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The Algebris Bullet: Dispatch from Washington

Key takeaways from the 2024 IMF Group
Annual Meetings in Washington,
attended by Algebris' Global Credit team.



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Dispatch from Washington

In US macro, the main risk is a resurgence of inflation while in Europe the risk is growth. This change in the relative balance of risk is likely to fuel continued divergence in interest rates and a strengthening in the US Dollar. U.S. recession fears have diminished among investors, though concerns around U.S. fiscal policy remain high. Trump is now considered the base case, leading to more balanced risk/reward views, even if a Republican sweep isn't expected. Globally, tariffs are seen as the primary risk, even more significant than geopolitics, while hopes for Chinese stimulus remain low.

Global Inflation

Global inflation is less concerning than a year ago, yet persistent challenges remain. Energy prices have stabilized, aiding headline inflation, but core pressures are still resilient, particularly with services inflation holding at 4-6% across countries. Though not back to pre-2022 levels, inflation is expected to remain a global risk into 2025.

Global Macro

The IMF projects global growth at 3.2% in 2025, with a slight cooling in the U.S. offset by upgrades in emerging Asia (excluding China). China's growth is anticipated to dip to 4.5%, while Europe is forecasted to remain stable but low. Fears of a global recession have largely dissipated, with tariffs identified as the main risk, outpacing geopolitical concerns. Most central banks are expected to cut rates, although some may slow or pause cuts as the economic cycle has not deteriorated as severely as predicted by the end of Q2.

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U.S. Inflation

Inflation in the U.S. remains a central worry. Core inflation at 2.7% is not perceived as fully aligned with target levels, with the "last mile" towards reaching targets proving challenging. Twelve-month forward core PCE estimates range from 2.5% to 3%, while the Fed targets 2.3%. Harris's policies are seen as inflation-neutral, while Trump's policies, due to reduced immigration, trade policies, and fiscal boosts, are expected to add a 0.4-0.8% inflation premium over a 12-month period.

U.S. Macro

The U.S. economic outlook is generally strong, with projections ranging from a soft landing to no landing. Recession is no longer a significant concern. Recent data revisions underscore consumer resilience despite high rates, with solid labor market data reinforcing confidence. Summer slowdowns are attributed to sectoral or seasonal factors. The primary drivers for potential Fed easing are real rates perceived as high and possible downside inflation risks. U.S. potential growth has slowed from two years ago, now closer to 2%, keeping the current growth rate above potential.

U.S. Monetary Policy

As the Fed remains in a blackout period, investors are recalibrating expectations. The market view has shifted from a prolonged rate-cutting cycle (ending below 3%) to a mid-cycle adjustment ending in the 4-4.25% range. Cuts in November and December are still anticipated, but there are risks to the terminal rate, which is currently priced at 3.5%. The neutral rate is estimated between 3-3.5%, compared to the Fed's long-term rate of 2.8%.

U.S. Fiscal Policy

U.S. fiscal policy remains a significant concern, with few optimistic views and some dire forecasts. JPMorgan anticipates a 165% debt-to-GDP ratio over the next 30 years, with most investors expecting a gradual increase in premiums as bond vigilantes re-emerge. Some foresee a potential crisis if debt reaches 130% of GDP, at which point U.S. Treasuries could start pricing based on fiscal policy concerns. Election outcomes are expected to impact fiscal paths, with a divided Congress potentially worsening budget management. Treasury bill issuance has increased but reached a 20% cap, making more Treasury issuance inevitable.

U.S. Elections

Current expectations point to a Republican-controlled Senate, a Democrat-led House, and a presidential race that could go either way. A Republican president would increase the likelihood of a government sweep. Trump is the expected winner among investors, though experts remain more cautious. Polls remain challenging to interpret, with a slight tilt toward Trump, who benefits from perceived momentum and the perception that the U.S. economy is on the wrong path. The election outcome may hinge on just a few thousand votes in critical states, with Pennsylvania potentially deciding the race. A Trump loss is expected to result in legal challenges, adding post-election uncertainty.

Republican Policies

Republicans' policies bring a high degree of uncertainty. Influential advisors are few, with Musk and Thiel being exceptions. Trump's firm stances include immigration and fiscal policies, though the latter requires congressional support. There's skepticism over his trade policies, particularly tariffs, which some view as leverage for tech and currency negotiations. China is a primary focus, but Germany and Japan are also targets. Trump's pro-business stance is offset by concerns over growth impacts from tariffs. Potential Fed interference also raises concerns, with pressure on Fed leadership and possible alternative appointments. Trump's first 100 days would likely focus on tax cuts, job creation, and increasing energy production to 3 million barrels per day. The agenda includes calming down Middle East, Ukraine, Taiwan but the way to do this is unclear. Intensification of discussions with Netanyahu and shadow discussions with Putin are likely.

Democrats Policies

Democrats' policies are seen as stable and predictable. Generally viewed as a continuation of Biden's economic approach, she is more focused on social issues and innovation, favouring small businesses. Her policies are perceived as unfavourable for large corporations, with priorities like affordable housing, healthcare, and consumer goods. Her plans may result in significant spending, though attempts to increase corporate taxes may face challenges, leading to a potentially expansionary fiscal impact.

Market Pricing of U.S. Elections

Trump is largely priced into the market, but a Republican sweep is not. This balancing act leaves risks more evenly distributed than a month ago, with a Harris outcome moderating Trump-related trades. In rates, a Trump presidency is expected to lead to higher and steeper yields, with a target of 5% on the 10-year. For FX, Trump policies are likely to drive a stronger USD due to tariffs. Equity outlooks are mixed; Trump is seen as less favourable than in 2016 due to tariffs, rate impacts, and heightened uncertainty.

Eurozone Macro

The outlook for Europe remains weak, with sluggish growth despite rising real wages and a lower savings rate. Tourism and hospitality are bright spots, particularly in peripheral regions, but they're unlikely to sustain long-term growth. Manufacturing, particularly in Germany, remains a concern. Europe is seen as vulnerable to shocks, with 10% tariffs posing a potential recession risk. Europe's exposure to China is also a concern, while the EU's Next Generation fund has not significantly boosted competitiveness. The Draghi plan is widely supported, but few believe it will be fully implemented.

ECB

The ECB has shifted toward a more dovish stance. Inflation below target in September reassures hawks, while PMI data suggests recession risks. There's a sense that the old deflationary environment is returning, with growth remaining the central concern. The terminal rate is expected to fall below neutral, between 1-1.5%. A 50bp cut is anticipated, though likely delayed until after November, pending data. Rising nominal wages pose an inflationary risk for 2025, with labour costs now the main inflation driver in Europe.

UK Fiscal Policy

Fiscal policy is a key issue as the UK considers whether to join the U.S. and France in heavy spending. Infrastructure spending is expected, and additional revenue measures will be closely watched in the upcoming budget. BOE officials aim to strike a cautious tone, wary of appearing overly dovish amid persistent services inflation.

China

China is expected to announce stimulus measures during the 4-8 November NPC meeting, focusing on consumer support and coordination with monetary policy. However, confidence varies, with many viewing even large stimulus packages as relatively small compared to past years. Tariffs remain a concern, with evidence of delayed investment in anticipation. The yuan will likely depreciate gradually in response, and initial tariff retaliation may target Apple imports. Broadly, Xi is expected to pursue negotiation, leading to significant bargaining.

Japan

The BOJ is expected to maintain its gradual approach, keeping some dovish expectations to avoid a repeat of past tightening shocks. Structural positioning in the JPY carry trade persists, with the real neutral range between -1% and 0.5%. The terminal rate is anticipated to reach 1-2% over the next two years.

Middle East

Focus has shifted from immediate conflict risks between Israel and Iran to a longer-term view of increasing but slower-developing risks.

Ukraine

The war has stalled, but recent rhetoric hints at slight openings to peace talks, albeit with non-negotiable preconditions. The U.S. elections could heavily impact support, as Trump is expected to reduce funding, while Harris would likely continue the Biden approach. European funding for Ukraine has increased significantly. Ukrainian bonds are viewed as a Trump-related trade.

Markets

Market sentiment is low, with reduced risk-taking compared to previous cycles. Investors are hedging with USD and curve steepeners focused on long-end yields. The divergence between U.S. and European terminal rates remains a dominant theme, and investors favour UST-Bund wideners and EURUSD downside. USDCNH and USDMXN are considered preferred Trump hedges.

Credit Markets

Credit investors remain predominantly long, with a strong belief in immaculate disinflation. Arguments for this include a record number of investment-grade upgrades and a low default rate of 1.5% in U.S. high-yield debt. Focus is shifting from broad market exposure to distressed stories with remaining upside potential.

Emerging Markets

EM investors have performed well in low-grade credit but experienced mixed results in local markets, especially in Latin America. Many have reduced exposure, awaiting U.S. election outcomes and potential Fed reactions. While interest in China remains limited, there is growing optimism around non-China Asia, particularly in India, Indonesia, Malaysia, and Thailand. Argentina stands out due to optimism over the Milei administration. The mood is strong on Turkey, South Africa, and Egypt; meanwhile, the views are more constructive on Ukraine. Brazil and Mexico remain worrying, although concerns are alleviating in the former.

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