, a Harris victory also means fiscal expansion – analysis of her economic agenda suggests the spending plans could increase deficits by $1.7tn over a decade, while the proposed corporate tax hikes would only reduce deficits by $1tn over the same period. A tight presidential race could also promote more spending promises, whoever leads. The final policy mix will likely be also dependent on the balance of power in the congress.

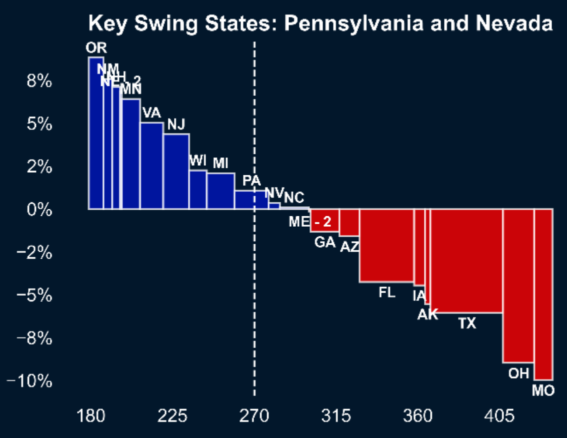
Polls for the House and Senate are indicating very close contests too. Combining all elections, there are four possible outcomes.

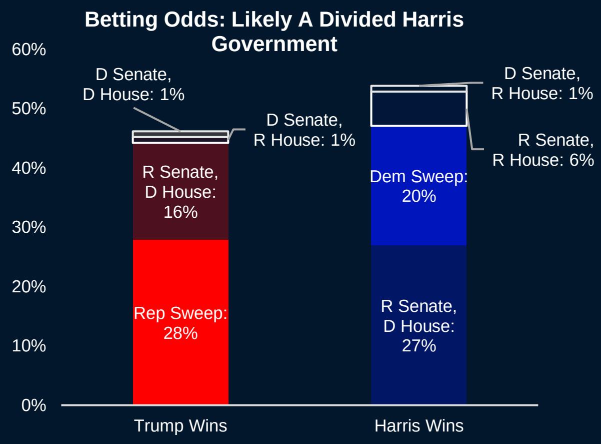
A Republican sweep: Fiscal policy is likely to be expansionary with the 2017 tax cuts likely extended and further corporate tax cuts possible. The impact on deficit could be partially offset by tariff increases. Immigration controls are likely to be tightened. The overall impact is likely to be the most inflationary.

Harris with a divided congress (most likely a Democratic House and a Republican Senate): Fiscal policy is likely to be slightly more restrictive than now, as Harris has proposed to raise corporate tax and called for a 28% capital gains tax rate on people earning over $1mn. However, benefit spending could stay high given her agenda to lower costs for American families.

A Democratic sweep: Benefit spending is likely to rise as per Harris' agenda, which will be partially offset by higher corporate tax rate and higher personal tax for upper income groups. A budget deficit could be more negative compared to a Republican sweep, given no offsets from tariffs.

4. Trump with a divided congress (most likely a Democratic House and a Republican Senate): In this scenario, tariff increases could happen faster and more easily than other fiscal changes such as higher spending or even lower taxes. As a result, the policy mix may be less supportive to growth.





Source: Andromeda Capital Management, FiveThirtyEight, RealClearPolitics, Polymarket. Data as of 25 September 2024.

3. Will the BoJ keep hiking rates, even as the Fed and ECB cut?

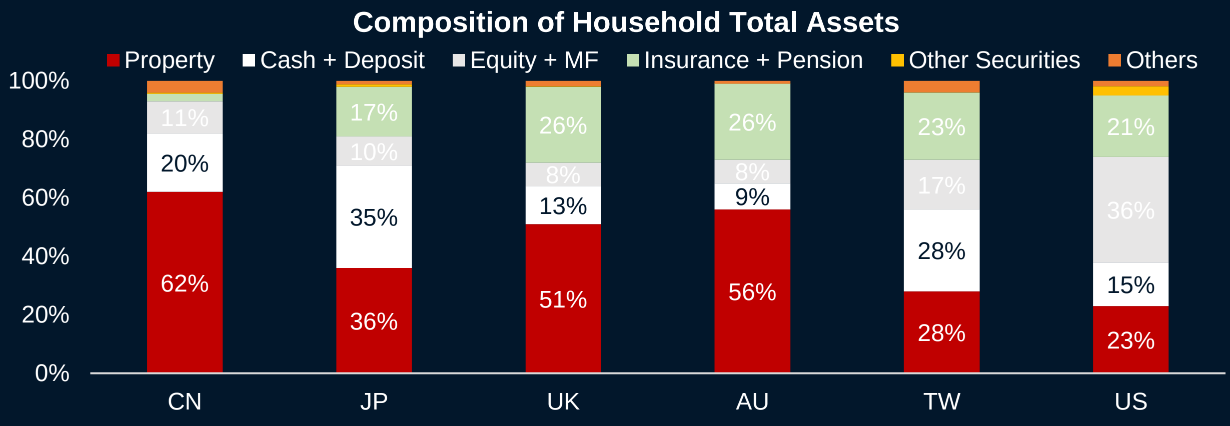
We believe the BoJ will continue to raise rates, even as other major central banks ease. Their primary motivation is to exit from decades of ultra-loose monetary policy and bring inflation sustainably back to target. After years of aggressive QE and negative interest rates, the BoJ sees Japan's economy as having reached a more resilient stage, allowing it to gradually normalise policy without jeopardising economic stability.

While the BoJ's primary goal remains escaping the QE trap and ensuring long-term price stability, there is a secondary consideration gaining importance: countering yen weakness and its effect on inflation. As Japan imports a significant amount of its domestic food and energy consumption, Japan has a relatively high FX depreciation to inflation pass-through rate estimated between 0.2 and 0.3. Consequently, while global inflation has been falling in 2024, Japan's inflation has remained relatively stable around 3%, driven in part by higher import costs, including energy. The BoJ's strategy of raising rates to strengthen the yen comes after previous efforts, such as selling U.S. dollars from foreign exchange reserves, proved less effective. In 2023, the yen faced significant depreciation, prompting the Japanese Ministry of Finance to intervene in the FX market. In October alone, it spent over $65 billion to stabilise the currency, which led to a noticeable reduction in Japan's foreign reserves. In 2024, the Ministry of Finance again spent around $37bn on FX intervention in July alone.

While the BoJ will continue hiking rates, they are likely to be much more cautious in signalling balance sheet tightening. The BoJ's balance sheet is the largest among central banks, making it a greater risk to global asset prices than the BoJ's base rate. As the Fed and ECB have also been very careful in signalling balance sheet reductions, we expect the BoJ to follow a similar approach. As highlighted in the ECB's May 2023 financial stability report and our previous Silver Bullet, the BoJ is the elephant in the central bank room. Significant shifts in its monetary policy have an outsized impact on financial markets and asset prices, including credit spreads, as evidenced by the volatility in August. Given that this volatility was likely greater than the BoJ anticipated, they may adopt a more cautious approach to tightening monetary policy in the future. However, the overall direction of their tightening path is unlikely to change.

4. Will Chinese growth reaccelerate on new stimulus?

China remains in a balance sheet recession, with the economy struggling to recover from years of debt-fuelled growth, especially in the real estate sector. The property market, which has long been a significant driver of household wealth, is now weighing heavily on consumption. Around 60-70% of Chinese household assets are tied up in real estate, and the ongoing slump is causing a "wealth effect" that dampens consumer spending.



Source: Goldman Sachs Research

The government is making efforts to increase this wealth effect and thereby boost growth through consumption, as seen by the measures announced this week: a package including rate cuts, lower mortgages rates for existing homes and even allowing investment managers to borrow funds to buy stocks.

The size of the stimulus is significant, and the largest seen since Covid. However, the impact on consumption is likely to be limited and short lived, as consumer sentiment remains low amid high uncertainty on government policy. More forceful fiscal measures directly targeting at boosting demand are needed for an economy stuck in a balance sheet recession.

Overall, the Chinese governments’ approach to stimulus remains modest and largely monetary in nature, prioritising financial stability over rapid growth and avoiding policies that could increase leverage. Put simply, the government is avoiding a recession with as little debt increase as possible. The government's focus on managing downside risks through controlled stimulus indicates a period of slower, more sustainable growth. We think overall growth will remain subdued, with GDP likely to grow around 5% in 2024, lower than in past recovery cycles. This cautious strategy is likely to maintain economic stability but suggests that China will not be a major driver of global growth in the coming years.

Chinese asset prices are trading at cheap valuations and are a consensus underweight among investors. The recent stimulus could lead to a short-term rally given the extremely low positioning. However, we do not see China risk as a compelling, structural long opportunity.

5. Where is the value in credit?

We are more cautious and selective on credit given how valuations have tightened since the summer. Despite tight valuations, fundamentals are solid and positioning remains underweight risk, especially in Europe. US credit, instead, is a relatively crowded long and offers tighter valuations.

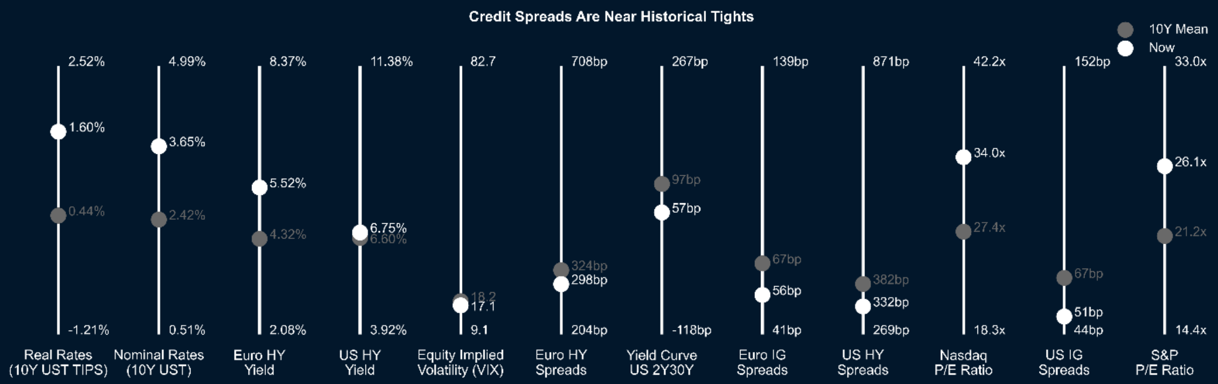
Longs. Structurally, we continue to like good quality assets with stakeholder support and a margin of safety. We see this as 'mezzanine-like' risk, i.e. credits which will be the second or third to fail within their sector in case of a deep downturn, not the first. Put simply, these are companies where there is sufficient support in the equity or debt that ranks junior to our position within the capital structure. We see opportunities in high coupon cyclical sectors like autos (Aston Martin, Adler Pelzer), high-end consumer (International Design Group), energy (EnQuest, Pemex) and banks (AT1 and T2).

Shorts. However, weaker and over-levered credits with aggressive management teams and with no clear plans to improve their balance sheets will continue to trade poorly. This includes credits like Thames Water, which has recently become distressed, and Intrum, where we believe the proposed restructuring doesn't address the capital structure, and represents a 'kick the can' exercise.

Idiosyncratic situations. We continue to like Ukrainian corporate and sovereign credit. Reports concerning Ukraine's allies preparing for a cease-fire is a positive development in our view, while the recent equity investment by Saudi Arabia's sovereign wealth fund (PIF) in MHP is further evidence of the asset quality that some of these companies possess. As we approach winter, the continued and increased support for the energy sector is a very material positive. Within the distressed space, we continue to monitor and trade actively interesting opportunities in credits such as Altice, Atalian (French cleaning company), and Grifols (plasma manufacturer), where we see near-term catalysts.

Convertible convexity. We think convertible bonds in cyclical names with low credit risk are attractive and can provide substantial upside convexity in a right tail scenario of higher growth and inflation, especially in sectors linked to commodities (Glencore, ENI), industrials (Ford) and real estate (Leg Immobilien).

We expect dispersion to rise and alpha opportunities to increase over the coming quarters.



Source: Andromeda Capital Management, Bloomberg. *10-year range. Data as of 25 September 2024.

Conclusions: Buy the Tails of Recession and Reflation

Credit spreads are just a few basis points away from record lows, both in investment grade and high yield markets. What's more, CDX indices in the US show the highest long risk positioning on record, according to DTCC data. The combination of dovish monetary policy, a large buffer of undeployed capital locked in non-mark-to-market funds, and relatively limited corporate issuance - have pushed credit markets to price in a solid growth / low inflation double rainbow scenario.

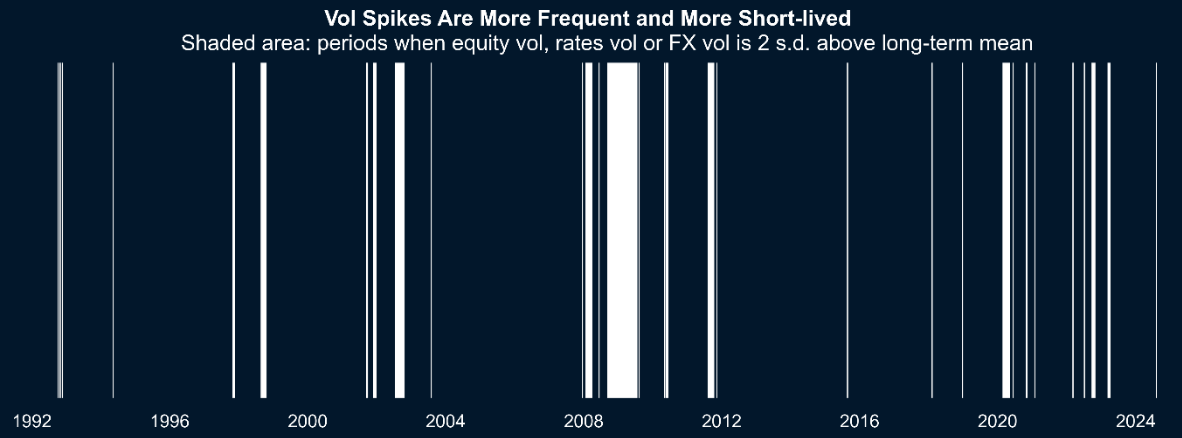
But underneath monetary easing lie broader fragilities in the global economy and its geopolitics. China's policymakers appear unable to revive consumption and growth. Europe's core industrial model is under threat, as highlighted by Mario Draghi's recent report. The US economy is on a more solid footing, but persistent deficits and geopolitical risks threaten the Dollar. Put differently, there's a chance that monetary and fiscal stimulus won't work, and that the economy will head into a downturn: this is the **downside tail** scenario.

What we are seeing, however, is a very sustained policy response. The Fed's 50bp cut is an emergency move without an emergency. China recently announced more monetary stimulus, which includes credit guarantees on real estate losses, and is ready to deploy more fiscal measures.

In a context of high geopolitical tensions as well as persistent social inequality and unrest, Western and Eastern governments will have no choice but to keep spending. They might end up over-stimulating the economy in the process. This is the **upside tail** scenario: a reacceleration of growth and inflation on a combination of fiscal and monetary stimulus.

This year, credit markets witnessed rising dispersion and some volatility with French elections in the summer and a growth scare in the US. We believe there is more to come. Today, hedging the tail of a downturn is very inexpensive in credit markets, especially around the edge of investment grade and high yield credits. Conversely, over-stimulation by central banks and governments could turn re-ignite growth and inflation, pushing rates wider and reducing the chances for weak credits to kick the can further. This upside tail scenario is extremely underpriced today.

Meanwhile, we continue to be trade selective situations with idiosyncratic upside. We own downside tail risk through tight credit shorts and upside tail through optionality in convertibles and high upside credit. Buy the tails.



Source: Andromeda Capital Management, Bloomberg

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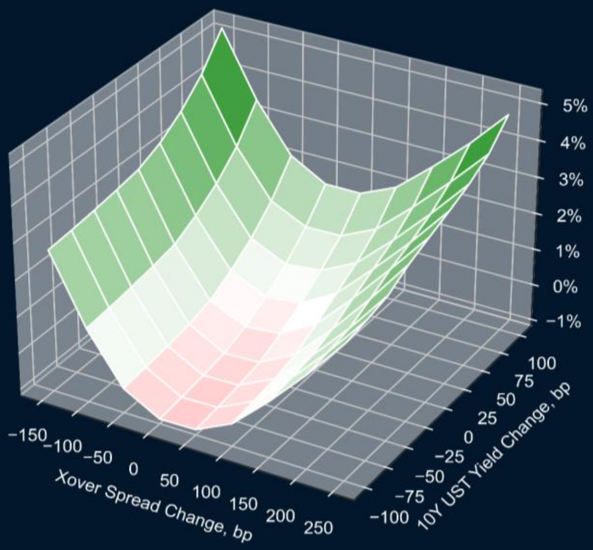

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Andromeda Capital Management is a global strategy focused on regime-changing themes and investing primarily in fixed income and credit. For more information, please contact ir@andromedainvestors.com or visit www.andromedainvestors.com

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