ANDROMEDA
CAPITAL MANAGEMENT

The Silver Bullet | The Limits of Monetary Magic

Every great magic trick consists of three parts or acts. The first part is called The Pledge. The magician shows you something ordinary: a deck of cards, a bird or a man. He shows you this object. Perhaps he asks you to inspect it to see if it is indeed real, unaltered, normal. But of course... it probably isn't. The second act is called The Turn. The magician takes the ordinary something and makes it do something extraordinary. Now you're looking for the secret... but you won't find it, because of course you're not really looking. You don't really want to know. You want to be fooled. But you wouldn't clap yet. Because making something disappear isn't enough; you have to bring it back. That's why every magic trick has a third act, the hardest part, the part we call The Prestige.

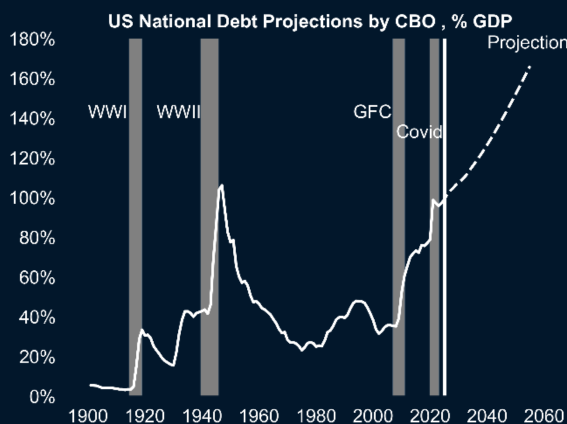
- Christopher Priest, The Prestige

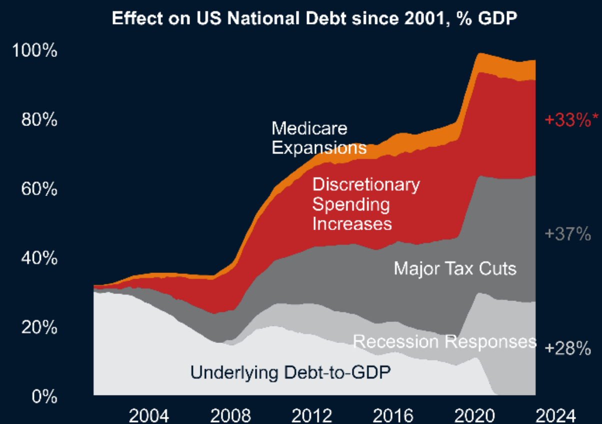
What is a magic trick? At its essence, it is to distract the public with one hand, while doing something else with the other. In this tightening cycle, the Federal Reserve has focused its rhetoric on front-end interest rates, as the active tool of monetary policy.

And indeed, looking at front-end rates at 5.25-5.5%, up from 0-0.25% two years ago, financial conditions might seem tight. They aren't. The Fed's balance sheet remains large, and while quantitative tightening halted its increase, other backstops like the Bank Term Funding Program essentially provided indirect quantitative easing.

At his latest press conference, Fed Chair Powell kept rates on hold and postponed expectations of imminent cuts, but reduced the pace of quantitative tightening for treasuries to $25bn a month, from $60bn a month. This brings the total cap for redemptions down to $60bn from $95bn a month – however, the total balance sheet run-off is likely to be even lower, at $40bn a month.

Why is the Fed tightening with one hand and easing with the other?





Source: Congressional Budget Office (CBO), Committee for a Responsible Federal Budget. The right 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.

Steve Liesman of CNBC asked exactly this question at the Q&A: “Is there a bit of a contradiction in the idea that you are reducing quantitative tightening, which is sort of an easing, while you're holding rates steady at a restrictive rate to try to slow and cool the economy and inflation?”

To which, the Fed’s default response was that “the active tool of monetary policy is of course the interest rates”, and that the plan to reduce its balance sheet is “a long, a plan we've long had in place to slow, really not in order to provide accommodation to the economy but to, or to be less restrictive to the economy, it really is to ensure that the process of shrinking the balance sheet down to where we want to get it is a smooth one and doesn't wind up with financial market turmoil the way it did the last time we did this and the only other time we've ever done this.”

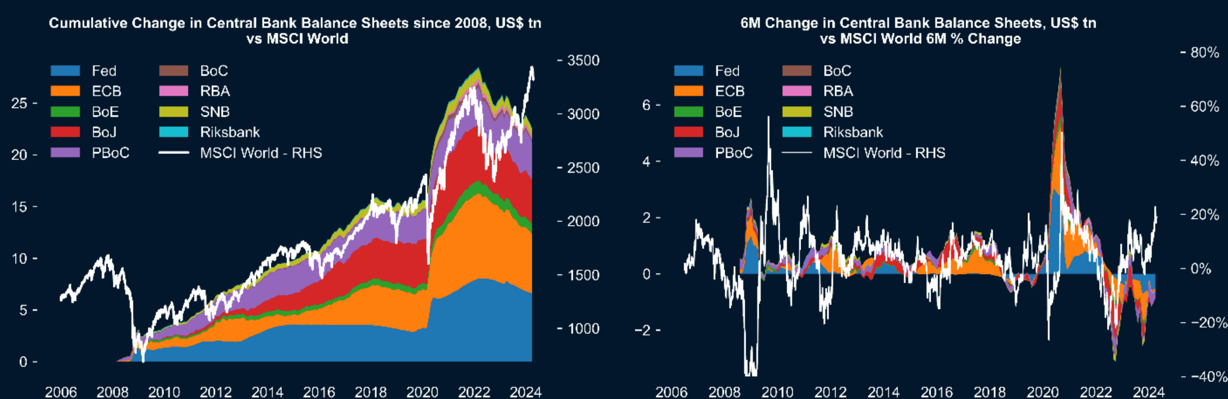
Calling front-end interest rates the only active tool of monetary policy is, of course, disingenuous. Balance sheet expansion has been a key tool for central banks to push yields lower, ensuring a strong fiscal policy response throughout the past crises.

So why is the Fed focusing only on the front-end? The official answer is to avoid financial stress, which was the result of past attempts to wind down the balance sheet, like in 2018. Yet, this would not justify *slowing* the pace of runoff: financial conditions are solid and volatility at record lows, indicating no imminent danger of a crisis, let alone even a mild selloff.

Therefore, the Fed’s focus on front-end rates alone cannot reflect its intention to avoid financial crises. It is likely a reflection of persistent deficits and the need for the US Treasury to fund them, without an excessive term premium. Put differently, fiscal dominance and persistent deficits have made the Fed unable to reduce its balance sheet without abrupt increases in long-term yields, which in turn could trigger either a too-large rise in term premium, or a financial stability event.

This is the Fed’s magic trick: showing the public it is doing a good job by tightening front-end interest rates, while capping long-end yields for the Treasury as well as large firms.

But as we have pointed out in our past analysis, this approach has only resulted in tighter financial conditions for the poorest of households and for small firms, i.e. the ones which can only fund at short-term maturities.



Source: Bloomberg, Central Bank Websites

Meanwhile, inflation is proving to be stickier, and not just on strong demand. Supply bottlenecks and regime change in global geopolitics are here to stay. Fiscal spending is likely to stay persistent too, as a backstop to the inequality gap that Fed policies are reinforcing.

Over time, the Fed's magic trick could backfire.

The simple reason is that Fed tightening isn't working. Higher front-end rates aren't really hurting demand, nor tightening financial conditions, for the following reasons.

First, most firms and households had termed out their debt over a decade of near-zero rates, reducing their base rate interest rate sensitivity. According to Goldman Sachs research, 98% of outstanding mortgages have fixed rates set below current rates, while investment grade firms have extended their average maturities to 13.9 years, up from 12.6 years pre covid, according to Bloomberg data.

Second, fiscal policy remains pro-cyclical, with projected deficits over six percent despite record-low unemployment.

Third, front-end rate rises have been coupled with dovish forward guidance, resulting in an inverted yield curve, which has kept funding conditions for bond issuers at lower levels than the yields on short-term Treasury paper – in some cases, allowing them to implement a carry trade.

And while Fed tightening isn't hurting demand, the easing of supply-side constraints and re-opening of the economy is likely to be a one off. The free flow of migration, which has contributed to keeping inflation low despite rising demand, might also be less relevant in the future.

If growth and inflation continue their upswing - as our estimates suggest - how will the Fed justify cutting rates and reducing quantitative tightening?

As the scenario of a soft landing becomes less realistic against persistently strong growth and inflation data, the Fed's stance will likely become less tenable. Ultimately, the Fed will have to choose between price stability vs financial stability.

Preserving price stability means keeping rates higher for much longer and continuing to reduce their balance sheets. It might prove to be a difficult choice, however, given high private and public debt burdens in developed economies, and rising geopolitical tensions against developing, commodity-rich countries.

There are three questions for investors.

The first is how long can the current policy stance last for and whether it will turn into a delusion. The second, is how much will other central banks potentially be able to follow the Fed, if interest rates remain on hold. And finally, what are the consequences for investors and asset allocators, and particularly for credit markets.

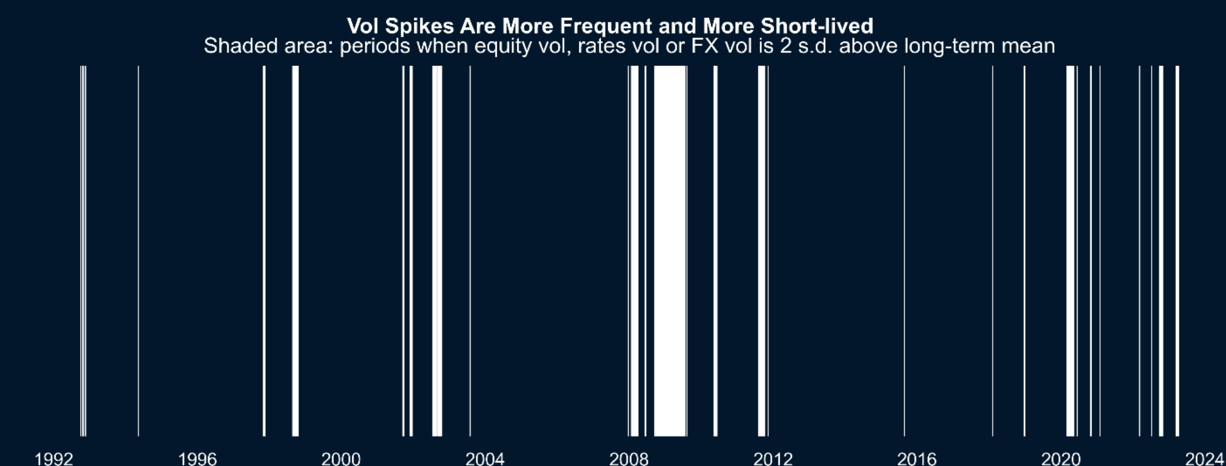
Delusion: How long can the Fed suppress volatility?

The short answer is we don't know. The Fed has been doing a good job managing inflation pressures and financial fragility at the same time – but hotter inflation data might test the limits of its policy.

Our framework to measure inflection points in the growth and credit cycle looks at top-down macro developments and bottom-up micro fundamentals on the one hand, combined with liquidity flows and positioning on the other hand.

Over the QE decade, central bank liquidity suppressed volatility in markets as well as dispersion across firms, keeping the lid on tail events and allowing unsustainable capital structures to survive. Credit spreads widened on the expectation of a harsh tightening cycle over the past two years; but central banks moderated their front-end hikes with dovish forward guidance and still-large balance sheet liquidity. This liquidity, once again, is keeping a lid on spreads, allowing even the most troubled firms to refinance and extend their debt.

However, this context of high liquidity, combined with record-tight valuations and late-cycle credit dynamics is potentially dangerous for investors in carry-seeking illiquid and/or private strategies.



Source: Bloomberg

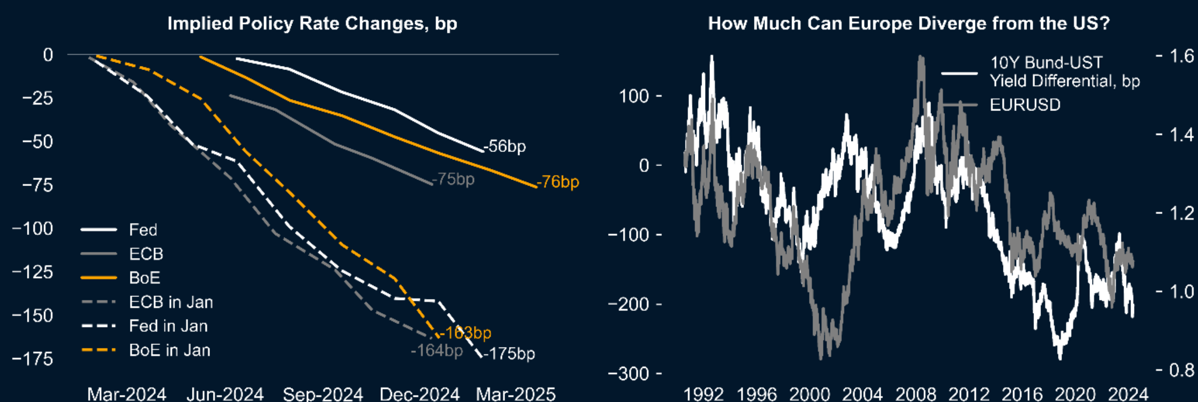
The previous decade of low interest rates created complacency amongst companies and debt overhangs in a variety of sectors, particularly the leverage-dependent ones like real estate and infrastructure. This year alone, several fragile capital structures have entered stress, which we discuss further below. While they remain idiosyncratic, these signs show that private and public capital structures remain unprepared for a permanent higher-for-longer yield environment.

So far, central banks managed financial system spill-overs from high rates with targeted easing programmes, like the Bank Term Funding Program (BTFP), hence attenuating volatility spikes, rather than reacting with broad-based cuts. But not all central banks have the willingness or the ability to react. Recent developments in Japan and the UK highlight the reluctance to raise interest rates, when economies face long-standing debt burdens previously financed at low rates. Over time, policy divergence between the US and the rest of the world will likely require more hikes elsewhere. Should the Bank of Japan continue to intervene to support the Yen, then it might need to sell some of its US Treasury holdings, for example, triggering volatility in long-term yields.

Divergence: Can other central banks follow the Fed?

The short answer no. Some central banks will eventually have to give up and accept divergence with its consequences, including further currency depreciation. This, in turn, might translate into yield volatility.

While the Fed has the *ability* to fight inflation and maintain its credibility, given US economic strength, other policymakers face a tougher challenge. Markets have become more focused on the widening gap in policy between the Fed and other central banks, which could potentially trigger volatility in yields and spreads.



Source: Bloomberg

Europe is showing signs of a reacceleration too. Unlike the US, European growth has greater signs of divergence and is not strong on all fronts: growth in northern Europe is lagging that of southern Europe, and goods-related sectors are lagging services-related sectors. However, in aggregate, Europe is not in a recession and high-frequency-data shows signs of a reacceleration. Growth will be further supported by a likely June ECB rate cut, continued defence spending and marginally improving China growth. The ECB has claimed that it could decouple its policy from the Fed. However, policy divergence could be hard to maintain with a weaker Euro boosting exports and feeding into higher inflationary pressures. So far Euro rates have remained more shielded as a relative value long position by investors against US rates, but this could change in the coming months.

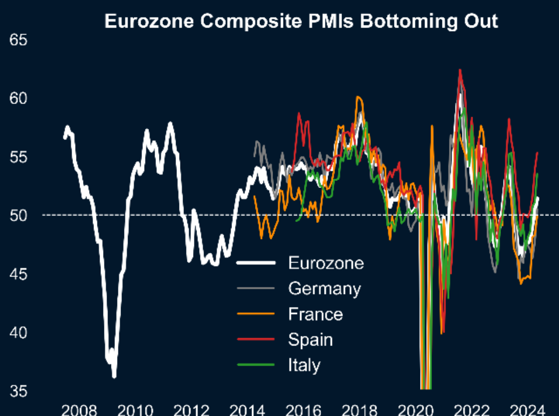
The Bank of Japan is back into no-action mode after the much-awaited first hike in March. The Yen continues to be the casualty, ripping through 160 briefly after the dovish April BoJ meeting before taking a pause on suspected interventions by the authorities. The last round of official FX intervention in 2022 cost ¥9.2tn, i.e. around US$ 64bn at the exchange rate back then. Japan's official reserves stand at US$ 1.3tn, with US$ 158bn in foreign currency deposits and US$ 978bn in foreign currency securities. In other words, the country still has some reserve buffer for further FX intervention.

Japan's Official Reserves, US$ mn

	Current Level	Last Intervention in Sep - Oct 2022		
	End-Apr 2024	End-Aug 2022	End-Oct 2022	Change
Foreign Currency Deposits	157,709	136,110	137,017	907
Foreign Currency Securities	978,004	1,036,781	941,331	-95,450
Gold	62,748	46,671	44,580	-2,091
Others	80,516	72,510	71,640	-870
Total	**1,278,977**	**1,292,072**	**1,194,568**	**-97,504**

Source: Ministry of Finance of Japan

While intervention worked in 2022 to temporarily reverse the fall in the Yen, it was also because CPI inflation peaked in the US and the Fed was turning less hawkish. This time the Fed is likely to remain hawkish given sticky inflation. In addition, the Japanese authorities are fighting against much bigger short interest in the Yen now compared to 2022. Eventually they will be forced to make a choice between abandoning the dovish stance and hiking rates vs selling foreign securities to fund currency intervention. Neither would be good news to the rates market.



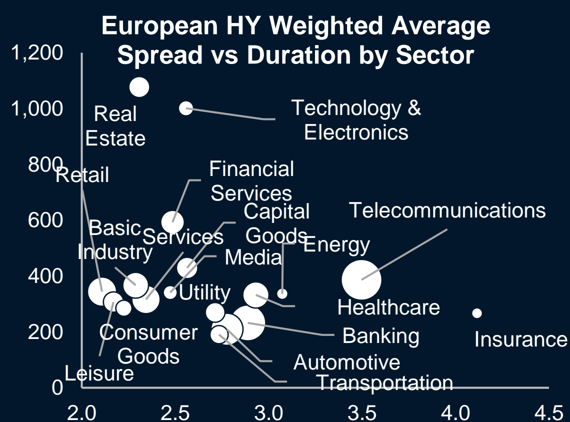
PBoC's Long-term Liquidity Injection (RMB bn)

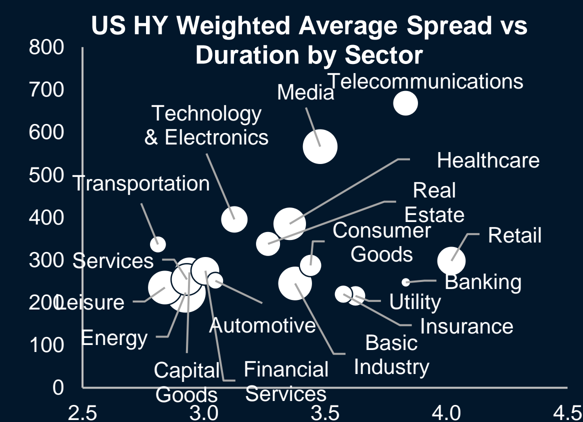
Major Channels	2015	2016	2017	2018	2019	2020	2021	2022	2023
RRR Cuts	3,400	700	0	3,650	2,930	1,750	2,200	1,030	1,000
MLF	21	2,792	1,064	410	-419	934	-897	0	2,525
PSL	698	971	635	692	158	-302	-433	351	99
Relending & Rediscounting	-3	90	202	322	164	2,240	700	970	400
Carbon Emission Reduction Facility	0	0	0	0	0	0	86	224	250
PBoC's FX Purchase	-2,823	-4,643	-464	-223	-24	-101	156	185	550
Onshore Central Bank Bills	0	422	0	0	0	0	0	0	0
Sum	**1,293**	**332**	**1,438**	**4,851**	**2,809**	**4,521**	**1,812**	**2,760**	**4,825**

Source: Bloomberg, Goldman Sachs Global Investment Research, PBoC, Wind

Other central banks in economies with high leverage are even more constrained in their ability to maintain restrictive policies. These include the BoE, which is faced with more entrenched stagflation right before the general elections; the Riksbank, as Sweden continues to be stuck in a housing slump; as well as the RBA, with households under mortgage stress given the country's high share of variable-rate mortgages and slowing growth.

China is clearly in a tough spot as the government tries to balance expanding the economy vs avoiding taking on more debt. Furthermore, domestic policy uncertainty is high which means distributed stimulus is underspent and has a lower impact than in the past. However, despite these headwinds, the size of the stimulus is meaningful. We estimate that the quantity of the stimulus is comparable to previous cycles, most recently 2018 and 2020. The question is, given real estate and construction are not benefiting from this stimulus, which sectors are? We think the stimulus is still making its way to discretionary spending, like European luxury and autos goods, which have continued to see stronger China demand relative to other cyclical sectors.





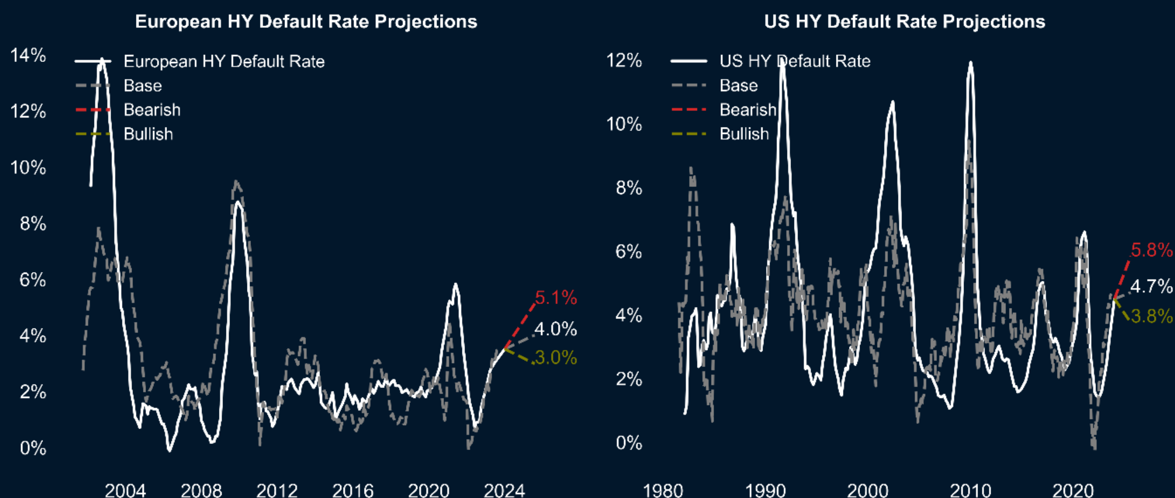
Source: Bloomberg

Dispersion: Will higher-for-longer rates translate into a credit crunch?

The short answer is no. Default rates will rise, but only gradually.

After a relatively benign start to the year, dispersion has finally taken central stage in the high yield market. Within a week, large capital structures like Altice France, Intrum, Ardagh, Grifols, and Atos saw bond prices plunge as creditors and debtors hired advisors to tackle over-levered balance sheets. Why did this happen now? While distinct business models, all these different businesses have two things in common – each took advantage of the low-rate environment to create extremely levered balance sheets and recent earnings have been soft.

This combination of higher-for-longer rates and weak earnings called into question the sustainability of these capital structures. And while over the past decade of low rates and quantitative easing, many unsustainable firms managed to survive, a continuation of the current high interest rate context could see more restructurings and defaults.



Source: S&P, Bloomberg

We estimate the high yield default rate to climb to 4.7% in the US and to 4.0% in Europe, up from 4.5% and 3.5%, respectively. Overall, we have a relatively constructive view of the high yield market. For the most part, company fundamentals are solid, and demand for high yield bonds remains firm, with over $0.5tn capital locked in private funds waiting to support firms under stress.

That said, we think weaker credits will continue to get punished, while those with stronger cash flow and more conservative balance sheets will be able to term out their debt, creating a dynamic of *the haves vs the have nots*, i.e. more discrimination between those that will survive and those that won't. This environment of persistent high rates and inflation volatility has further to go, and in our view will create more alpha opportunities within credit markets.

Conclusions: Delusion, Divergence, Dispersion

Mark Twain once said it's much easier to fool people than to convince them that they have been fooled.

Central bankers have engineered a front-end hiking cycle, hurting only a few areas of the economy, while keeping their balance sheets intact – and with that, keeping financial conditions loose for the majority of borrowers. As discussed earlier, this means risk assets remain buoyant and inflation is likely to persist.

Analysis from the BIS has shown that several quarters of above-target inflation can result in entrenchment: we are already outside the transitory safety zone.

We estimate US core and headline CPI at 3% at the end of the year. If our models are right on persistent inflation, then the implications for markets and asset allocators are significant:

1. Fiscal stimulus will continue to drive demand, growth and inflation, supporting risk assets;

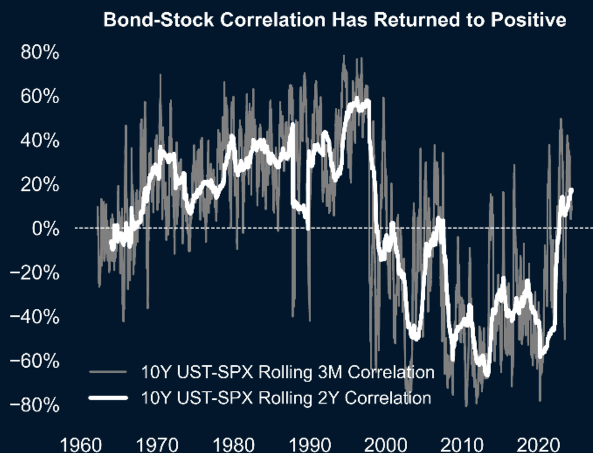
2. The Fed won't be able to cut rates this year, or will do a one-and-done rate cut at best. The ECB will likely do one cut, and it might soon end up looking like a "reverse Trichet" policy error;

3. Other central banks like the BoJ, the BoE and the Riksbank will struggle keep up with higher-for-longer rates, given economic fragility and debt overhangs. Their currencies will keep depreciating;

4. Long-end yields will continue to climb higher, over 5% for US 10-year Treasuries and over 3% for Bunds;

5. Dispersion and defaults will gradually grow in credit, although will likely remain idiosyncratic.

How should investors and asset allocators navigate this environment?



Source: Bloomberg

At a recent central bank meeting, I was asked *why investors are so positive on risk assets.* My reply was that the question should have been instead about *why investors are so negative on central bankers.* From a simple reading of the recent moves and inflows in stocks, gold, credit, and private assets, one would conclude that there's irrational exuberance.

But the signs of an irrationally euphoric environment are not here yet: most allocators have been reluctant to deploy risk, and firms are not increasing leverage. Gold, credit, monopolistic stocks and private assets rising in tandem suggests an attempt to rationally preserve capital from persistent inflation and/or to hide from the volatility that might affect liquid assets.

Put differently, some investors are hiding from mark-to-market in private assets, others are looking to outperform inflation through beta or alpha in public markets. All groups are going to experience the consequences of the new environment. But only some are making the right decisions.

These are some key conclusions we believe will affect investors and asset allocators:

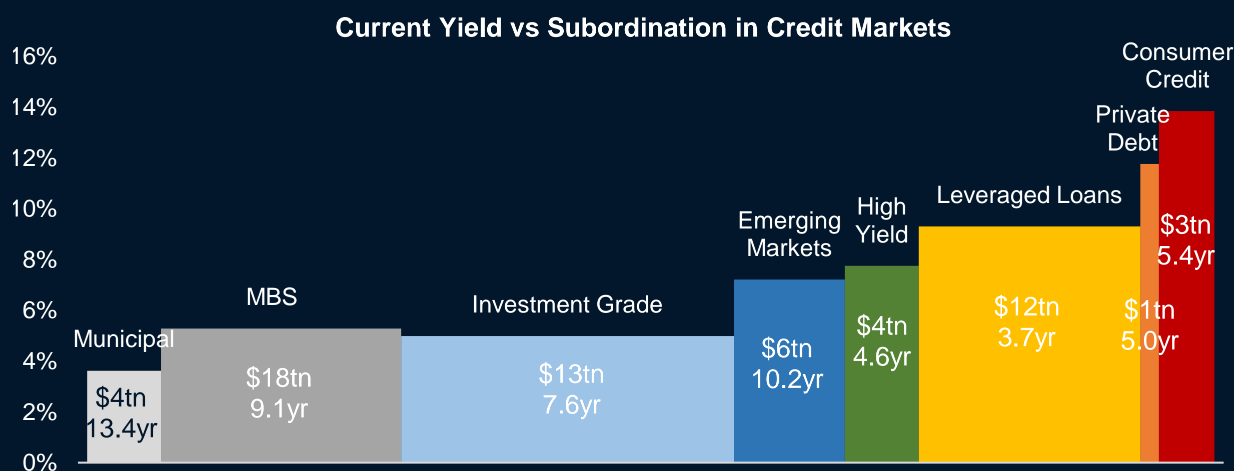
1. Persistent inflation with a neutral/dovish central bank reaction function is positive for risk assets. But the winning asset allocation mix and the portfolio construction characteristics are wildly different from the era of low inflation and low interest rates. While a typical balanced portfolio contains a lot of equities and government bonds, commodities and credit are likely to perform better going forward;

2. Bond-stock correlations will continue to shift back to positive, undermining the effectiveness of balanced portfolios and risk parity strategies;

3. Carry-seeking portfolio construction will prove less effective than a bar-belled and more nimble approach, able to monetise volatility events;

4. Dispersion across single name performance will keep rising, as the weakest firms will have to acknowledge permanently higher funding costs;

5. Higher-for-longer will expose weaker balance sheets. Private investment strategies offering low double-digit returns in exchange for long-term capital lock-ups will look unattractive and ineffective, as the IMF has highlighted in its latest Global Financial Stability Report.



Source: SIFMA, ESMA, Fed, ECB, Bloomberg. Labels show outstanding amount and weighted average maturity.

To sum up, our base case scenario is that fiscal spending and a neutral central bank reaction faction will prevent large shocks in markets. This is positive for risk assets and for credit. However, valuations are tight and single name dispersion is increasing. In addition, persistent inflation might test the resolve of central banks in weaker and more levered economies.

This means investors should stay nimble and ready to capture opportunities.

Today's liquidity premium on private credit, for example, at around two percent on average, does not compensate for the illiquidity of long-term lock-ups and for missing out on future volatility events.

We believe the current combination of rising yields, rising dispersion and low credit spreads is no longer attractive for long-biased strategies. Conversely, this environment is an attractive opportunity set for active strategies looking for convex upside-downside. We continue to extract alpha from relative value opportunities and remain ready to capture any future volatility.

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