The Silver Bullet
ALGEBRIS INVESTMENTS

Throw in the Powell

"And the one thing all human beings do when they are confronted with uncertainty is pull back, withdraw, disengage, and that means economic activity, which is really dealing with people, just goes straight down."
- Alan Greenspan

At the end of 2018, we called for political volatility but no recession in 2019. As markets increasingly priced in recession risks in Europe and particularly in credit, we pointed out value in the sector – although we were too early in positioning ourselves.

Today, markets are rebounding and some recession fears are fading. Central banks have blinked, moderating their hawkish stance. Will this be a dovish slowdown with above-trend growth, and what are the positive and negative risks?

Our base case scenario for 2019 is one of a benign, dovish slowdown.

1. Monetary policy: the cornerstone underlying our view is a more dovish approach from central banks.

Central banks, starting from the Fed to the PBOC and the ECB, have started moderating their hawkish ambitions and are gradually switching the dial to pause or even back to stimulus.

Inflation expectations remain contained in the US, despite declining unemployment, for a variety of structural reasons including demographics, technology, still-rising workforce participation and low energy prices. The Fed is near the end of its hiking cycle, as discussed by Chair Powell in his latest press conference, and ready to slow down the pace of balance sheet run-off if needed.

In Europe, inflation continues to undershoot vs expectations, due to a lack of fiscal spending, lukewarm credit easing conditions – see the latest ECB's latest lending survey – and a tightening in financial conditions across bond markets. The ECB recently shifted its forward guidance on the balance of risks to the downside, and said it is considering a new TLTRO for banks. Meanwhile, Eurozone small and mid-sized banks continue to strengthen coverage ratios, although profitability remains an issue – and not just in the periphery. We believe the ECB may be considering a partial exemption from negative deposit rates, as it becomes increasingly aware of its adverse effects on bank profitability and lending to the real economy.

In China, the government has gradually shifted from launching a multi-pronged approach to stimulating the economy. This is not likely to be anything similar to the post-2008 fiscal easing. Instead, it is likely to be a continuation of cuts in the PBOC's reserve and policy rates, improved lending conditions for SMEs, tax cuts for firms- expected to be around 2tn yuan. The PBOC also recently enabled primary dealers on the open market to exchange perpetual bonds issued by commercial banks for central bank bills, while China's insurance regulator, the CBIRC, eased restrictions for insurers looking to invest in perpetual debt.

With central banks leaning back towards easing and growth still above 2% in the US , 1% in the Eurozone and around 6% in China, last year's recession fears appear overdone today. As a result, many risk assets have staged a January rally – with credit moving from a

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

Aditya Aney, CFA
Portfolio Manager
aaney@algebris.com

Pablo Morenes
Portfolio Analyst
pmorenes@algebris.com

Jacopo Fioravanti
Macro Analyst
jfioravanti@algebris.com

Lennart Lengeling
Macro Analyst
lennart@algebris.com

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

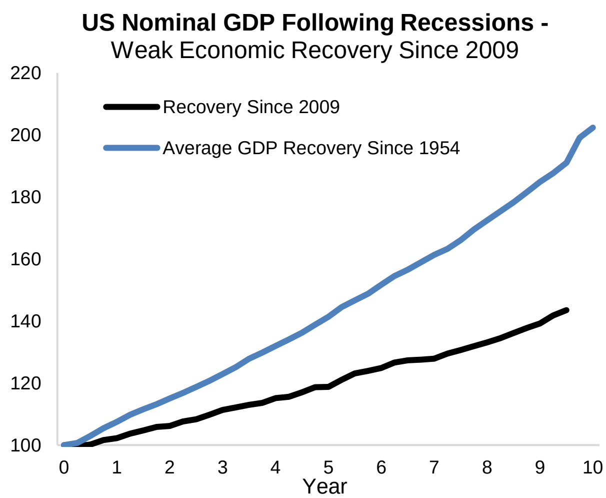
Algebris (UK) Limited
1 St. James's Market
London SW1Y 4AH

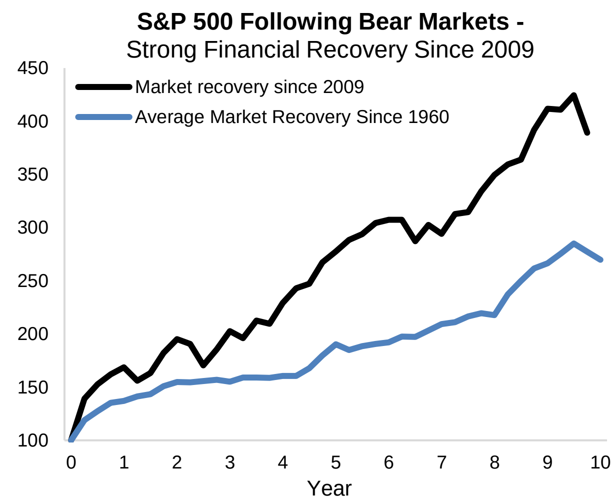
Tel: +44 (0)203 196 2450
www.algebris.com

liquidity air-pocket fall in December to a short squeeze. That said, we believe there are still opportunities, and many assets – particularly in Europe – remain priced for too-high tail risk. Monetary policy, however, is only one supportive factor – and it is increasingly less effective. As central banks pour more liquidity in the corporate bond market and banking system, the marginal benefit of lower borrowing costs decreases.

And while markets outperformed the economy since 2009, as shown below, last year we have learnt that even a mild a slowdown and a shift in monetary policy can result into very disruptive price action across markets, which in turn can reverse QE's wealth and confidence effect.

As a result, a late-cycle economic equilibrium with slowing growth supported solely by central bank *put options* is intrinsically fragile. The key to understand whether today's dovish slowdown will last, or if it will have upside (or downside) risks is therefore fiscal and trade policy.

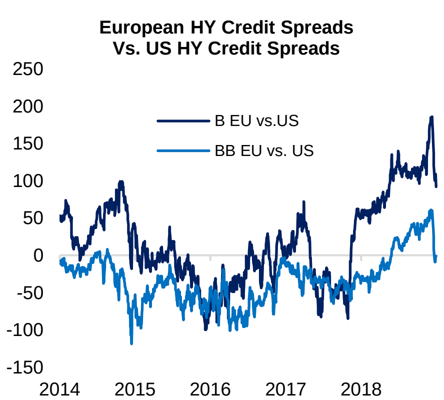




Source: Algebris (UK) Limited, Goldman Sachs Global Macroscope – Bear Necessities Update

2. Fiscal policy: we see modest upside from China. European policymakers, instead, remain behind the curve. As fiscal stimulus gradually fades in the United States, China is preparing to implement a new round fiscal easing. The details will be fully unveiled at the annual party congress in March: what we already know is that this won't be comparable to what China implemented following the 2008 crisis, when it poured 4tn yuan in the economy and doubled total social financing.

That said, China's slowdown in recent years was caused by the country's drive to deleverage starting from 2016, which focused initially on state firms and local government, then on the financial sector a year later, and most recently the trade war kicked off by President's Trump's administration in the U.S.

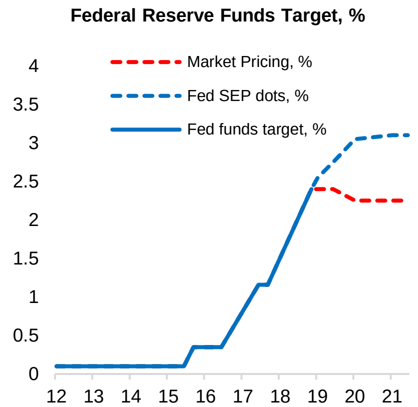


Source: Algebris (UK) Limited, Bloomberg

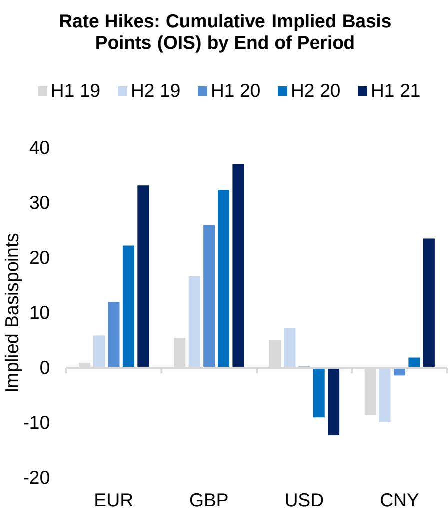
While China has made some positive steps in increasing transparency and deleveraging the circle of wealth management products, local government financing and shadow banking, it has also learnt the lesson that – like in Europe – it is difficult to normalise monetary policy *and* deleverage the financial system at the same time.

Overall, we see China's stimulus as a counter action to stabilize a decelerating growth trend, rather than a source of substantial upside.

European policymakers are not going to be as reactive. We recently met French policymakers in Paris to discuss political and growth risks, and while the agenda remains firm on reforms of pensions, labour market and public sector jobs - there seemed to be an insufficient sense of urgency on any plan to counteract the sharp decline in growth (and political consensus) the French government is experiencing.



Source: Algebris (UK) Limited, Bloomberg, Federal Reserve



Source: Algebris (UK) Limited, Bloomberg

And we would not expect anything more from Germany's policymakers, which after falling into a technical recession in Q4 2018, are more worried about leadership succession and European elections than growth plans.
Navigating amid even stronger populist cross currents are Italy and the UK. Both the Italian and the British governments have moderated their tone, reducing the tail scenario of an excess deficit and a hard Brexit, respectively.

But the populist innuendo gluing together Italy's multi-colour coalition will likely face further tests following European elections, with the Five Star Movement's likely to continue losing ground on its unrealistic spending and pension plans.

Similarly, as the dream of a quick, painless and clean Brexit meets the reality of political compromises, the UK government's narrative continues to lose ground, even though Theresa May remains in power by a thin margin.

With political consensus and European elections as the primary focus, 2019 is likely to be a transition year in European policy, with limited scope for stimulus. That said, fears of extreme events, particularly in Italy and the UK, are proving to be overdone, consistent with our view.

To sum up, we expect fiscal policy from China to be a further *put* against growth deterioration, rather than an aggressive boost.

3. Trade policy: certainty could be the biggest stimulus.

If monetary and fiscal policy can help growth to stay around or above trend, trade policy is the key to determine whether today's dovish slowdown is sustainable. Uncertainty around trade has delayed business decisions and compounded volatility in financial markets last year, consistent with what Mr Greenspan said – with the US government shutdown adding to already elevated geopolitical risks.

If uncertainty has created disengagement and volatility, certainty could be the biggest stimulus. The outlook for a long-term agreement between the US and China remains dubious. However a temporary truce is possible, perhaps with China committing to purchase more US goods. That said, long term stability will likely depend on China's use of intellectual property and its control of telecommunications software and hardware. On these concerns, the Trump administration recently targeted Huawei and ZTE and pressured US firms to not sell their products. Without transparency on the appropriation of intellectual property and interference in telecommunications, US-China trade relationships could further deteriorate, down to an outright ban of Chinese hardware, for example. China's reaction has so far been muted, although the Chinese ambassador to the EU recently complained about Huawei's discrimination.

Meanwhile, it is interesting to note that the Trump administration has had to moderate its stance on the US-Mexico wall, partly taken hostage by the government shutdown it engineered.

In the UK, we think Brexit is evolving towards a kick-the-can deal, where the PM will manage to achieve an extension, albeit having to renounce to some of the red lines previously part of the negotiation. While no-deal risk remains existent even after this week's amendments, we think either UK lawmakers will soften their stance and/or Europe will be able to grant an extension.

To sum up, we think the thaw in US-China relationships will be temporary.

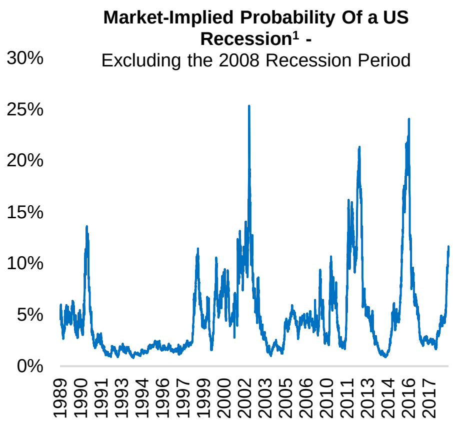
The combination of dovish monetary policy, China's fiscal stimulus and a temporary thaw in trade negotiations should support our base case of a dovish, benign slowdown.

Risk assets should perform well in this dovish slowdown, as long as growth remains above or around trend. That said and given last year's price action, one question remains open.

What could go wrong?

Beyond 2019: Recession Risks Are Overblown

"To prove that Wall Street is an early omen of movements still to come in GNP, commentators quote economic studies alleging that market downturns predicted four out of the last five recessions. That is an understatement. Wall Street indexes predicted nine out of the last five recessions!"
- Paul Samuelson



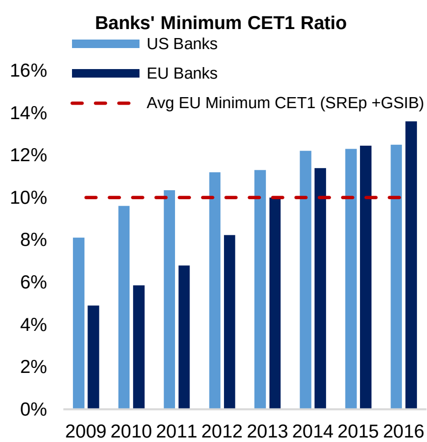
Source: Algebris (UK) Limited, Bloomberg, FRED

1) Independent variables used in the regression: Moody's Baa and Aaa Credit Spreads Relative to 10y Treasury Yield, 10Y2Y Yield Curve

What are the risks to our view? If dovish monetary policy, some fiscal stimulus and low energy prices can keep the cycle going, the counter-argument is often that imbalances are growing larger, and that these could destabilise growth and the financial system. Our sense here, as discussed above, is that markets may have been too pessimistic about the cycle. Below is our model calculating the market-implied probability of recession, which at the end of last year was around 15%, with daily jumps above that. This may seem a low number in absolute value, but it is close to what markets told you during other US recessions in the past, suggesting a high level of worry.

What can trigger a recession? Economic cycles don't die of old age, but typically they get killed by the Fed. US recessions have come in combination with over-tightening by the Federal Reserve and/or a sharp deleveraging across the economy as well as falling asset prices. There are a few exceptions, like the 2001 internet-stock bubble burst, and the 2008 global debt crisis.

If we look at monetary policy today, there are relatively low risks that the Fed may turn aggressively hawkish, ending the cycle prematurely. Banks both in the US and Europe are also in better health compared to past crises, having raised capital.

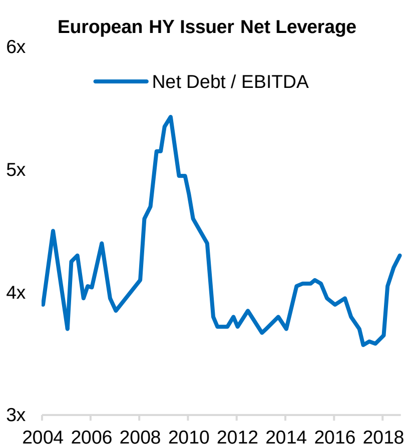


Source: Algebris (UK) Limited, EBA, Federal Reserve

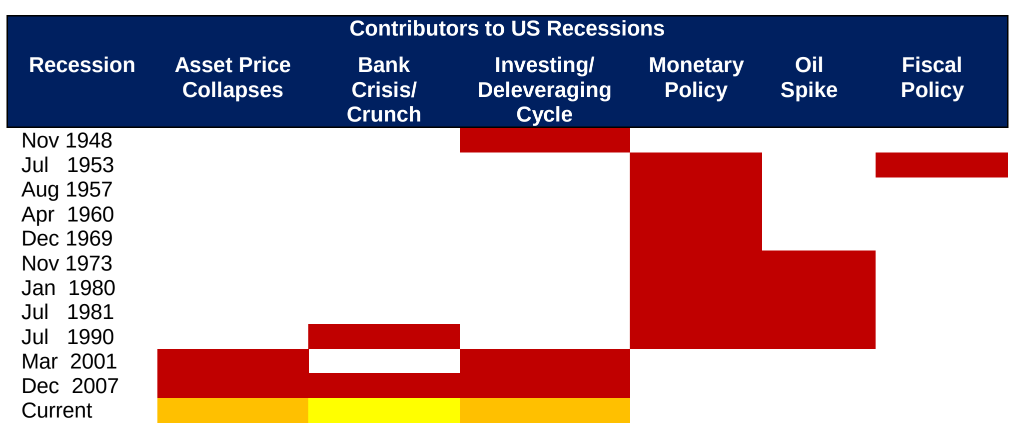
That said, today's worry could be around asset prices and a potential deleveraging cycle. We have already flagged the areas where corporate leverage has increased the most –the US high yield and leveraged loan market, for example, as well as some emerging market corporates (The Silver Bullet | Interplanetary Bubbles). However, European firms have lagged behind the leverage cycle and remain more conservative. The average leverage for European high yield issuers has ticked up to around 4.3x, up 0.7x from last year (0.4x adjusting for changes in composition), but remains much lower than its crisis peak, as shown on the left.

Therefore, one conclusion could be that since central bankers are a lot more cautious today, recession risk may be lower, given monetary policy support. But rather than an imminent growth shock, there is another more worrying risk Western economies face: Japanification

Rising sovereign debt, stagnant demographics and a lack of response from fiscal policy mean central banks may be no longer in the economy's driving seat. Put differently, monetary policy may be less effective going forward, due to the limited room for easing. We have long argued that some central banks, like the ECB, may have completely the exit train for normalisation (The Silver Bullet | Have Central Banks Missed the Exit Train?, May 2018). This opens up more questions: what will monetary policy be like in a future slowdown? And if the world is stuck in a *QE infinity* environment, then will governments and fiscal policy step forward to the driver's seat? The pivot point between a benign dovish slowdown and Japanification risk will be the reaction function of fiscal policy and governments.



Source: Algebris (UK) Limited, J.P. Morgan High Yield Talking Points



Source: Algebris (UK) Limited, Goldman Sachs Investment Research

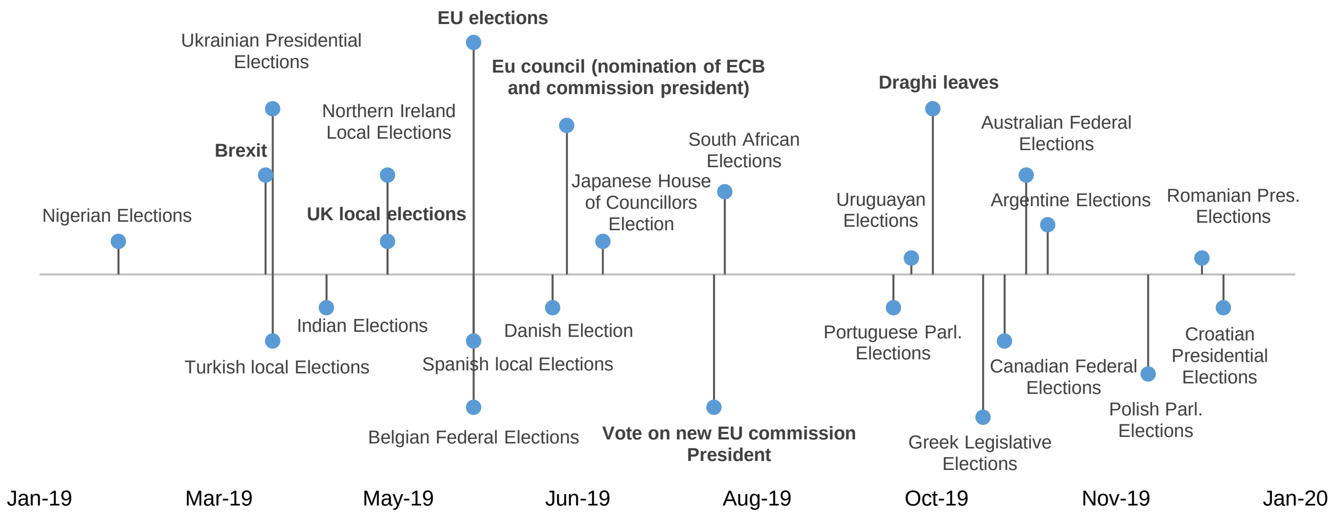
Rise and Fall of Populists: The Flight of Icarus

"When tyranny becomes law, rebellion is a right."
"Flee the country where a lone man holds all power: It is a nation of slaves."
- Simón Bolívar

Any economic forecast for 2019 depends on how geopolitical events will unfold. Populist governments and regimes have sprouted around the world, in part thanks to rising wealth inequality, something we have been flagging for years as a collateral effect of monetary policies. But populist regimes largely centred their narratives on migration and nationalism, often implementing unrealistic *Icarus-like* fiscal policies.

Could 2019 be the year where populist governments come under pressure meeting the hard reality of balance sheet, financial markets and public opinion?

2019 Political Calendar



Source: Algebris (UK) Limited

Italy's "target 100" pension reform aims at anticipating retirement in a country with an ageing population and public debt levels among the highest in the world. The US-Mexico border wall could cost between $8-12bn but may be defeated using $20 ladders or shovels. Turkey's dance with monetary and fiscal stimulus pushed construction to over ten percent of GDP, similar to pre-crisis Ireland and Spain. A sharp rise in NPLs awaits Turkish banks over the coming quarters. Brazil's Bolsonaro recently advertised an ambitious reform plan, including privatisations and a reduction of pensions. Will he be able to succeed in all the reforms at once, where others have failed? In the UK, Brexiters continue to advertise a quick and cost-free exit from the European Union, a scenario which is increasingly looking to voters as Mary Poppins' spoonful of sugar.

As we learn from the work of Dornbusch and Edwards, populist governments sooner or later run out of ammunition and hit both fiscal and credibility bottlenecks. This is already happening in the UK, where the popular vote has shifted against Brexit, and in Italy, where the Five Star Movement has lost around ten points in post-election polls.

As in the legend of Icarus, despite the many warnings by experts, populist governments are eventually exposed by their own unrealistic economic policies.

Once this happens, the incentive becomes clinging on to power - and how long populist leaders may be able to do so depends on a country's resources as well the strength of its democratic institutions.

In a good outcome, a period of populism may be followed by a return to orthodox policy: Greece is a case in point, where the government turned down its anti-European rhetoric, essentially eating its hat on the 2015 bailout referendum.

In a bad outcome, populists will try to retain power at any cost: it has taken nearly twenty years for its people to - almost - end Venezuela's Chavez-Maduro regime, started in 1999.

A third scenario is for current populists to be replaced by new ones. Italy's Northern League may soon replace the current Five Star-led coalition. The opposition may replace the current tory government at the next UK elections, but with little structural improvement on the country's Brexit strategy. In the US, an anti-inequality backlash could take place, should Republicans lose (see Elizabeth Warren's recent tax proposal on the ultra-rich). However, a better education system and more productive investments are also needed to increase equality of opportunity and social mobility.

Several EM countries this year will face make-it-or-break-it political events, including Argentina, Ukraine and Venezuela. Voters in Argentina and Ukraine will face the decision of electing governments which promise to pursue populist / unsustainable policies or those on the path to reform.

In Argentina, incumbent President Macri has lost ground in the polls since last year's economic crisis and now faces a re-election challenge in October. Running against Macri's Cambiemos party is the Peronist party Unidad Ciudadana and the centre-left party Justicialista. If Kirchner doesn't run as the Unidad Ciudadana candidate, it could increase the probability of a Macri victory, which would support investor sentiment: in latest polls, Macri's "positive image" is higher than other candidates. Additionally, while the Justicialista's policies would be more left learning than Cambiemos's, both parties are likely to maintain the IMF's programme and reformist policies. However, if Kirchner decides to run, this increases the risk of Macri losing and the re-emergence of Peronist policies, including default on foreign debt. Kirchner and Macri are tied in the polls including in scenarios with a run-off election between the two.

In Ukraine, while voter intentions are fragmented across at least 5 Presidential candidates, we expect the final winner to support the IMF programme and – potentially – pro growth policies. While all candidates have not registered to run yet, voters will mostly likely have to choose from incumbent President Poroshenko, Fatherland Party's Tymoshenko, Civil Position's Hrytsenko, popular comedian Zelensky and independent Boyko. Poroshenko and Hrytsenko will likely signal a continuation of previous policies, relative to the other candidates. Tymoshenko, currently leading in the polls, has positioned with a more aggressive stance towards the IMF, however we expect this to moderate. Additionally, she has signalled greater pro-growth measures including fiscal stimulus. The two "wild card" candidates are Zelensky and Boyko. While little is known of their economic plans/ foreign policy stance, a recent interview with Zelensky signalled a more moderate tone towards the IMF.

In Venezuela, two decades of Chavista politics may be coming to an end. In recent days, opposition leader Guaidó has claimed the Interim Presidency of Venezuela with support from some countries. While the situation remains volatile and past attempts to overthrow Maduro have failed, this time could be different. Maduro is running out of money which has thus far helped keep him in power. The Bank of England has denied Maduro's request to tap Venezuela's $1.2bn gold reserves, and the US has imposed sanctions on state-oil company PDVSA. If Maduro does step down, the question remains will elections take place and who would take charge. While Guaidó may stand for anti-Chavista policies and if elected would be positive for Venezuelan risk assets, the risk remains that elections would result in a fragmented coalition with Maduro's PSUV retaining power.

Conclusions: European and EM Opportunities

Our outlook for 2019 is positive: we believe we are in a dovish slowdown with some tactical upside risk from fading trade uncertainty and fiscal stimulus in China. With lower oil prices and growth still around or above trend, risk assets should continue to perform well. In addition, as the Federal Reserve leans towards easing and China implements a new stimulus, last year's relative outperformance in the United States' vs the rest of the world may gradually reverse.

We have added to corporate and bank debt last year, as lack of market liquidity exacerbated the sell-off. We believe the most unloved assets in fixed income are in Europe. In our view, Brexit is likely to be extended and Italy's current coalition will likely reshape itself after elections into a more business-friendly alliance. We believe European assets offer an opportunity now, as many investors have abandoned them on fears of tail events or political complexity. That said, the economic cycle is slowing, so we have narrowed our focus to national champion banks and free-cash-flow positive corporates, and positioned short on cyclical businesses with aggressive capital structures and a lack of competitive edge.

In emerging markets, we believe risk assets will continue to benefit from the Fed's recent moderation. However, valuations are not cheap overall, especially in hard currency debt. Therefore, we therefore focus on countries where some risk premium still exists due to political uncertainty, and where events may lead to a positive outcome: Argentina, Ukraine and Venezuela. We see US credit markets as relatively less attractive overall, having recovered more quickly from last year's fall and being much ahead in the leverage cycle.

In rates, we are biased to trade a widening in interest rates, especially in Gilts, and in currencies an outperformance of Europe and EM vs the Dollar.

Beyond 2019, our focus is on politics and geopolitics. While central banks will likely have to reverse their normalisation course in case of a further slowdown, any room for easing will be limited. This will put politicians and fiscal policy in the driver's seat.

One result is likely to be higher fiscal spending and higher deficits, as well an attempt to redistribute wealth and reduce the high level of inequality which technology, globalisation and asset-driven monetary policy have favoured. The agenda proposed by US Democrats or the British Labour party points in this direction: higher taxes, more spending.

Holders of government bonds will face an increasing supply of paper and a slow deterioration in sovereign balance sheets. Investors in corporates and banks instead will benefit from an above average spread and an extension of the economic cycle.
This is why we remain positive on selective opportunities in credit.

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], joined by portfolio managers/macro analysts Aditya Aney and Pablo Morenes.

For more information about Algebris and its products, or to be added to our Silver Bullet distribution list, please contact Investor Relations at algebrisIR@algebris.com. Visit Algebris Insights for past Silver Bullets.

Additional reading:

European Central Bank. The Euro Area Bank Lending Survey – Fourth Quarter of 2018. 22 January 2019.

University of Chicago Press. The Macroeconomics of Populism in Latin America. January 1991

Sources:

The source for all images is Wikimedia Commons unless indicated otherwise.

Previous issues:

The Silver Bullet | 2019: Populism and Volatility, but no Recession, 05 December 2018

The Silver Bullet | Europe at a Crossroads, 10 October 2018

The Silver Bullet | The Economics of Populism, 10 September 2018

The Silver Bullet | The Vigilantes Are Back, 7 August 2018

The Silver Bullet | A Slow Motion Re-pricing, 30 July 2018

The Silver Bullet | The Age of Fragility, 5 June 2018

The Silver Bullet | Have Central Banks Missed the Exit Train?, 1 May 2018

The Silver Bullet | Is the World Running Out of Safe Havens?, 28 March 2018

The Silver Bullet | A Fragile System: The Return of Volatility, 27 February 2018

The Silver Bullet | The Bond Bull Run: Is This It?, 1 February 2018

The Silver Bullet | 2018: Irrational Complacency, 12 December 2017

The Silver Bullet | The Central Bank Bubble: How Will It Burst?, 31 October 2017

The Silver Bullet | Interplanetary Bubbles, 21 September 2017

The Silver Bullet | Currency Wars: The Inflation Menace, 17 August 2`017

The Silver Bullet | Rebalancing and Revolutions, 20 July 2017

The Silver Bullet | The Low Volatility Trap, 15 June 2017

The Silver Bullet | Is the Reflation Trade Over?, May 22, 2017

The Silver Bullet | Europe's Opportunity, May 4, 2017

The Algebris View | Investing in the Time of Populism, Fiscal Excesses and the End of QE Infinity, April 20, 2017

The Silver Bullet | Introducing the Brexit Walrus, March 31, 2017

The Silver Bullet | Europe's Long Way out of QE Infinity, March 23, 2017

The Silver Bullet | Don't Fret about Frexit, March 8, 2017

The Silver Bullet | Greece: More Melodrachma, No Default, February 20, 2017

The Silver Bullet | Don't Give up on Europe, February 6, 2017

The Silver Bullet | 2017: When Inflation Dreams Become Nightmares, January 19, 2017

The Silver Bullet | 2017: The Movie, December 14, 2016

The Silver Bullet | Investing in the Time of Populism, November 15, 2016

The Silver Bullet | Trick or Tantrum?, October 31, 2016

The Silver Bullet | The High Price of a Hard Brexit, October 12, 2016

The Silver Bullet | Central bankers: the tide is turning, September 7, 2016

The Silver Bullet | Perpetual Motion, August 12, 2016

The Silver Bullet | We are still dancing, July 14, 2016

The Silver Bullet | The Divided Kingdom, June 28, 2016

The Silver Bullet | Brexit: it's not EU, it's me, June 13, 2016

The Silver Bullet | Trumponomics, June 1, 2016

The Silver Bullet | Brazil: The Caipirinha Crisis is Just Starting, May 17, 2016

The Silver Bullet | China: Feeling the Stones of Japanification, May 4, 2016

The Silver Bullet | Alice and the Mad Interest Rate Party, April 19, 2016

The Silver Bullet | Helicopter Money (that's what I want), April 12, 2016