The Silver Bullet

ALGEBRIS INVESTMENTS

Europe at a Crossroads

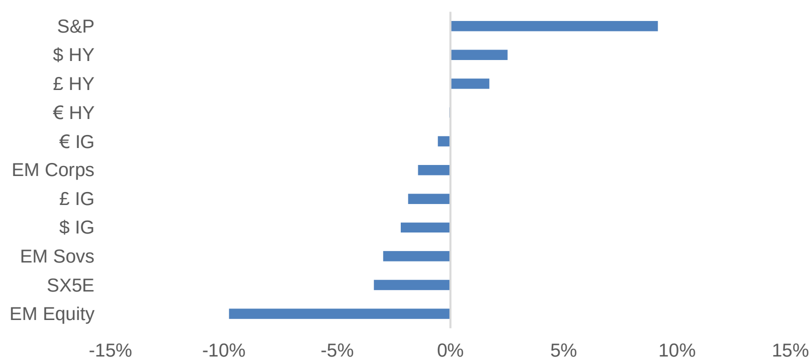
"Regardless of the outlook for fundamentals or the relationship between price and value, many people sell in a downdraft because, well, you have to do something, and they feel it's unreasonably passive to just sit there. But something about which I feel strongly is that it's not the things you buy and sell that make you money; it's the things you hold"

Howard Marks

Europe is at a crossroads. With ECB quantitative easing about to end, markets are bearing the weight of uncertainty from populist governments confronting the EU in Italy and the UK. Here is how we think things will play out.

1. Divergence and opportunity. 2018 has turned out to be a year of divergence between the US and the Rest of the World. Compounded by tariffs and trade protectionism, US assets are almost the only to have generated positive return year to date. In credit, US high yield bonds and the energy sector in particular have been the best performer: bonds which traded at 50c on the Dollar in 2016 today above are par with little upside left.

European HY has underperformed other DM HY credit
Total Return, YtD



Source: Algebris (UK) Limited, BAML Indices, Bloomberg. Data as of 3 October 2018.

2. Credit is still tight overall, but opportunities are arising. The divergence in growth and valuations in stock and bond markets between the US and the Rest of the World is now nearing a post-crisis high. This divergence may be justified by the stronger economic performance of the US economy, as well as by binary events hanging on Europe's future (Brexit and Italy's new government) and China. That said, even European firms outside of the UK and Italy trade at a record premium to their peers in the US, controlling for rating quality.

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

Aditya Aney, CFA
Portfolio Manager
aaney@algebris.com

Pablo Morenes
Macro Analyst
pmorenes@algebris.com

Jacopo Fioravanti
Macro Analyst
jfioravanti@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

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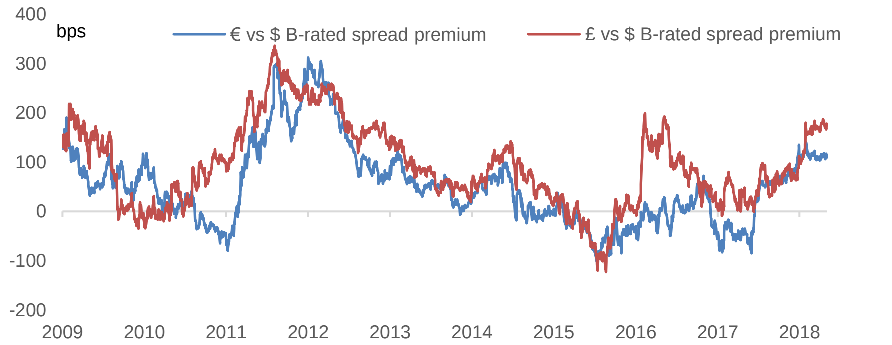
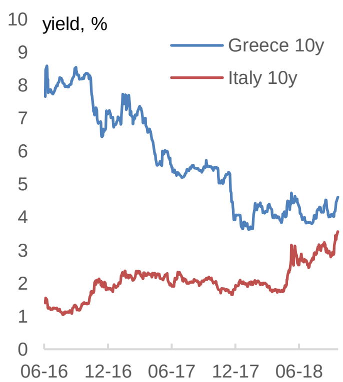
European B-rated spreads are wider than US B-rated spreads



Source: Algebris (UK) Limited, BAML indices

3. Europe at a crossroads: Brexit and Italy. This is not the first time that Europe finds itself at an existential crossroads, and with markets pricing in elevated levels of tail risk. The management of the UK's exit from the EU is one risk which could – in theory – create a cliff effect hurting the UK and albeit less, the European economy. Italy's new government has adopted a stark confrontational stance with the EU, threatening to undo years of reforms and attempts to reduce the country's high debt/GDP ratio. Both events are likely to unfold over the coming months. Investors who have been active in Europe over the last decade may remember many cases where the EU or the Euro were seen nearing the edge of a cliff, yet thanks to European institutions, the worst case scenario was eventually avoided. Is this time different?

Italy converging to Greece
Greece and Italy 10y yield



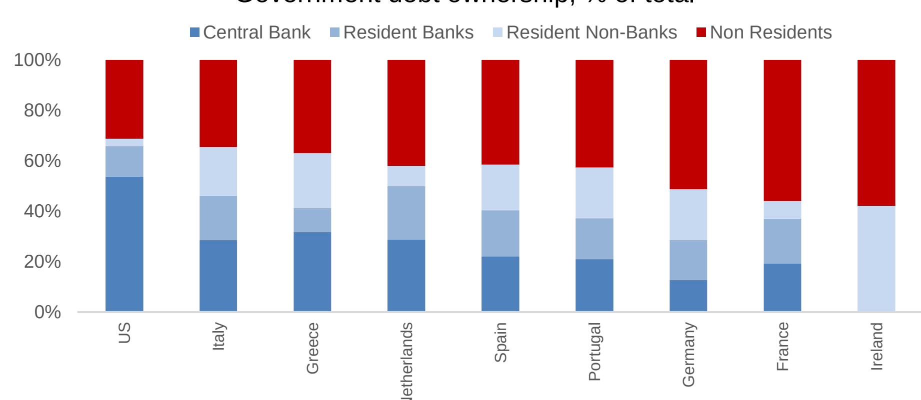
Source: Algebris (UK) Limited, Bloomberg

4. Italy: looking through electoral propaganda. *"In the Land of Toys, every day, except Sunday, is a Saturday"* – says Pinocchio's friend Lamp-Wick, inviting him to the party. *"And if the Fairy scolds me?" "Let her scold. After she gets tired, she will stop."*

The new Italian government recently published a budget draft including a 2.4% deficit plan for 2019, accompanied by an unwind of pension reforms and generous growth forecasts. The budget was received with popular acclamation and sold as a turnaround point for Italy's fortunes, despite rising concerns in financial markets.

As a result of the government's confrontational stance against the EU and the Euro, many investors have moved away from Italian government paper, pushing 10-year BTP spreads as well as funding costs for Italian corporates to record highs. Needless to say, the budget's growth assumptions are unrealistic, in an environment where Europe and the global economy are both slowing.

Italy's public debt is owned by Italians
Government debt ownership, % of total



Source: Algebris (UK) Limited, Bruegel. Data: Sept 2017 for all except Germany. Ireland does not separate Resident non-bank and central bank. Germany data approximated by combining Sept-17 central bank holdings and Jun-15 for other holdings.

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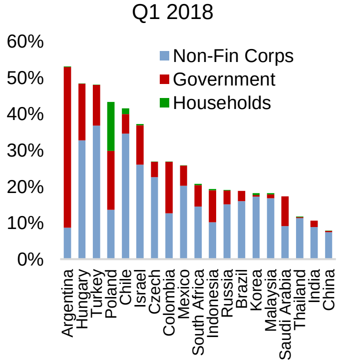
That said, electoral promises have to be put into the right context: the governing coalition is made of the Northern League (NL), representing votes from the industrial North, and the Five Star Movement (5S), which won heavily in the South. The two parties have had very different agendas: NL promised to fight immigration and lower taxes, 5S promised universal basic income and job growth.

Since elections, NL's leader Matteo Salvini has consistently won more consensus in the polls, touching 34% recently, especially after winning more cooperation from other EU countries in dealing with migration. Five Star, instead, which made more far-reaching promises given Italy's fiscal constraints, has been losing consensus. Today, short-term bonds as well as CDS markets price a high probability of re-denomination/exit risk, and 10-year Italian BTPs trade only 90bp tighter than Greek GGBs. This is in part due to several anti-Euro remarks by government officials, later on denied. We think short-term exit risk is overstated. Italy remains a country in current account surplus and with nearly 70% of its debt owned by domestic institutions. The real risk is for Italy to accumulate further additional debt of a potential economic slowdown ahead. Italy's public debt currently stands at 132% of GDP: any slowdown in growth worse than -1% a year could push debt/GDP near 140%.

In Collodi's book, Pinocchio breaks away from his friend Lamp-Wick, escapes the Land of Toys and is finally saved by his master. Italy's governing coalition is fragile and Matteo Salvini, initially a minority partner, has proven to be its real leader. One likely scenario is that the coalition between the Five Star Movement and the Northern League will eventually break, perhaps after European elections. This means the next government may be a centre-right coalition led by the NL, with a business-focused agenda. In this context, the proposed three-year measures should be seen as expensive electoral propaganda, rather than a long-term plan. We hold on to our Italy exposure in high yield credit and financial debt, with tail hedges for volatility in FTSEMIB, SX5E and €/$ in case of contagion.

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



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

5. Kick-The-Can Brexit. Our expectations are for a kick-the-can Brexit extension deal, though the journey to an agreement will likely be volatile. We think either Brexit extremes – a Hard Brexit or Soft Brexit – are unlikely at this stage of the negotiations. A Soft-Brexit deal would be rejected by pro-Brexit Conservative MPs while a Hard-Brexit deal would be rejected by both Labour and pro-EU Conservatives. We expect a final deal will likely include an extended transition period during which the UK would remain in the customs union. In this scenario, we think short-dated UK HY credit spreads are too wide relative to their global peers. We therefore like being long selective UK HY credits, partially hedging the risks of a Hard-Brexit with a GBP short. In our Hard Brexit scenario, we see significant downside risk in GBP both given the economic consequences of a Hard Brexit and as we think the BoE is unlikely to be able to defend the currency with higher rates given high domestic household leverage and economic imbalances (see also The Silver Bullet | Introducing the Brexit Walrus).

6. Tail risks vs European institutions. As we have seen before, market prices imply a relative risk premium for European assets as elevated as in 2011. We think this is exaggerated. In part, this is due to a structural underweight from global investors as well as the difficulty to price political binary events. That said, European institutions have evolved and are potentially stronger than they were at the start of the crisis. The ESM, for instance, still has nearly €500bn of firepower and the OMT is available to countries asking for help, albeit with conditionality, in addition, the ECB recently signaled some flexibility to twist the duration of its reinvestment programme.

7. ECB normalisation. To make things more difficult, the ECB will soon reduce its quantitative easing purchases and has guided a rate hike next summer, which should gradually move interest rates up from -0.4%. We have long argued how the exit sequencing in Europe should have been different than in the US, where financial markets make up a larger part of financing. In our opinion, the ECB should normalise deposit rates first rather than ending QE, helping bank profitability and lending to the real economy in the periphery (without fearing the impact of a higher currency on exports, which are most sensitive in Germany). But the normalisation

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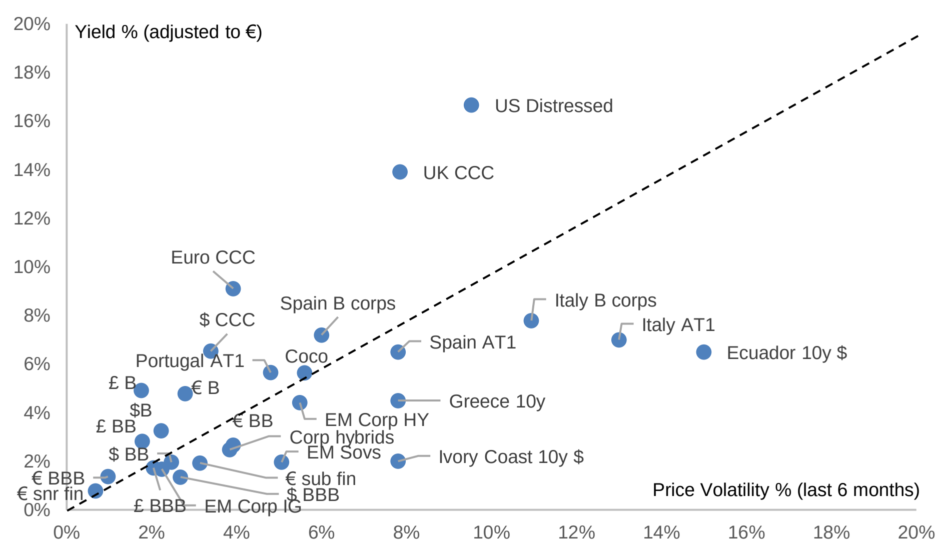
path is set, and perhaps ending QE purchases too quickly, it may contribute to some volatility in bond markets. That said, experience in US markets shows that credit spreads and rates volatility reacted before the end to Fed purchases, and calmed down thereafter.

8. What about China and EM? In the IMF's latest Economic Outlook, 2019 global growth was lowered, especially amongst EM countries. The IMF have attributed weaker EM growth partly to idiosyncratic risks (Argentina, Turkey) and partly to the rise in trade tariffs – China's 2019 growth was revised lower by 0.2pp. In our view, EM risks remain skewed to the downside. We think that positive market momentum from China's reserve requirement cut or Brazil's left-wing parties losing ground, may be eclipsed in the short-term by stronger macro forces including rising US real rates and further escalation of trade-wars. In our view, trade wars will persist into early next year, even if Democrats win a majority in Congress, given popular backing of trade tariffs against China amongst US voters. We are therefore short EMs, but especially those where we see limited growth potential, high debt burdens and rising risk of populism, including South Africa and Russia (The Silver Bullet | The Economics of Populism).

9. Do investors get paid enough for European risk? Assuming investors want to take a contrarian positive view on Europe the question is whether they can withstand a volatile mark-to-market over the coming months. The chart below shows the yield premium, adjusted by currency, for a sample of investment grade and high yield rated bonds, comparing with annualised volatility over the past 6 months. Despite a volatile price action, medium and short-term maturities in Euro and Sterling high yield appear attractive in comparison to emerging market debt. We think this reflects a persistent underweight by investors who have left Europe unloved, while turning to opportunities in EM much more quickly.

European periphery spreads compensate for the volatility



Source: Algebris (UK) Limited, BAML Indices, Bloomberg. $ yields adjusted by 3% and £ yields by 1.4%. COCO is the Iboxx € AT1

10. What are we doing? We started 2018 aware of the potential for volatility to rise, but without predicting a re-emergence of European fears and the consequent spread widening in Europe. As a result, our Macro Credit Fund (MCF) portfolio suffered a negative mark-to-market through the year. That said, we sold part of our bond holdings in January and March at higher prices, and we have been using some of that dry powder to add long exposures in the UK and Spain, in selective names at short maturities (3-5 years). Our portfolio coupon

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yield is now close to 6% in Euro and 9% in Dollars, while our yield-to-maturity is in the high single-digits, with a duration of around 4 years.

We maintain hedges in emerging economies which we believe trade too tight vs economic and political risks: South Africa and Russia in particular.

We do not know when the bottom will come for European and non-US assets more generally. However, we do see elevated signs of investor fear, which makes us more positive about the potential for an opportunity. We remain positive on the long-term survival of the Eurozone. That said, investors do not need to express a decade-year long view, as yields in short maturities are already at extremes. The risks in Italy and the UK could deteriorate further on a political confrontation with the EU – although fundamentals remain positive. But what if nothing happens?

If Europe survives over the coming quarters and the binary events of Italy and Brexit get resolved through a compromise and an extension, respectively, then holders of European credit will get paid very well to wait.

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 Aditya Aney and Pablo Morenes.

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Additional reading:

Conte, G. and Tria, G., Documento di Economia e Finanza 2018, 2018

Guiso L. Herrera H. Morelli M. Sonno T. The populism backlash: An economically driven backlash, 2018

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

Sources:

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