The Silver Bullet

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The Pandemic Revolution

History moves not in a line, but in tipping points. Investors often focus on the short-term business cycle, assuming the current economic and political infrastructure will remain in place. *There are decades where nothing happens; and there are weeks where decades happen* – Lenin said with reference to the Russian revolution. The Covid-19 pandemic and its policy responses call capitalism into question: should taxpayers bail out firms where shareholders got large dividends but paid little in taxes? Who will pick up the public debt tab?

The answers to these questions bring an acceleration in history, pushing forward economic policy ideas as well as geopolitical developments which have been in the making over the past decade.

Capitalism and globalisation have failed to distribute wealth efficiently. Growth rates have declined since the post-war period, for structural reasons well-known as *secular stagnation*. Yet as the economic pie grew slower, returns on capital continued to exceed the ones on labour. Median real wages have stagnated over the past thirty years, while corporate profits and wealth inequality soared. Corporations and *rentiers* shaped the economic system to their advantage, with loose tax systems and anti-trust laws tolerating monopolies, as G. Zucman and J. Tepper point out in The Hidden Wealth of Nations and The Myth of Capitalism.

With individual gains but socialized losses, capitalism is no longer capitalism. Like for the 2008 financial crisis, this year's pandemic has shown that the current economic system based on limited liability firms operating solely for the shareholder ultimately rests upon the responsibility of national balance sheets. The need for public intervention to bail-out the private sector was already evident from central banks *quantitative easing* programmes. With government bailing out entire sectors, the transition towards state intervention is even more explicit.

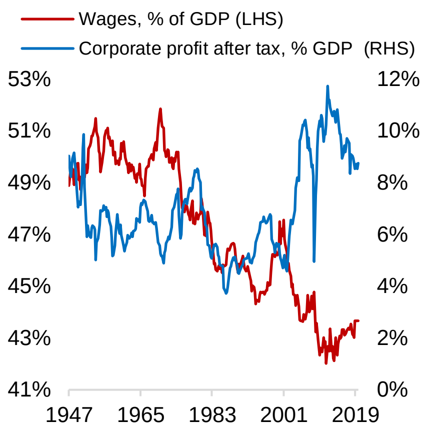
The airline industry is a case in point. Many airline bosses walked away with cash but left their planes and employees grounded. EasyJet's founder paid himself a £60mn dividend in March. Richard Branson, owner of Virgin Atlantic and a resident of low-tax BVI, asked the UK for a £500mn bailout and Australia for another £700mn.

Taxpayers and investors are likely to pick up the tab. Governments are likely to impose restrictions on equity buybacks or dividends, while strategic sectors and firms, or large employers, may benefit from increased protection.

Public debt levels will grow as a result and government debt will become riskier. Many developed countries will see their debt levels exceed 100% of gdp, including France and the UK. This will expose bondholders to negative returns against inflation in the future. Some won't be able to repay: the IMF and World Bank called for debt relief for 76 of the poorest nations, including their bi-lateral loans.

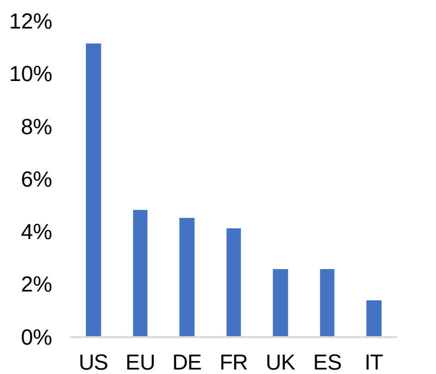
Central banks will continue to act, to limit the rise in funding costs due to rising public debt. The Fed recently announced an additional $2.3tn in asset purchases, including some high yield rated debt. The Bank of England, boosted its facility to directly fund HM Treasury, a move towards debt monetization. While only the Bank of Japan currently engages in controlling the whole yield curve, this may become the norm in other countries: a new paper by the New York Federal Reserve discusses how the Fed controlled long-dated Treasury yields in the 1940s. Losing their independence, central banks will likely remain locked into these programmes for the foreseeable future, going from a buyer of last resort to the buyer of first resort.

Corporate Profits have Risen, Wages Have Stagnated



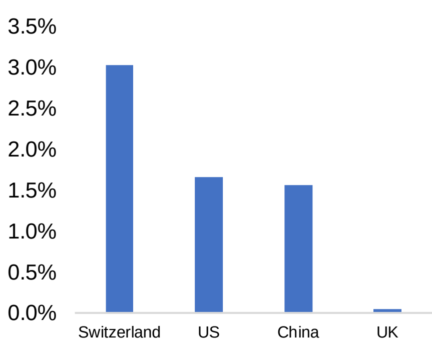
Source: Algebris (UK) Limited, FRED Economic Data

Fiscal Response to Covid-19, % 2019 GDP



Source: Algebris (UK) Limited, IMF Policy Tracker, Bloomberg, Eurostat

Loan Disbursements Made to SMEs in Response to Covid-19, % GDP



Source: Algebris (UK) Limited, PBoC, Ministry of Finance of China, UK Finance, SBA.gov, Forbes, EDF.ch, Eurostat

Note; for China we assume the whole first batch of re-lending and re-discount quotas, the whole special lending quota to policy banks, the whole financial bonds for SME loans program and the whole re-insurance from the state financing guarantee fund have been disbursed.

This pandemic will leave the world with more debt, persistent inequality and evidence of poor governance by global institutions. Who will emerge to solve these problems? Will countries coordinate or get into an every-man-for-himself fight? Monetary policy has provided a palliative so far, but it can't solve structural issues like lack of productivity or supply disruptions.

Absent structural solutions, the result will be a combination of monetary debasement, populism and social unrest. This is not a new phenomenon. The best-case scenario is a *beautiful deleveraging*, where public debt levels gradually retrace to sustainability and inflation is contained. But history suggests otherwise. The late Roman empire shaved silver coins as it disintegrated; Henry VIII replaced silver coins with copper to pay for wars against France and Scotland; the British empire allowed double-digit inflation to erode bondholders' wealth following the War of Independence; the Weimar Republic precipitated an inflation spiral. In the worst-case scenario, history shows that when nation-states take control of the economy, money ceases to be a store of value – it becomes a mere instrument to ensure their survival.

Our open society based on free markets needs change to survive. Taxpayers will question corporates who receive low-interest loans today and assess their behavior in the future. Bondholders forced into low bond yields may eventually balk at the rise of inflation. Central banks' liquidity won't be able to lift all boats in sovereign and corporate debt. In sum, the crisis will be an opportunity to reform capitalism and bail-out mechanics, giving a share of the upside to all stakeholders. But the process won't be orderly: some firms and countries will emerge as winners, others will have tougher times.

Winners and losers in the post-Covid world

We see a transfer of risk from the private to the public sector, and more value in selected corporates and banks than in sovereign credit. In fact, several sectors will receive support, and all governments will leverage up. But strong governments will have more room to help their firms than weak sovereigns. In this context, the strength of the public sector backstop will matter at least as much as corporate balance sheet quality – a weak firm in a strong country may survive, while a strong firm in a weak country may not.

The US and Germany have already put in place the strongest support measures for credit, both for large firms as well as SMEs. The Fed is now buying bonds below investment grade, and both have entered large-scale programmes to guarantee SME loans.

National champions will also receive public support in a credit-friendly way. German carmakers, for example, are still enjoying market access thanks to the implicit guarantee offered by government equity stakes. In the US, implicit bailouts are taking place thanks to the recently announced Fed's "fallen angels" purchase program. Large airlines are making use of public credit lines, which in this phase improve creditworthiness.

Aside from government-supported sectors, banks, utilities and telecoms offer good opportunity. Unlike in 2008, banks are now part of the solution, and responsible for the transmission of credit to the real economy – what the BIS has called the last mile. Capital ratios for core European banks are now 14% on average, twice the amount in 2008.

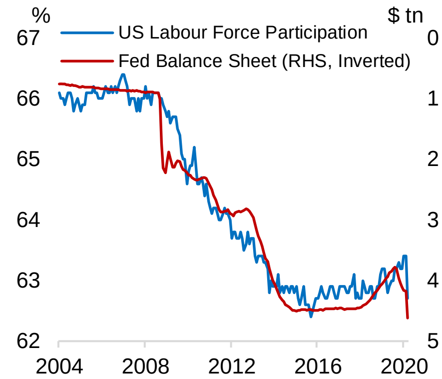
More levered sectors without government support may be the losers: retailers/consumers for example, as well as energy. Levered firms in these sectors already price-in steep losses.

In emerging markets, the Covid crisis combined with low oil will eat into growth, challenging countries with high levels of external debt. The ability for developing economies to get through this phase will depend on liquidity buffers and scope and timing of official support.

The outlook looks grim in Central/Latin America and Sub-Saharan Africa, where both short-term debt and reliance on commodities are high. Among large EMs, Turkey and South Africa start from the weakest position, while Indonesia, Russia, Brazil and Mexico have built up a larger buffer to deal with external shocks over the past ten years. A Large and broad EM support package from the IMF is currently finding little enthusiasm, especially from the US. Small, ad-hoc programs may still help but are not enough to support the weakest economies.

Finally, sovereign debt in developed markets does not look attractive. For now, yields stay low thanks to the massive QE programs adopted by major central banks. Still, inflation and large issuance plans are likely to put upward pressure on curves once the most acute phase of the crisis is over. Even if central banks manage to control yield curves, returns against inflation will likely be meagre, against rising debt levels.

Fed Balance Sheet vs Demographics



Source: Algebris (UK) Limited, FRED Economic Data, Real Vision Finance

How we are positioning

Today, the Macro Credit fund (SLVBTBU ID) offers a yield over 5% in €, with an average rating of BBB. We are invested at 70% capacity, up from 45% at the beginning of February. This means we have substantial liquidity to deploy in resilient issuers.

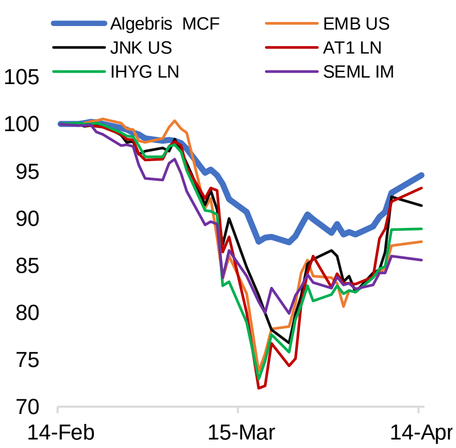
We used the sell-off as an opportunity to lock-in substantial yields in high quality firms, as we wrote in our The Silver Bullet I Nothing Left To Sell as well as in our recent podcast.

We primarily bought defensive investment grade credits in the telecoms and utilities sectors, like ENEL, ENI and Vodafone. Within high yield and cyclical sectors, our approach has been very selective. We have focused on national champions with solid balance sheets, ample liquidity and those most likely to be eligible for government support, like VW and Ford. In contrast, we have thus far avoided B-rated, cyclical credits which we think would need to restructure and are unlikely to receive government support.

We remain cautious on EMs and selective on both sovereigns and firms. We continue to prefer hard currency bonds over local bonds. We are short on Turkey and South Africa FX, and focus few long positions on Indonesia, Russia and state-backed firms like Petrobras and Pemex, in hard currency.

Now, the opportunity is in high yield and B-rated credits, with a focus on those with government support and positive cash-flows. The upside in high yield firms which depend on a re-start in economic growth, for example in the auto sector, is substantial and can provide equity-like returns in a positive scenario. Markets are likely to remain volatile, but we think patient investors will be rewarded.

Normalised Performance from Market Peak
14 Feb 2020 = 100



Source: Algebris (UK) Limited, Bloomberg

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, Gabriele Foà and Jacopo Fioravanti.

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Additional reading:

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IMF, Policy Responses to COVID-19, 10 April 2020

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