The Silver Bullet | War Economy

There is a widespread view in the Maga movement, including senior levels of President Trump's circle, that neoliberal economics has failed and Ricardian economics is no longer relevant. We are in a populist nationalist fight.

- Steve Bannon, FT interview, January 2025

Neoliberal economics went wrong. The Western social contract has been broken a long time ago, and populism is the result of persistent inequality and a lack of opportunity for new generations. While it was easy for over eighty percent of young adults born in the post-war years to be richer than their parents, today's young generations struggle. At the core is a lack of productivity and investment, and ultimately a lack of competition. These problems, of course, are neither solved by monetary stimulus, nor by markets regulating themselves.

The result of broken capitalism is populism. In economics and market terms, a populist is simply someone who portrays a quick fix, selling a political dream to the electorate and pursuing it with unsustainable policies.

A first wave of populist governments in the US, UK, Italy and Greece achieved mixed results and in most cases were not able to live up to their promises. The result was often a return to more orthodox policy. In some cases, like Greece, post-populist policy worked to boost growth and address structural imbalances.

In others, like the US, it failed. While the Biden administration did boost growth with substantial fiscal spending, it failed to address inequality. At the same time, Fed front-end hikes combined with dovish forward guidance and limited QT failed to contain inflation and even hurt short-term borrowers and small businesses the most, leaving wealthier households untouched, as we discussed earlier. The result is a return to populism.

Will Trump 2.0 be better than the first?

Since mid last year, we anticipated a Trump victory and its potential consequences. Investors priced the election results with optimism. Today, we find the investor consensus a very optimistic one across financial markets. This consensus appears based on the following assumptions.

First, that disinflation will continue and that the Fed will continue to adopt a dovish reaction function. Rates markets currently price fewer cuts, but the path remains downward. Second, that the Trump administration will be able to boost growth and reduce spending at the same time, optimising public spending even in its first years. Third, that US exceptionalism will continue to run, while at the same time China and Europe are flirting with sluggish growth.

We believe consensus is wrong and too optimistic on these three points. We expect US growth and inflation to stay up, and the Fed to lean against persistent inflation. We expect the US to keep running a substantial deficit, pushing long-term yields higher, as the supply of Treasuries resumes to average and long maturities. We see upside in Europe on concentrated pessimism and short positioning, with EU-level spending picking up and a ceasefire in Ukraine boosting growth.

After a decade of monetary dominance and quantitative easing, are investors ready for fiscal dominance**? A *populist national fight* means we are in a de facto war economy where recessions are not allowed, spending and inflation are persistent, the Fed put becomes softer, and dislocations and volatility become more frequent.**

ANDROMEDA
CAPITAL MANAGEMENT

1. Fed: Higher for Longer as Inflation is Stuck

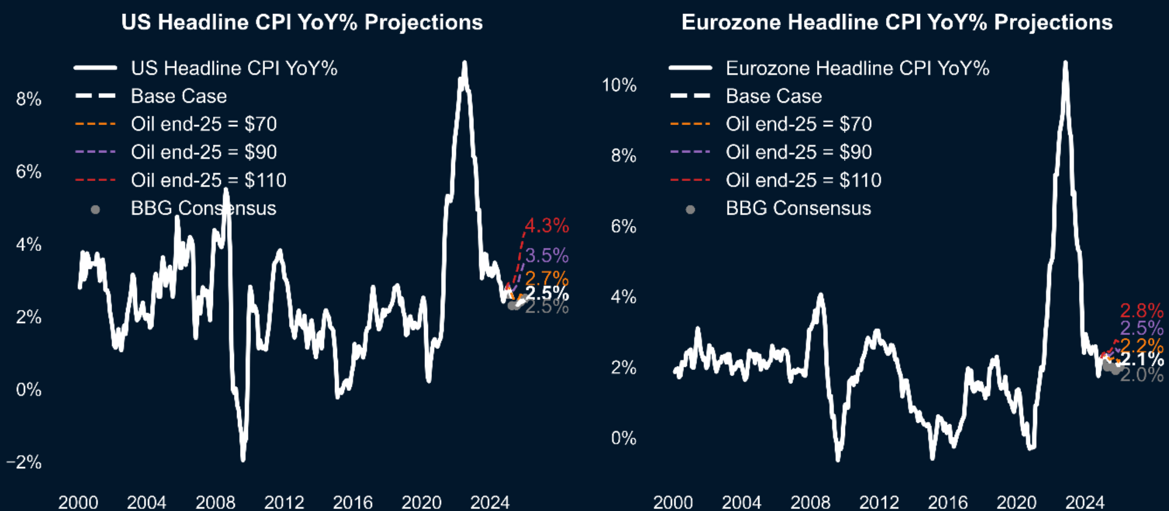
2024 saw the idea of "immaculate disinflation" changing from an investors' dream to the base case. This is now the key condition for market optimism this year: that the economy is resilient, disinflation will continue, and the Fed will remain dovish and cut rates further.

However, history has shown that inflation comes in waves. It is unlikely that the relatively painless disinflation seen last year will continue smoothly in 2025.

First, the low-hanging fruit has already been picked – a large part of the decline in US headline and core inflation over the past year was helped by goods price deflation, which was still correcting from the distortions caused by Covid-related supply chain disruptions, most notably in the vehicle markets. This normalisation process is likely coming to its end: month-on-month core goods inflation has returned to positive for the past three months, while auction prices for used cars are starting to rise again. In contrast to core goods, housing inflation and other core services inflation have stayed much stickier. Year-on-year rent inflation is still running at around 5%, while the leading indicator of house prices is showing signs of a rebound. Core services ex rent inflation also seems to be stabilising at a higher trend vs pre-Covid. With core goods deflation ending and core services inflation sticky, the overall disinflation process is likely to stagnate.

Second, the new Trump administration's policies will likely introduce new inflationary shocks. While the impact of higher tariffs on inflation is likely to be one-off rather than trend-changing, there is still uncertainty over their scope and how they would affect companies' supply chain relocation plans. In addition, tighter immigration policy could reduce labour supply in some specific sectors like construction or hospitality, further entrenching services inflation. Potential bank deregulation could also ignite further easing of financial conditions, supporting growth and inflation re-acceleration.

We expect inflation to remain above the Fed's target throughout 2025, with potential for upside surprises. If inflation gets stuck or even re-accelerates, the Fed will likely need to stick to a restrictive policy stance for longer, especially given the economy is still resilient. While markets have already priced out over 100bps of cuts for 2025 over the past months, investors may be challenged to fundamentally reassess their assumptions about the Fed's reaction function.



Source: Andromeda Capital Management, Bloomberg, FRED, Bureau of Labor Statistics, Eurostat

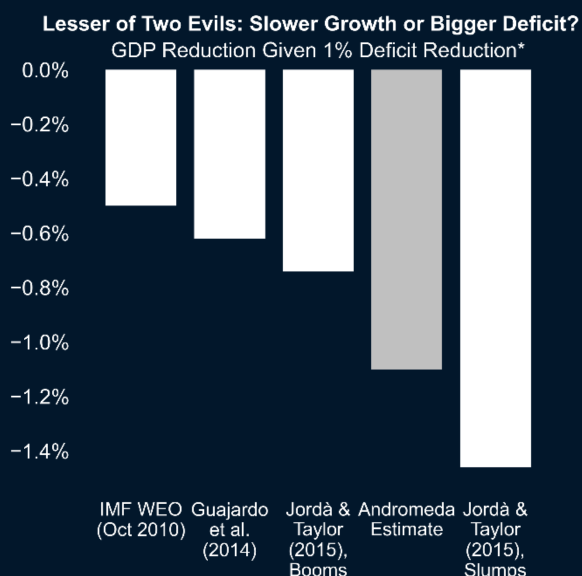
2. Trump 2.0: Continued Fiscal Expansion Boosts Growth and Deficits

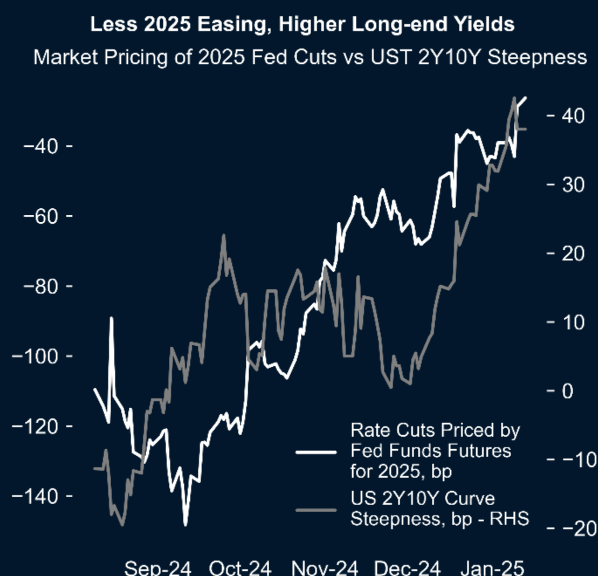
Incoming US Treasury Secretary Scott Bessent has a plan to fix the US economy, titled '3-3-3': 3% fiscal deficit, 3% real growth and 3m barrel increase in daily oil production. Under the previous Trump administration, US oil production increased by nearly as much, making this target credible. However, we think the 3% real growth rate and 3% fiscal deficit target are incompatible.

First, since the 1970s/post Bretton Woods period, there has been no time during which the US fiscal deficit contracted by 3pp without a recession. The only exception to this was during Clinton's first administration, and that was as the US was coming out of a recession prior to him assuming office. The US's economic exceptionalism is just as hooked to all-you-can-eat credit, as with every other western economy.

Second, Trump is not interested in running a fiscal deficit of 3%: during his first term he ran a fiscal deficit which increased sequentially and averaged 4% of GDP, excluding the 2020/2021 Covid years. During his campaign, he rarely spoke of lowering the fiscal deficit and continues to mostly tout lowering the trade deficit. Plans to cut costs are also mostly political posturing, as with Musk's and Ramaswamy's DOGE initiatives to cut $2tn in costs (1/3rd of the budget). For instance, the number of federal workers has remained broadly flat since the 1950s, with most of the employee increase at the state level, which would be harder to tackle.

This Trump administration's policy mix will likely rhyme with the previous one's: expansionary fiscal policy in favour of growth, pressure on other countries through tariffs, and higher inflation as a result. The one major change, however, is that there will be an increasing focus on diversifying the debt issuance away from the front end and moving towards the belly and back-end: the Trump team repeatedly criticise Yellen for failing to do so.





Source: Andromeda Capital Management, IMF WEO (Oct 2010), Guajardo et al. (2014), Jordà & Taylor (2015), *Standardised for 2-year period. Bloomberg

3. US Exceptionalism: Eurozone Pessimism is Overdone

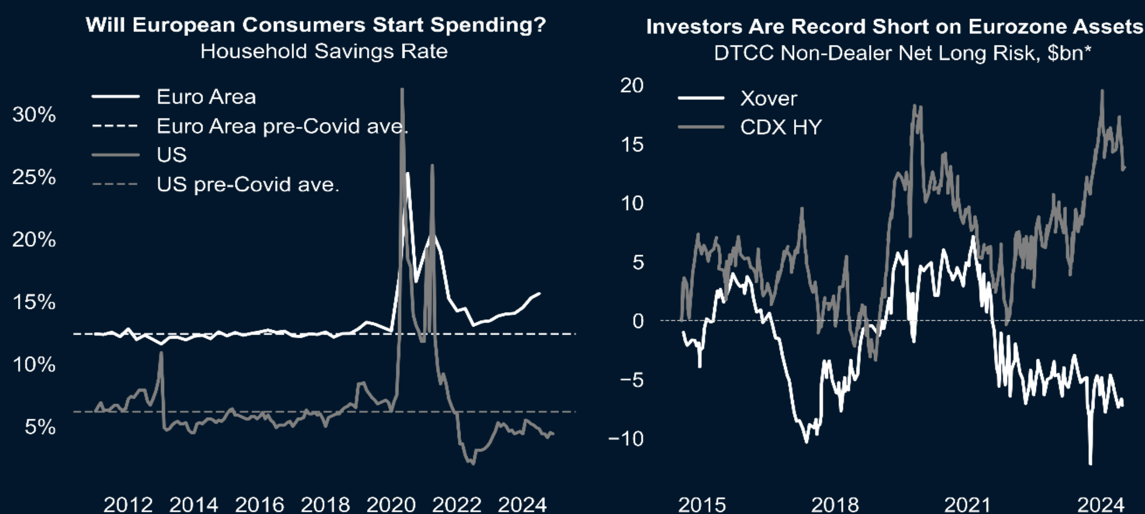
In contrast to investors' continued faith in strong US growth and asset performance, sentiment toward Europe has been increasingly pessimistic. Admittedly there are valid reasons for investor scepticism, including sluggish growth, domestic political noises and global trade tensions. However, concentrated short positioning in European assets suggests that such a negative view may be overdone.

First, while Europe still faces a weak growth prospect, it is far from a recession. German 2024 growth is likely around 0%, but France and Italy are closer to 1%, with Spain, Greece and Portugal between 2-4%. Furthermore, European corporate balance sheets are strong with leverage at an all-time low, and despite weak consumer confidence, unemployment continues to decline to near record levels.

Second, fiscal spending will continue, and structurally positive growth catalysts are likely to materialise over the coming year. Counterintuitively another Trump term could benefit Europe by compelling it to deepen integration and step up spending on defence, technologies and infrastructure, as envisioned in the Draghi Plan. Such a shift in fiscal priorities could find more support after the German Federal Election in February. Furthermore, a cease-fire in Ukraine would be a key positive catalyst, as Europe will be heavily engaged in Ukraine's reconstruction and benefit from normalised trade with Ukraine for agricultural and metal resources.

Third, the Euro area has improved on its structural issues since the last crisis. Banks have cleaned up their loan books, built up capital buffers and are finally starting to consolidate too. This is the most notable in Italy where Meloni is advocating for fewer, larger banking groups. Structural issues remain open in the UK instead - where household leverage remains high, and tax revenues are reliant on a small and mobile population. The UK government's strategy has so far failed to ignite growth and investment, and this is why we do not see the same upside for UK assets.

Fourth, Chinese growth seems to have bottomed out, with policymakers signalling continued stimulus, which should reduce some headwinds for the Eurozone too. Finally, investors are record short on Eurozone assets, and record long on US credit, as shown by DTCC data.



Source: Andromeda Capital Management, Bloomberg, BEA, Eurostat, GS Research, DTCC. *On-the-run + previous 2 series.

Conclusions: Wartime Economics and Fiscal Dominance

If you are not buying volatility, you are probably selling it
- Anonymous credit trader

Investors need to rethink their strategy and adapt to a world where fiscal policy dominates, and governments are engaged in a global populist fight akin to wartime economics. We see three scenarios for 2025:

1. Volatile Goldilocks - 50%: in our base case, growth reaccelerates on fiscal stimulus and investment, particularly in the US, while trade policy does not result in a tit-for-tat retaliation. The US economy enjoys 3% growth and 2.5-3% inflation. Despite persistent inflation, the Fed continues with dovish forward guidance, delaying but not cancelling rate cuts. However, geopolitical risk and inflation volatility mean that risk assets will trade in a wider range compared to the past few years.

2. Hawkish Conflict - 30%: the second scenario is one of still positive growth, but more inflation due to supply bottlenecks in labour markets and tariff retaliation. If inflation surpasses 3%, the Fed will likely lean against fiscal policy in the second half of the year, reversing last year's unwarranted emergency cuts. Risk assets will experience a stronger correction in this scenario, without recession-like valuations.

3. Stagflationary Tantrum - 20%: the worst-case scenario is a combination of persistent inflation with a downward growth shock and/or a financial accident. While we do not foresee substantial recession risk in the US economy, the current consensus is near-zero. At the same time, banks and insurers still remain exposed to duration, asset managers are record long on credit, and households on stocks. A sharp increase in inflation and/or a hawkish policy turn could ignite a repricing of assets with feedback loops into the broader economy. This is not our base case, but tail hedges are inexpensive and worth adding, in our view.

Most investors are positioned for a stable Goldilocks scenario. The world has changed. Valuations are near historical tights, and everyone is in the same trades, with long positioning at a record.

The Fed cut rates just before fiscal profligacy. The moment of reckoning is coming. Inflation is not coming down. Term premia will rise further. Spreads will rise, in crowded investment and high yield credit. Eventually, central banks will capitulate, but not yet.

We are positioned for wider rates and spreads, and long selective upside opportunities.

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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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