The Silver Bullet

ALGEBRIS INVESTMENTS

The Economics of Populism

"The price paid by good men for indifference to public affairs is to be ruled by evil men." - Plato

Ten years after the crisis, the quantitative easing music is fading. As the lights turn on, a scary reality is emerging for investors still dancing to the tune of monetary policy: the imbalances which caused the crisis are still present, there is less room for policy error, and a crowd of disenfranchised electorates is asking for payback time.

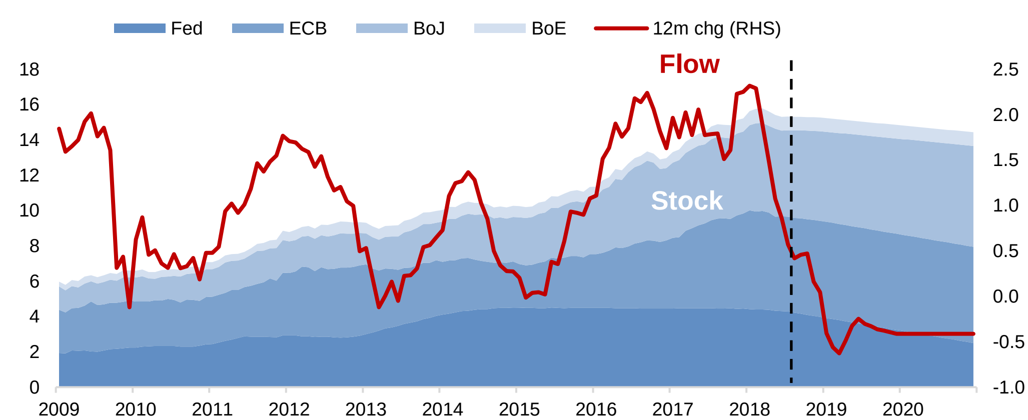
The bad news is that with a few exceptions, the debt imbalances at the root of the financial crisis have grown larger. Emerging market sovereign and corporate debt has grown thanks to inexpensive liquidity. Even though Eurozone banks have recapitalised, periphery sovereigns remain at record high debt levels, with the exception of Greece. UK households have borrowed up to £200bn of consumer debt. Even countries which were previously considered safe like Canada, Australia, New Zealand and Sweden have developed housing bubbles.

Growing debt and rising fragility in financial markets has also reduced central bankers' ability to exit stimulus. The Federal Reserve is on its way to normalise policy, thanks to the strength of the US fiscal expansion. However the ECB, the Bank of England, RBA and Bank of Canada may not have the chance to fully normalise rates and build a buffer for intervention before another economic slowdown.

Most importantly, while monetary policy gave a boost to growth, it generated an asset-rich and wage-poor recovery. The resulting wealth inequality and polarisation in opportunities between the young and the old and between large cities vs suburban peripheries has caused the implosion of centrist parties and provided fertile ground for extremists.

From Quantitative Easing to Quantitative Tightening

G4 Central Bank Balance Sheets, $tn



Source: Algebris (UK) Limited, Bloomberg, Central Bank websites.

Alberto Gallo, CFA
Portfolio Manager,
Algebris Macro Credit Fund
Algebris Tail Risk Fund
Head of Macro Strategies
agallo@algebris.com

Tao Pan, CFA
Portfolio Manager
tpan@algebris.com

Aditya Aney, CFA
Portfolio Manager
aaney@algebris.com

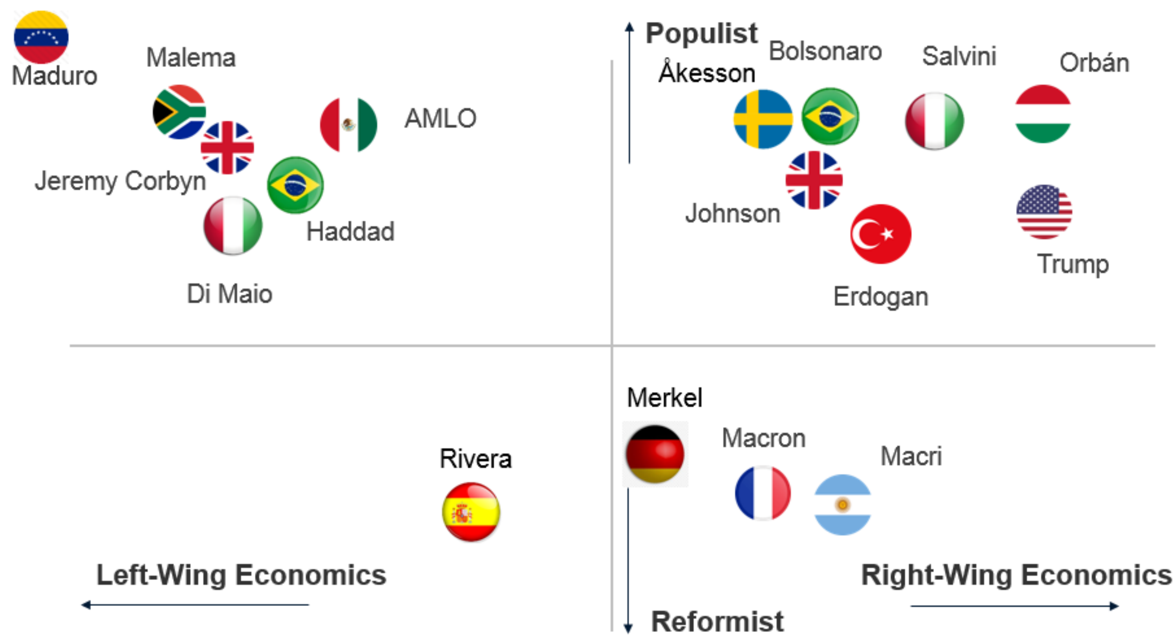
Pablo Morenes
Macro Analyst
pmorenes@algebris.com

Tom Cotroneo, CFA
Chief Risk Officer
tom@algebris.com

Algebris (UK) Limited
1 St. James's Market
London SW1Y 4AH

Tel: +44 (0)203 196 2450
www.algebris.com

Today, investors navigate a world with similar debt overhangs and less monetary policy ammunition than pre-crisis, but with new governments promising to solve their electorates' problems with unorthodox, simple economic shortcuts.



Source: Algebris (UK) Limited

The Populist Playbook: Dreams, Enemies, False Promises

What do Donald Trump, Nigel Farage, Nicolás Maduro, Recep Tayyip Erdoğan, Matteo Salvini and Vladimir Putin have in common?

History is rich of populist examples. Thucydides writes of Cleon, a general who in 427 BC pitted his Athenian countrymen to start a war against Sparta and to decimate the entire population of Mytilene. Like Cleon, populist leaders share at least three common characteristics:

First, they promote themselves as advocates of the people against the elites, promising to bring change and solve their country's complex economic issues, often with a simple solution. The dream of bringing back America's florid industrial past, or achieving a cost-free Brexit, or giving citizenship income to Italians regardless of public debt levels are just that – economic dreams.

Second, populists ignite anger against a common enemy: Mexico, the EU, immigrants are some of the recent choices.

Third, once electorates have fallen in their trap, the populist playbook is to perpetuate their dream, at all costs. This includes presenting an alternative reality as well as pursuing unsustainable economic policies. In Italy, an article by the Five Star party recently called the increase in BTP yields a positive, as sales from "foreign speculators" offer more returns to domestic savers. Turkey's President Erdogan recently urged his countrymen to convert all their savings in Turkish Lira, defending their country against foreign speculators. In most populist regimes, members of the media and other fact-based organisations have often been single out and regarded as enemies of the people.

		UK/Brexit	US/Trump	Italy/5S & NL
1. Dream	Economic	£350mn a week	Revive manufacturing	Jobs
	Political	Take back control	MAGA	Contract with Italians
2. Enemy	Foreign	Europe	Mexico, China, NK	EU/ECB
	Domestic	Immigration	Immigration	Immigration
3. Policies	Militarism	Spain/Gibraltar/Russia	Defence spending	Police spending
	Nationalism	Tax haven	Wall, Buy American	UBI
	Protectionism	Tariffs	Border Adjustment Tax	Flat tax
Results	Large deficits Resource misallocation Rising public debt		**Financial Repression** (Inflation, Taxes & War)	

Source: Algebris (UK) Limited

The Populist Trap: An Economic Tragedy in Four Acts

There are typically four phases, for the economics of countries under populist rule, as [Rudiger Bornbusch and Sebastian Edwards]() summarised in the 90's:

Phase 1: Conviction (Italy, Britain, United States, Brazil). This is the start of a populist policy cycle where the government commands public support and is fully convinced of its proposed solutions for the country's economic issues. In some cases, the economy may receive a short-term boost from stimulus, while longer term problems are yet to emerge. Italy likely falls in this phase at the moment, while Brazil is at risk going into the October election.

Phase 2: Bottlenecks (Russia, South Africa). In the second phase, a rapid demand expansion driven by stimulus could start to meet supply-side constraints, leading to rising inflation and worsening trade balances. Public debt and deficit also start to grow.

Phase 3: Crisis (Turkey, Argentina, Venezuela). This is when all the economic imbalances in the country manifest and confidence starts to wane. Currency depreciation starts to accelerate, leading to capital flight. Budget deficit and debt climbs rapidly, rendering government policies unsustainable. The central bank gets stuck in a dilemma between hiking to defend the currency and easing to support growth.

Phase 4: Orthodox stabilisation (Greece). This is when orthodox policies take over, often under a new government and with an IMF programme. Structural reforms and austerity measure will be enacted, and the economy will undergo painful adjustments to stabilise.

Populist Policies: the Good, the Bad and the Ugly

Bond and currency investors have met populist rhetoric by selling first and asking questions later. They are right to do so: history shows populist promises often end in tears, both for investors and for the electorates that have fallen for them.

Today's populist governments propose a range of solutions, many of which are of mild economic impact, but some of which are much more dangerous. The endgame in most cases, unfortunately, is most damaging for the same people that populist manifestos were advocated for – the weakest segments of each country's population.

We can divide populist measures in three categories: the good ones, the ugly ones, which are only good in the short term, and the bad ones.

The Good: Education, productivity, investment. The long-term solutions are to invest and improve productivity: over time, gains in efficiency and productivity are ultimately the key to higher wages and living standards. For too long, government policies allowing to borrow for a new house (or a holiday, or a car), like `Britain's' Help-to-Buy scheme, have been a cheap substitute for long-term investment in productivity.

The Bad: Trade wars, protectionism, military conflict: trade has been a win-win since the start of economics. Globalisation has helped to reduce poverty, increase healthcare and promote development across the world. However, some have missed out: the middle and low-income classes in developed countries suffered, as production was outsourced elsewhere.

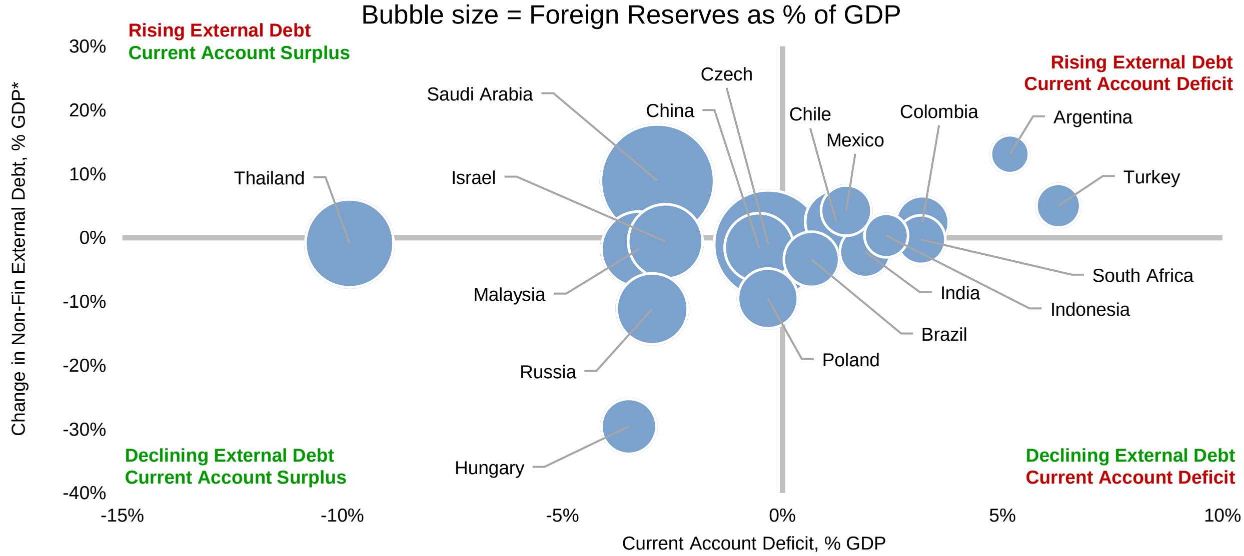
Despite political promises, however, it is difficult to imagine a return to mass domestic industrial production in the U.S. or the UK. Why? The cost of hiring workers in developed markets, where productivity has stagnated over the past decades remains higher than their Chinese or Korean colleagues, who are paid a fraction. A quick, tempting solution is to impose trade tariffs, trying to isolate each economy. In a first round of tariffs, the country imposing them may gain, boosting domestic production for goods that would be otherwise imported. Over time however, this means less imports or a higher cost of goods, which will eventually hurt the workers themselves, as consumers. The UK is a case in point, importing around half of all the goods it consumes. The dream of a clean Brexit with a stronger economy is therefore the economic equivalent of Peter Pan's Neverland.

In the worst scenario, populism can even lead to military conflict and a humanitarian crisis. Venezuela is a case in point: hyperinflation, rising crime and chronic food shortages have not stopped Nicolás Maduro's authoritarian regime.

The Ugly: Universal Basic Income, Tax Redistribution. The last set of policies are the ones that would put a patch on the inequality issue, without addressing its root causes. Redistributing some wealth from the rich to the poor will help to rebalance some of the windfall from QE. However, among the root causes of inequality are a lack of equal access to good education, as well as tax systems which encourage wealth-preservation. Again, the U.K. is a case in point, where non-domiciled wealthy individuals or corporates pay little on foreign assets, while middle-class employed workers are taxed on capital gains as income.

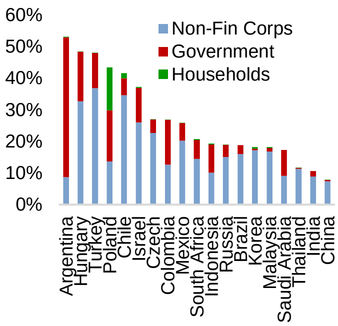
Flow and Stock Vulnerabilities across Countries

Bubble size = Foreign Reserves as % of GDP



Source: Algebris (UK) Limited, IIF, IMF, Bloomberg. *Non-fin external debt includes debt of non-financial corporates, government and households.

Debt imbalances have grown
Foreign currency debt, % GDP
Q1 2018



Source: Algebris (UK) Limited, IIF, IMF, Bloomberg

Conclusions: Investing in Times of Populism

Today, the biggest risks – and opportunities – for investors lie where private or public debt imbalances are meeting with populism. Below are some the countries which have been and/or will be the hotspots of populist economics:

Turkey's Lira nearly halved in value this year, as President Erdogan continued to keep interest rates low supporting infrastructure investment, rather than allowing the central bank to fight inflation. Rapid currency depreciation is likely to translate into a domestic credit crunch, given corporates' high reliance on external financing. We believe Turkey is the third phase of the populist playbook – crisis – and its situation will deteriorate further, and that the CBRT will fail to surprise. Sovereign debt appears fairly priced now, with most debt imbalances existing in the private sector – but not yet an interesting buy.

Argentina's currency and bonds have suffered heavy losses this year. This puts the current reformist government in a dilemma, given its heavy reliance on foreign currency debt. To regain market confidence and maintain continued IMF support, President Macri has to accelerate structural reforms, which he may have initially hoped to spread over a two-term Presidency. However, accelerating reforms puts at risk his popularity to ex-peronist candidates at elections next year. We are positive on Argentina to survive the next 12 months, but neutral on maturities following the upcoming elections. An agreement between President Macri and opposition leaders Massa could provide more certainty on a post-election agenda. Argentina has been in the fourth phase of the populist cycle, but it risks falling back into crisis.

In Brazil, the prospect of Lula-backed Fernando Haddad making it to the final ballot for elections in October has caused a strong depreciation in the Real, as this could lead to a rollback of structural reforms essential for taming the country's rising public and private debt. However, credit spreads on public and private debt remain tight and we believe markets are still complacent about election risks and debt imbalances in the private sector. We believe Brazil is back in the first phase of populist economics, and valuations do not compensate for upcoming risks.

South Africa, often considered one of the darlings in EM, is one country where we see substantial vulnerabilities. With high public and private debt levels and structural unemployment, the ANC government is left with few policy tools to help re-grow the country's economy.

The Populist Trap: An Economic Tragedy in Four Acts

Pre-conditions	1. Conviction	2. Bottlenecks	3. Crisis	4. Orthodox Stabilisation
• Inequality • Disenfranchised regions and parts of the population • Implosion of the political centre • Immigration issues	• High public support • Fully vindicated in their policies • Economic expansion without high inflation	• Demand expansion constrained by supply-side issues • Rising inflation • Worsening trade balances • Rising public debt and deficit	• Confidence waning • Currency depreciation accelerating • Capital flight • Rapidly rising public debt and deficit	• Orthodox policies take over • IMF programme • Painful adjustments to stabilise

Amid an early recession and to prevent losing seats to the growing populist Economic Freedom Fighters, the ANC government is considering the implementation of land expropriation. We believe the economy suffers from tight bottlenecks in labour markets and rising private debt which will prevent the SARB to fight inflation – with the best case scenario one of stagflation. Like Brazil, South Africa is in the first phase of the populist cycle, with deteriorating economics and risks and valuations reflecting even more complacency.

In the **UK**, absent a clear plan for Brexit, a sliding Pound could put further pressure on levered UK consumers, who are already squeezed by stagnant real income, rising interest costs and a cooling property market. We think the UK faces a binary event where tail risk is under-priced in FX and rates markets, though we see selective opportunities in credit.

Italy's bond yields have risen to 3% over Bunds under the Five Star and Northern League coalition, projected to increase funding costs by around €3.7bn in 2019, according to estimates by Cattolica University. In our view, Italy has been oversold and offers opportunities across corporate debt, and we believe investors have been too worried about the budget and short positions will be squeezed when fears meet a more moderate reality. We believe Italy is in the conviction phase of populist economics, but that its institutions and positive current account balance will limit the damage.

The **United States** remains in the confirmation stage, helped by the Trump Administration's fiscal stimulus and capital inflows back to domestic markets from Europe and EM. We do not expect the US to run into bottlenecks in the near term, however, a rising deficit and/or a further escalation of trade tensions could eventually spill-over to US weaker growth. Long-term, the question remains open whether aggressive trade policies and the use of the US Dollar as an instrument of international economic coercion will penalise the US economy.

In our Macro Credit Fund, we have been adding to our long positions in short-dated high yield bonds across countries where we think populist risks may be overstated (Italy, Spain) or where we see selective opportunities (UK). We remain short/neutral where policy willingness or ability are likely to deteriorate: Turkey, Argentina, Russia, South Africa, Brazil.

In our Tail Risk Fund, we remain positioned to capture re-pricing of these risks, particularly across emerging markets where we think valuations reflect complacency: Russia, South Africa, Brazil.

Cleon was killed by Spartans troops as he fled from Amphipolis. While frustrated electorates may be lured to believe in unrealisable economic promises, price action already shows that investors have already much harder to fool. With liquidity from global QE drying up, today's populists do not fight on the field of battle, but in financial markets. It may be the same investors they blame who will bring them back to reason, or ultimately show them the door.

The Silver Bullet is Algebris Investments' macro investor letter.

Alberto Gallo is Head of Macro Strategies at Algebris (UK) Limited, and is Portfolio Manager for the Algebris Macro Credit Fund and the Algebris Tail Risk Fund, joined by portfolio managers/macro analysts Tao Pan, Aditya Aney and Pablo Morenes.

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Additional reading:

Dornbusch, R. and Edwards, S., The Macro Economics of Populism in Latin America, 1991

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Sources:

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