The Algebris Bullet

Algebris INVESTMENTS

Wartime Economics

April 2022

> It's a victory when the weapons fall silent and people speak up.
>
> Volodymyr Zelensky

Davide Serra
Founder & CEO

Sebastiano Pirro
CIO & Financial Credit Portfolio Manager

Gabriele Foà
Global Credit Portfolio Manager

Silvia Merler
Head of ESG & Policy Research

Tao Pan
Head of AI and Big Data

Wartime Economics

In history, wars have been symptoms of broader trends. WWI marked the end of the globalization wave that started with the industrial revolution, and WWII the beginning of a new era of global integration. The ongoing Russian invasion of Ukraine is no exception.

Globalization has been the clear trend for the first twenty years of the century. The big unintended consequence was cementing the partnership between China and Russia. Their strategy to hoard commodities and onshore the world's manufacturing proved beneficial for the West, but raised vulnerabilities. At the end of 2021, China held 30% of global market share in semiconductors, and Russia 20% of the market share in natural gas.

Since the election of Trump in 2016, domestic issues went straight to the top of the agenda in most Western countries. The sudden retreat from Afghanistan has been a marking post of the new US foreign policy agenda. In this new world, economic dependence on countries with different political priorities looks less appealing.

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Eventually, the economy will follow the politics. Russia's imperialist ambitions will accelerate the green transition and trigger a European re-think of defense and energy agendas. The cold war between the US and China is already leading to more domestic investment in high-tech components in the US.

Shorter term, however, tectonic shifts mean macro adjustments. Uncertainty over commodity and manufacturing input supply means persistently higher inflation, and jurisdiction risk will be an important component again for trade and manufacturing flows.

As polarization means reduced economic opportunities, the same applies to investment. Quickly rising inflation means real yields are more negative despite nominal rates being higher, and confiscation risk is now back in regions where real yields are positive.

Investors thus face the choice between losing money *slowly*, investing in developed market government bonds, or *quickly*, investing in less cooperative countries.

The "lower for longer" trade that characterized the past ten years is unlikely to work in the next ten. Higher inflation and a shrinking global opportunity set means investors should refocus their priorities from yield to quality. Alpha and capital preservation will be the key in fixed income markets.

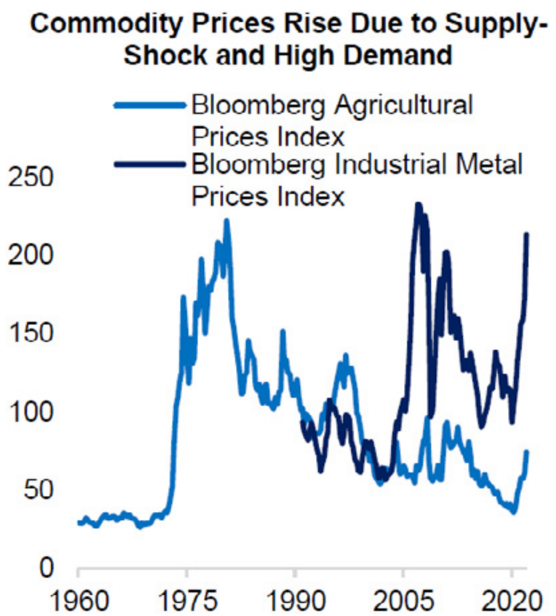
Our analysis suggests the war is unlikely to trigger a recession in Europe, but the inflation shock will be persistent. Central banks will thus remain full steam ahead with tightening. We see most opportunities in European credit and remain wary of funding-dependent areas (e.g. EM).

War - Global implications

In our view, the war impacts global macro via three main channels: commodities, as exports of energy and grains are disrupted; European growth, as the region is a net commodity importer from Russia; central banks, as policymakers will need to choose between growth concerns and higher inflation. Overall, we think the commodity shock won't subside soon. Inflation will thus remain elevated. European growth will take a hit but is unlikely to fall into a recession over the next 12 months. Central banks are thus likely to go full steam ahead with hikes.

1. Commodities - Higher for longer

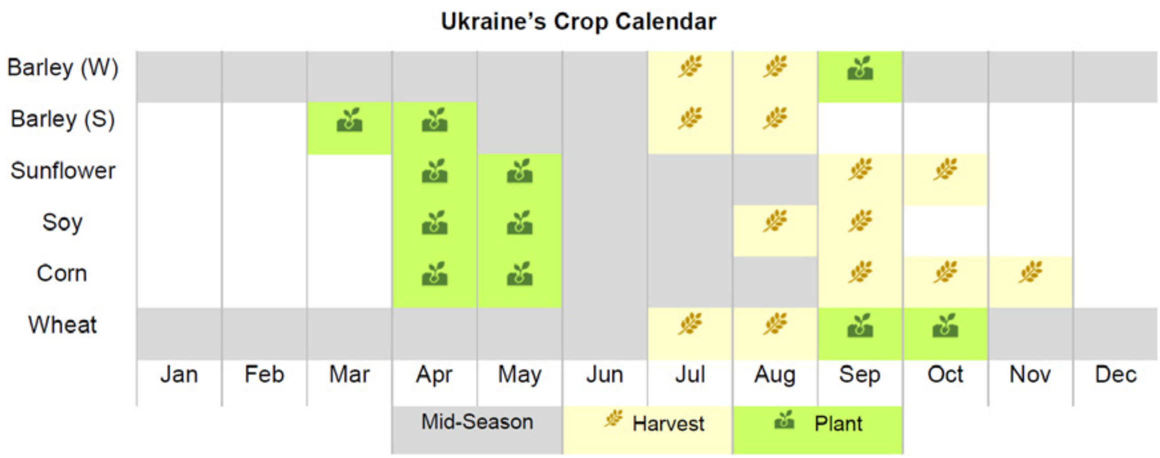
Commodity prices reflect a substantial war premium, but may be bound to rise further, as the war adds to fundamental constraints already in force before. The risk of higher prices is higher in commodities where either (i) supply constraints are significant, or (ii) where supply constraints are moderate, but demand is still very strong. The former includes agricultural commodities like wheat and corn. The latter includes energy commodities like oil and natural gas, and base metals like nickel, aluminium, and copper.



Source: Algebris Investments, Bloomberg. Data as of 28 March 2022.

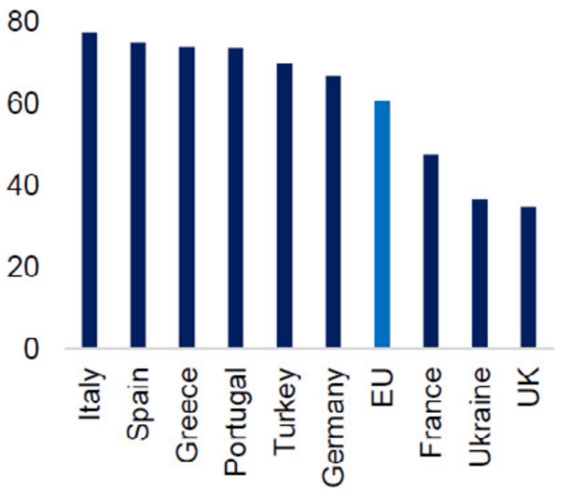
Agriculture – One year of lost harvest

Ukraine is the [breadbasket of Europe](). The country accounts for 10% of total global exports in wheat, 14% in corn, 17% in barley and 51% in sunflower oil. Corn, soy and sunflower are planted in April-May while winter barley and wheat are planted in July-August. One lost harvest is thus guaranteed in all agricultural markets. The US Department of Agriculture [estimates an 18% drop in corn exports in 2022](), and comparable drops seem likely in all the above markets. Grain shortages



Source: Algebris Investments based on USDA data affect the meat industry too, as feed turns scarce. For example, 55-65% of chicken production cost comes from the feed alone. Inflationary pressure from higher grain prices is thus likely to extend for one annual cycle and trickle down quickly on the broader food component of inflation.

Europe's Net Energy Imports as % of Total Energy Consumption



Source: Algebris Investments, Eurostat. Data as of 2019

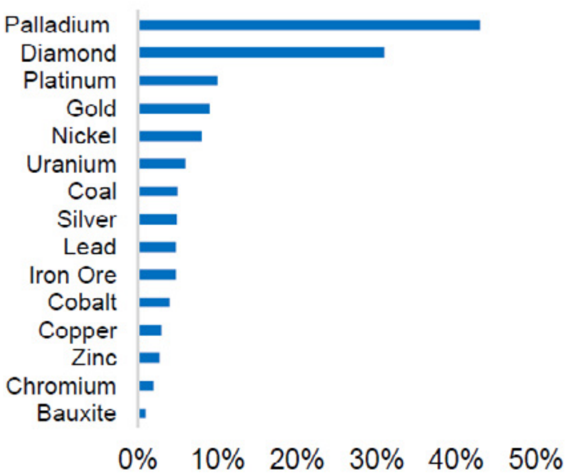
Energy – No replacement for Russia (yet)

Russia is a major global supplier in both oil and natural gas. Russian oil production is 11mbd or 11% of global demand. Overall, alternative sources may fill just half of the gap: the recent release of strategic reserves from the US may account for 1mbd, and 4mbd may originate from Venezuela and Iran, depending on how fast political gridlock is unlocked. Saudi's incentive to cooperate with the US remains low, as the recent OPEC decision underscores. On natural gas, Russian production accounts for 12% of global output. Europe in particular imports 40% of LNG from Russia. In principle, European countries have the infrastructure to replace Russian imports through excess capacity at LNG terminals, but physical constraints to the amount of gas that can flow via pipes mean no quick transition may be possible. The search for alternative sellers is more elusive than in oil markets as ability to supply is strongly linked to proximity.

Base metals – Several quarters to fix trade disruptions

Russian production is most important for precious metals (40% of global Palladium production, 10% platinum, 9% gold) than for base metals. Among base metals the more significant impact is on nickel (8% of global production), aluminium (14% ex-China production) and copper (7% ex-China production). The key question around reducing the supply/ production distribution is how long it will take for old trading channels (Russia with the West) to be replaced by new ones (Russia with China/ India). The answer depends on the market but generally speaking it will take more than a few quarters. For instance, GS research estimate rerouting Rusal aluminium supply to China could take "several quarters" and Russia-India are still in the early stages of discussing a Rubel-Rupee payment method outside SWIFT.

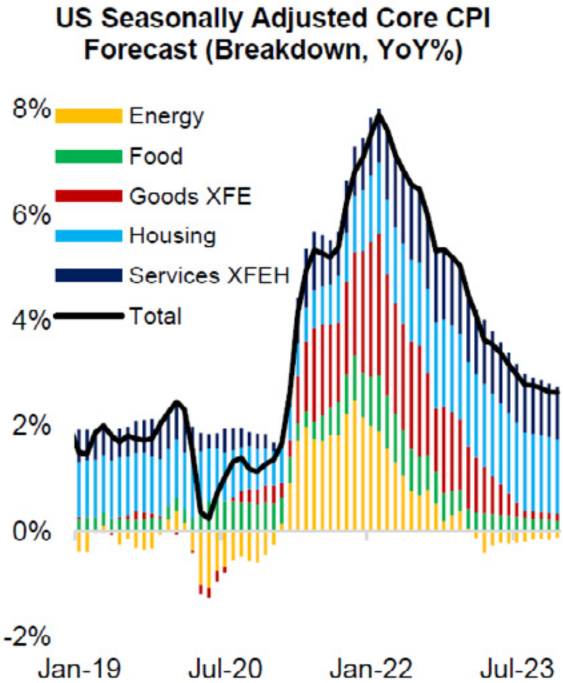
Russian Production of Metals - Share of Global Production 2021 (est.)



Source: Algebris Investments, Mining Technology. Data as of Dec 2021

Green infrastructure inflation – Elevated for base metals and energy

The invasion of Ukraine has further highlighted to governments the need for energy security. Increasing the renewable energy output is the only way to achieve energy independence for several countries, certainly core Europe. This transition to green infrastructure will create additional



Source: Algebris Investments, Bloomberg. Data as of February 2022.

demand for raw material and labour. According to GS research, to meet global green-goals (net zero, clean water), $6tn in annual green capital expenditure is required for the next decade, up from around $3.2tn invested per year between 2016 and 2020.

Copper is a good example of why the green infrastructure will contribute to commodity inflation. The excess demand for copper could result in a deficit lasting for the entire decade, reaching around 20% of annual demand by 2030. In comparison, China's property sector accounted for 10% of global copper demand in 2019. The copper example could extend to other base metals too, highlighting another channel that will keep metal prices elevated.

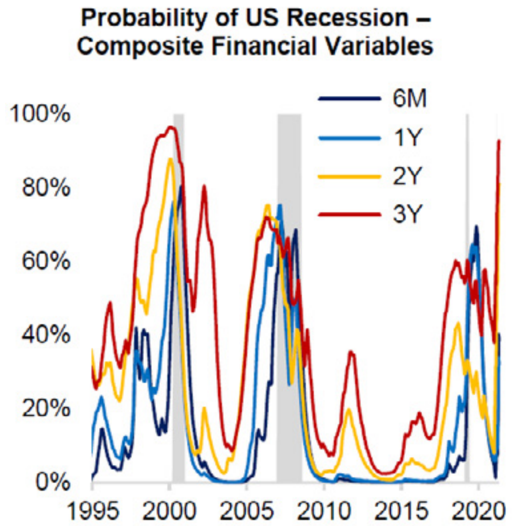
Inflation – Bound to stay high

In the US, food accounts for 15% of the CPI basket, in line with transport, and fuel accounts for another 5%. Core European countries have similar weights. The supply shock in commodities will thus continue to exert upward pressure on headline inflation in both the US and Europe. The March inflation print in Europe (7.5% yoy, 1.6% higher than in February) is a strong alarm bell. Food and energy contributed to over two-thirds of the print, and second round effects on core inflation are yet to be seen. The US may see less of a spike, given lower exposure and some peaks in bottlenecks from Asia. Still, the 2.5% 2023 consensus expectation for US inflation is likely to be seriously challenged by the sustained increase in commofity prices.

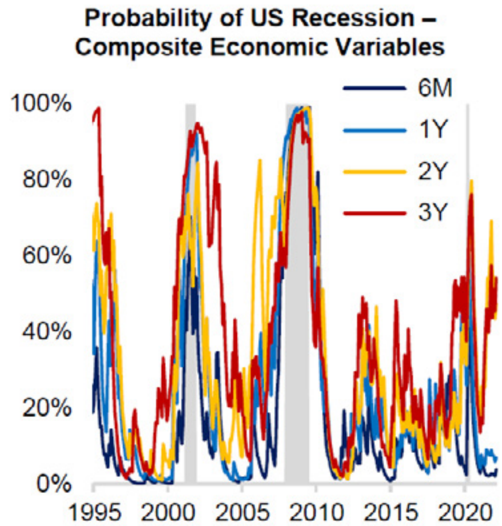
2. Recession fears - Vastly exaggerated

Rising commodity prices pose growth headwinds by squeezing households' disposable income and company margins, which in turn dampen consumption and investment. However, with strong growth momentum coming out from the latest Covid waves, we think a near-term recession is unlikely. Despite recent moderation, PMIs remain in expansionary territories, and unemployment rates are reaching record-lows in both the US and Europe. At the same time, households are sitting on around $2.5tn and €1tn of excess savings respectively, which should help cushion the commodity price shock and support a catch-up in spending on services.

To assess the likelihood of a recession in the US and Euro Area, we construct prediction models using different variables over different time horizons. Using only economic variables, our models suggest a less than 10% probability of recession in both the US and Euro Area over a 6-month or 12-month horizon, as macro data continues to be strong. In contrast, models using financial market variables such as yield curve steepness, credit spreads or equity market moves are pricing over 30% probability of a near-term recession in the US and over 50% probability of a near-term recession in Europe. The big discrepancy between implied recession probabilities of macro data and market variables suggest that recession fears are likely exaggerated, as our back-tests showed that models using financial market variables are more likely to give false positive signals over near-term recessions.



Source: Algebris Investments, Bloomberg, FRED-MD, ALFRED. Data as of February 2022. Note: For the US data since Jul-1963 covering 8 recessions, as defined by NBER. Gray bars denote recessions.



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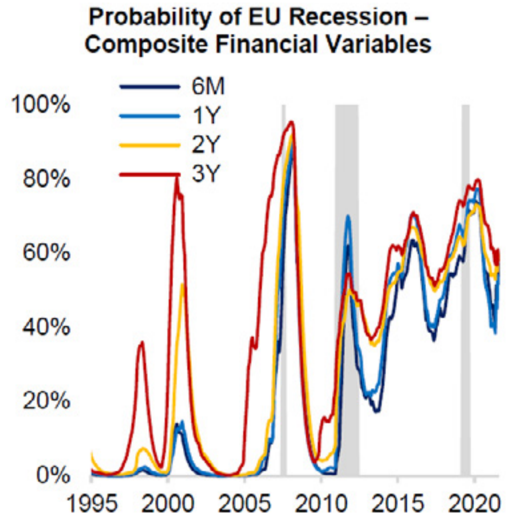
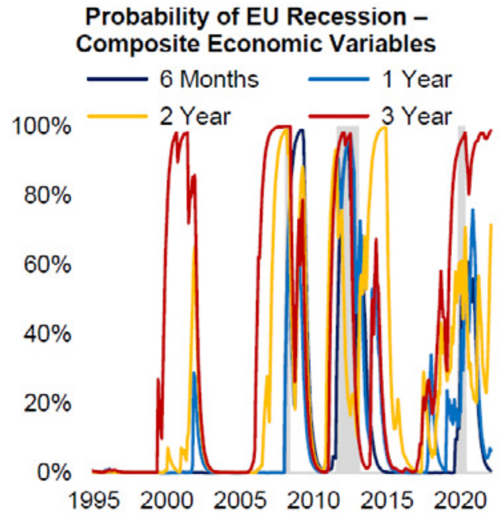
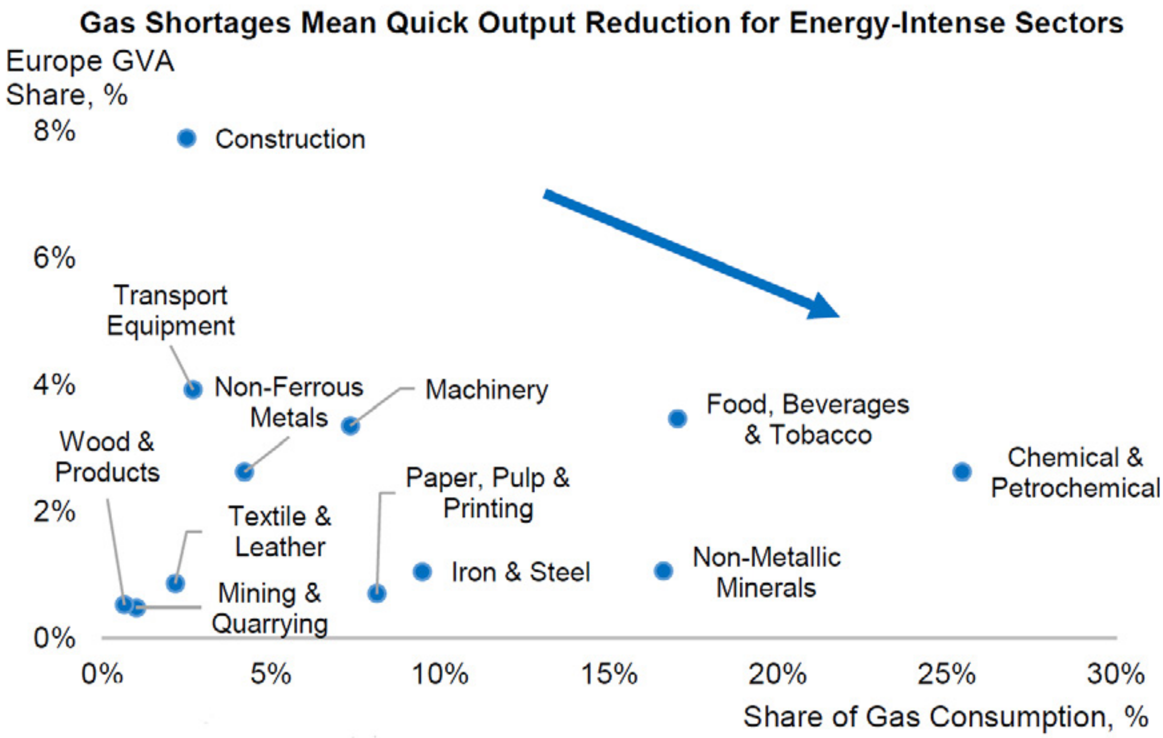


Source: Algebris Investments, Bloomberg, FRED-MD, ALFRED. Data as of February 2022. Note: For the Eurozone data since Dec-1986 covering 4 recessions as defined by EABCN. Gray bars denote recessions.



Source: Algebris Investments, Bloomberg, FRED-MD, ALFRED. Data as of February 2022. Note: For the Eurozone data since Dec-1986 covering 4 recessions as defined by EABCN. Gray bars denote recessions.

Risks, however, are higher for Europe. While the US is relatively shielded from the impact of the war, the Euro area is exposed to a protracted energy price shock as well as the tail risk of a complete cut-off of Russian gas supply. As Europe imports 35% of its gas from Russia, the latter would entail the need for energy rationing and forced production cuts for the industrial sector. According to our analysis of various industries' share of gas consumption vs GVA contribution, a full cut-off of Russian gas could mean a 2.8pp hit to the Euro Area GVA, even if we spread production cuts across industries in an optimal way to minimise GVA losses. In this scenario, Europe is likely to at least go into a technical recession. With Putin changing the rules for gas trading and calling for payments in rubles, such a risk is getting increasingly material.



Source: Algebris Investments, Eurostat.
Note: GVA stands for Gross Value Added
Data as of December 2020 for gas consumption and December 2019 for GVA share.

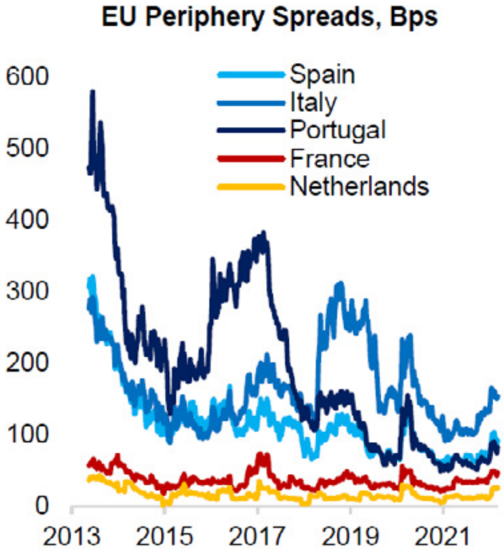
3. Central banks – The good, the bad and the ugly

Central banks globally are reacting very differently to rising inflation, as some turn very hawkish quickly while others remain behind the curve and deny persistent inflation. Their reactions are functions of domestic constraints – like high corporate or sovereign leverage, the economy – energy importer status, and politics.

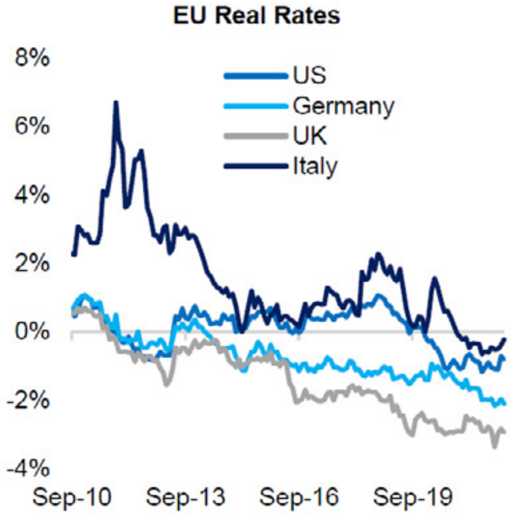
We see three different approaches to how monetary policy is being conducted. We call them the "Good", the "Bad" and the "Ugly". The "Good" central banks lie in economies in which bankers and politicians act in moderation, thereby stabilizing growth and managing inflation to moderate below peaks but above pre-pandemic levels. Sovereign debt deleveraging and structural reforms will lead these economies into state capitalism, and ultimately out of the QE infinity trap. We count the Fed and the ECB to this group.

The "Bad" central banks are those whose policymakers react in panic, causing credit crunches and demand destruction. A following recession ultimately causes inflation to retreat - meaning these central banks have committed a policy mistake and will need to continue to supply easy liquidity to fight low inflation. We include China's PBOC and Russia's CBR here.

The "Ugly" are central banks whose policy makers are in denial of inflation running above target, risking inflation expectations to de-anchor, asset prices to fall and their fiat currency to devalue. The result is a state of policy anarchy, whereby the people lose trust in the institutions. We see the Turkish central bank and (longer-term) also the Bank of England in this camp.



Source: Algebris Investments, Bloomberg
Data as of 01 April 2022



Source: Algebris Investments, Bloomberg
Data as of 01 April 2022

The Fed – Full steam ahead

The Fed heralded a prolonged hiking cycle for 2022 and beyond, with their first 25bps hike in March. Given low energy dependence, the US economy is less affected by the war, which allows the FOMC to focus on domestic macro. The US economy faces inflation well beyond target paired with historically tight labour markets, as February headline CPI at 7.9% and the March unemployment rate at 3.6% reiterated recently - leaving markets to wonder just how fast the Fed will hike. OIS markets currently price a rate of c.2.50% by December, implying hikes of more than 200bps over the remaining 6 meetings this year. Following the March meeting, the speaker narrative quickly shifted to a more hawkish stance, discussing multiple hikes of 50bps for the decisions in May, June and July. Next meetings will also bring more clarity regarding the pace at which $9tn balance sheet will be wound down. Given larger size than in previous tightening cycles, run-off caps for Treasuries and mortgages could be large, e.g. $60bn/$40bn per month, which would shrink the balance sheet to c.$6trn in 2.5 years.

While markets are front-loading the hiking cycle into 2022, chances for rate cuts amid recession fears are already implied further out in the curve: OIS markets are expecting cuts of 40bps and 30bps in 2024 and 2025, respectively. We see substantial upside to terminal rates beyond 3%, should the "policy-mistake" and therefore a recession not materialise. Simultaneously, despite typically weakening after the first hike as global central banks follow the Fed with hiking, we still see upside for the US dollar versus dovishly-anchored currencies like JPY or CHF, if the FOMC tightens by more than markets price today.

The ECB – Gradually pulling the plug

Given Europe's proximity to Ukraine and the country's high dependence on energy imports, markets long believed the ECB would prolong easy monetary policy, to avoid imposing additional stress on financial markets. Instead, the ECB surprised markets with a hawkish pivot, announcing a faster-than-expected tapering schedule to €40bn, 30bn, 20bn in April, May and June, respectively with the potential to terminate asset purchases thereafter. Most importantly though, the ECB decoupled the end of APP from the timing of the first rate hike, meaning the lift-off could come any time after June (instead of necessarily "shortly after" the end of APP). OIS markets price the ECB to hike 80bps by year end, and another 125bps in 2023 - arriving at a terminal rate priced at around 1.4%.

Sequencing was reconfirmed, although we believe a reverse order of hiking rates before ending QE could be beneficial to the block: The Eurozone's economy is much more bank-centric than the bond-centric United States, for example, hence bank lending activity is of greater importance for a functioning system. Higher (non-negative) interest rates would improve bank profitability and ensure continued liquidity access for European corporates. In addition, continued QE for longer would maintain stability in credit markets, thereby easing stress on government and corporate balance sheets. In addition, this would ensure the migration towards energy independence and ultimately promote green transition, as cheap access to funding remains in place.

The end of almost a decade of asset purchases in the Eurozone, when it comes, will result in material repricing of bond and credit across corporates and sovereigns: Spreads across IG, HY and periphery sovereigns have been artificially deflated and will see a new regime of higher, sustained volatility in credit, rates and FX markets along with wider spreads and higher yields.

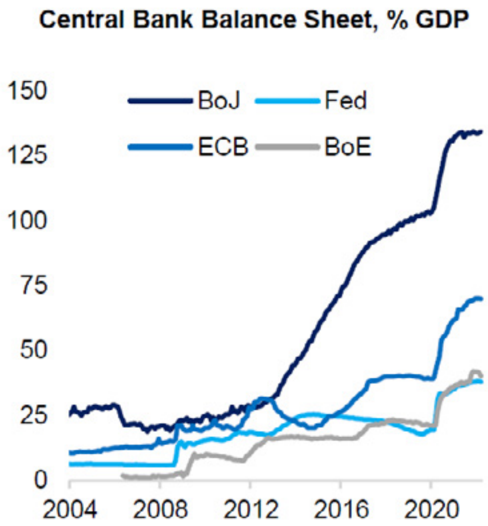
The BoE – Denying reality

Denial of reality can have ugly consequences, as is arguably the case for the Bank of England and England's economy. Last year's awkward hesitance between hiking and not hiking destroyed a lot of trust in central bank credibility, resulting in a material disconnect between market pricing and BoE communication: For March, markets were pricing almost 50/50 odds for a 50bps hike, instead a dovish 25bps hike followed with 1 dissent voting for no hikes at all. This raises question marks over the path ahead for the BoE, in light of record-inflation amid Brexit in addition to Covid and the war in Ukraine. OIS markets are pricing another 140bps of hikes this year, taking the bank rate to 2.1% by year end, which looks ambitious in our view in contrast to policymakers who show little willingness to guide markets and continue to emphasize risks to inflation as two-sided.

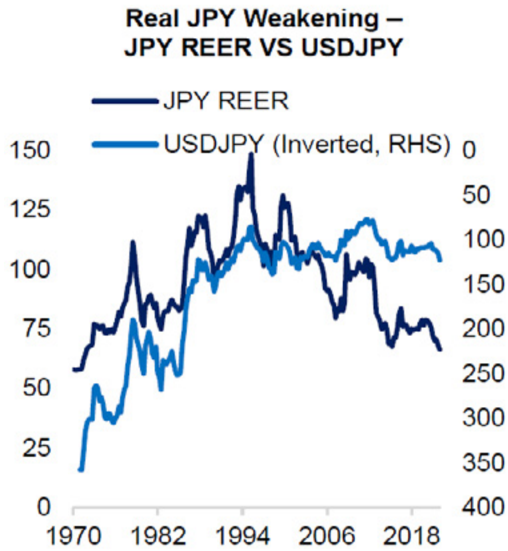
Besides eroding real wages in the UK, the GBP has lost any hawkish support and hence loses in value. We expect the GBP to remain weak throughout the year, especially versus currencies of hawkish central banks such as the USD or cyclical economies such as CAD, AUD or NZD.

The BoJ – The ultimate tail

Japan's central bank has stuck to a dovish policy for decades, most recently introducing yield curve control in 2016 to anchor rates for the economy. Ever since, the BoJ was forced to expand the tolerance band around the 0% target for the 10Y-point from initially +/- 10bps to now +/-25bps most recently in 2021. The strong commitment to printing new currency for bond purchases has led the BoJ firstly to owning the largest balance sheet as a percentage of GDP at 134%, secondly to them owning more than half of JGBs outstanding and thirdly, the real effective JPY weakening considerably since the 1990s. Despite ongoing, strong language and actions by policymakers to defend YCC - in our view either JGB yields, or the JPY will eventually have to give. Rates markets have already been challenging the BoJ to date, pushing 10Y yields close to the 0.25% maximum tolerable limit, triggering a purchase spree of bonds from 28th March onwards - which in turn led the JPY to weaken the most since 2015, to ¥125.



Source: Algebris Investments, Bloomberg
Data as of March 2022



Source: Algebris Investments, Bloomberg
Data as of 01 April 2022

USDJPY at ¥125 has been a sound-barrier in 2015 for the finance ministry to defend, and policymakers argue the weaker currency helps to raise inflation. In our view however, the artificial construct of keeping rates low and the currency not too-weak as the Fed pushes full-on, making the BoJ giving up either easy monetary policy or the JPY, the "ultimate tail-trade".

Rest of the world – Divergence ahead

Smaller central banks are diverging but can roughly be grouped together by geographic or political proximity. Banks of cyclical economies such as the BoC, RBNZ and Norges Bank have led the way of hiking rates in DM and their currencies continue to outperform versus more dovish G10 counterparts. In EM, Mexico and Brazil amongst others have followed suit, as commodity exports strengthen the economy.

The RBA instead has been hesitant to date, pointing to subdued wage growth to only pre-pandemic levels. Yet, markets are already betting the RBA will follow suit shortly: OIS forwards price 200bps of hikes this year with chances of a lift off between June and August, 135 bps next year and a terminal rate of 3% by December 2023 – the highest G10 rate by December 2023, after with the RBNZ at 4.3%. The Central Bank of Turkey is an outlier to date, as the CBRT instead chose to cut rates, pushing real rates even further into negative territory. We see no reversal of this policy under Erdogan and think the Turkish Lira will remain weak.

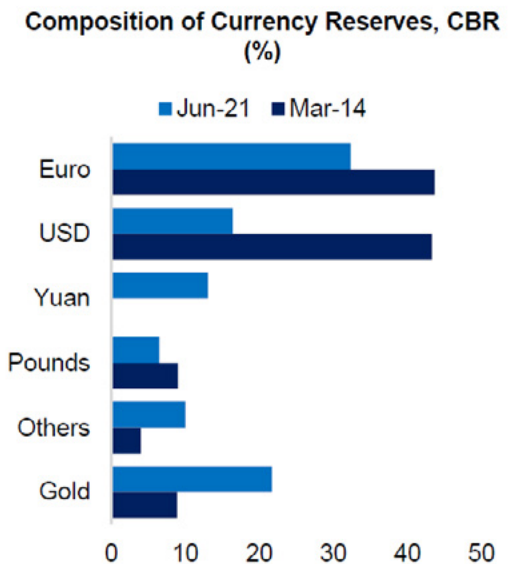
The PBoC looks caught on another planet, as the Chinese economy was overwhelmed by a drastic zero-Covid policy and a harsh clamp-down on the Real Estate and Technology sectors. After staying on the side-lines for so long and surprising markets by not cutting rates in March, the Chinese central bank will eventually need to ease policy to keep Chinese growth afloat - and follow suit on the easing steps recently announced by the Financial Stability Development Committee.

War - Local scenarios

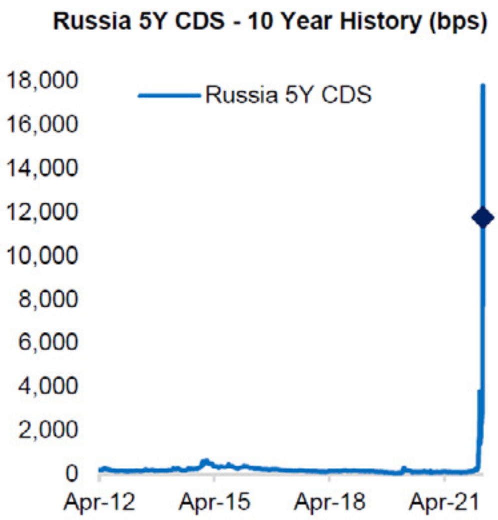
On February 24th, the Russian government ordered a "special operation" for the "denazification" of Ukraine. Since then, Ukraine has seen four consecutive weeks of full war. Russia de facto started a vast ground operation aimed at controlling the country, from East to West. Ukrainian resistance has been fiercer and more organized than expected, leading the operation to last longer than initially perceived. Currently, Russia claims the control of the East including some major cities. Kyiv and the center of the country are far from being controlled by Russia, while the West is still fully controlled by Ukraine.

Multiple negotiation rounds have taken place since the beginning of the war, without any leading to a truce or ceasefire, let alone a final agreement. More recently, Russian press has suggested that control of the Donbass region is the actual target of the operation. The claim falls short of initial Russian requests, which included broader territorial concessions and a strong commitment against NATO membership. This may suggest a prolonged military operation is not sustainable for Russia, and is in line with reports of higher-than-expected casualties on the Russian side.

Based on these considerations and the economic hardship imposed by the new regime of sanctions, we believe the war may last weeks, but not months. We would thus expect the two parties to come closer in terms of territorial concessions over the next few weeks. The key question for the global economy and markets would thus be how the past few weeks will shape the relationship of Russia with the rest of the world in the coming years.



Source: Algebris Investments based on CBR Data. Data as of June 2021



Source: Algebris Investments, Bloomberg. Data as of 11 April 2022

Sanctions - As tough as they could be

The West has refrained from sending troops on the ground and has reacted mostly via economic and financial sanctions towards Russia. Since February 24th, more than 3,000 new sanctions have been imposed globally on Russia, making it the most sanctioned country in the world by a good deal. The strongest measures have surely been the cut-off of Russian banks from the swift system and the freezing of Bank of Russia's assets. With these, the West has de facto reduced Russia's available assets by 90%, and dealt a huge blow to the Russian payment system. Following sanctions, dollars in the economy became scarce and the currency massively devalued, turning Russia from one of the strongest to one of the weakest countries by external positions, basically overnight. The one area in which escalation still has some room is in commodity exports.

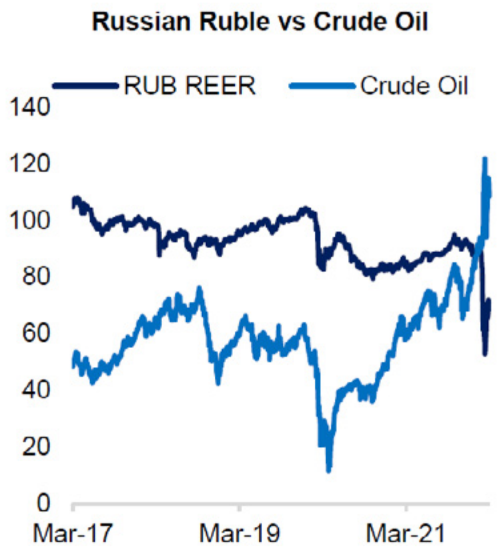
The West has so far refrained from banning commodity exports, especially as Europe struggles to replace Russian gas in a reasonable amount of time. The US has imposed an oil ban, but it is de facto meaningless for its imports. A prolonged escalation may thus see a cut-off of commodity exports as the next natural leg. Recent Russian requests to settle gas payments in rubles may be the first step in this direction. We think it's unlikely for sanctions to be reverted any time soon, even on a peace deal. A quick and broad deal could nevertheless pave the way for some relaxation of the hardest measures over time.

Russian debt – Default in sight

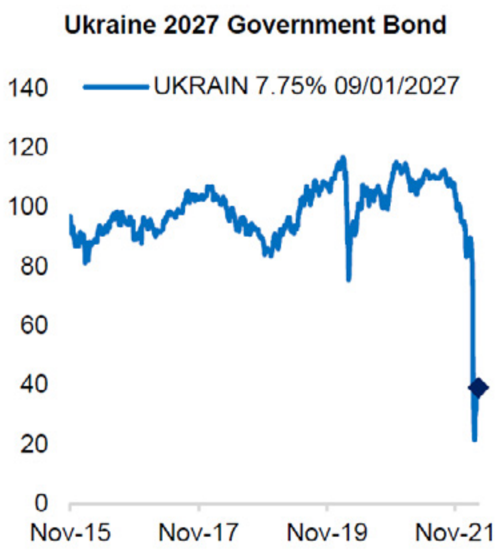
So far, Russian entities have remained current on their international debt. After a period of uncertainty, the government was able to pay investors USD coupons due in the third week of March. Corporates have also avoided default so far, with all coupons and principal paid to investors over the past month.

A default on international debt, however, seems at this point unavoidable in the next months. Recent comments from Treasury officials suggest the derogation to CBR freeze may not last long. The Russian Finance Ministry recently confirmed that April maturities were settled in rubles as the paying agent could not execute paying orders. Accounting for grace period, this would amount to a technical default by early May.

The Russian default may be technical for now but, as time goes by, ability to pay will be challenged too. With reduced oil exports, the 2022 current account may be in the order of $90-100bn, just above the $80bn of external debt coming due, making repayments tight over the next 12 months.



Source: Algebris Investments, Bloomberg.
Data as of 28 March 2022



Source: Algebris Investments, Bloomberg.
Data as of 28 March 2022

Finally, willingness to repay is unlikely to persist if sanctions stay in place. The government has already frozen local debt coupons and principal repayments for international investors, so some comparable action may become the norm on international bonds. Russian 5 year CDS, among the tightest spreads in global emerging markets until the end of February, now prices a 99% chance of default. Russian bonds have dropped fixed income indices and are now illiquid.

Russian economy – 20 years backward

Swift sanctions and the sudden lack of assets dealt a strong blow to the Russian economy. On Monday, February 28th, the ruble devalued 30% and the central bank was forced to hike interest rates by 12%, bringing the base rate to 20%. Following the currency crash, inflation is likely to reach high single digits, and tight monetary policy means no credit extension. The economy is thus likely to experience a deep recession, in the order of 7-8% of GDP. Banks have suffered runs initially, but the situation has stabilized following large liquidity injections from the central bank. Dollars in the economy remain scarce, and deep capital controls have been imposed since February 28th.

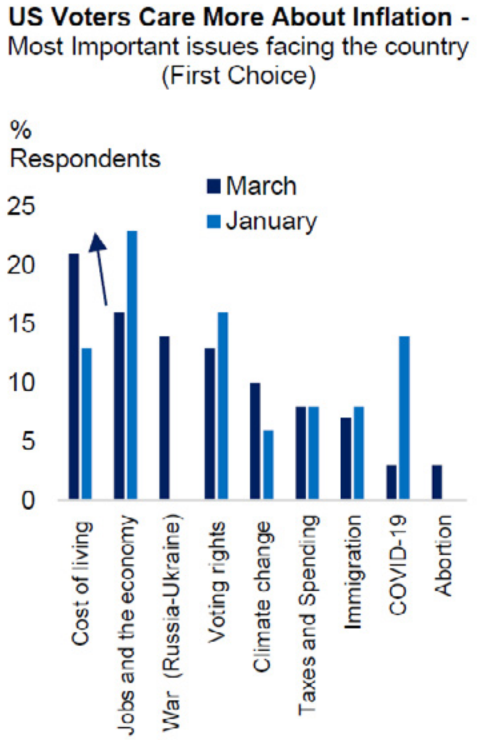
In practice, sanctions have cut Russia off from the global economy. Aeroflot has cut all international flights, meaning that, on top of capital, people's mobility is effectively restricted too. Gas and oil exports remain the only things that link Russia to the rest of the world, and the only source of hard currency. With most European countries making plans for energy independence in 12-18 months, a prolonged tension looks less and less sustainable. Russia thus managed to go back 20 years in just one week, and Russian isolation may now be the new normal.

Ukraine – Bond prices reflect permanent war

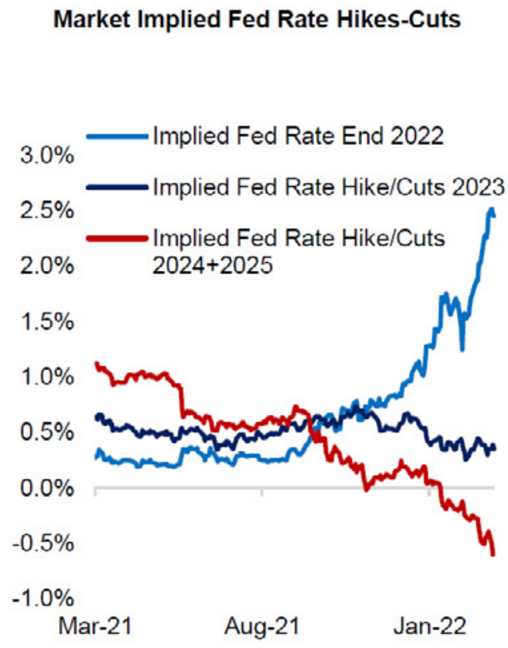
For Ukraine, a prolonged war means large economic damage. Initial estimates, though rough, quantify the destruction of the stock of capital of $100bn so far, or half of pre-war annual GDP. The war is thus likely to deliver a double-digit recession, and a strong increase in debt to GDP.

Still, the case for a worse-than-priced-in public debt restructuring is not clear-cut. Public leverage was low at the beginning of the war, around 50%. A bear case on GDP, like a 30% contraction in both 2022 and 2023, would bring debt/GDP to 120%. The IMF is likely to require haircuts on bondholders, but unlikely to require the country to de-leverage too aggressively. For example, requiring the country to reach 80% debt to GDP (similarly to Argentina, which has an IMF program), would mean a 40% haircut, making bonds worth 60 cents, versus the 40 cents level they currently trade at.

Current prices would be justifiable for debt/GDP equal to 170% or higher, suggesting current valuations reflect uncertainty over time of a ceasefire. Furthermore, the liquidity picture is likely to remain acceptable, with the country displaying $28bn in reserves at the end of February and capital controls imposed immediately, not to mention the c.$20bn of aid approved by the US and EU so far. Time is not on Ukraine's side, a longer war means higher damages, but current levels remain well undervalued vs plausible restructurings.



Note: 1000 adults interviewed for the polls in the survey. Source: Algebris Investments, NBC News Survey Study #220137. Data as of 18-22 March 2022



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Conclusions – Bond beta is dead, long live alpha

1. We see the Russia-Ukraine war as a symptom of a larger and longer development in history. Russia and China started their partnership in the '90s and tightened in after 2014. Over time, their strategy to hoard commodities and onshore the world's manufacturing made the world benefit from low prices – but vulnerable at the same time. The policy mix in developed economies, meanwhile, was complacently centred on a combination of tax cuts and low rates, which increased inequality and did boost productivity. Since the Trump administration, it had already become clearer that domestic issues had started to undermine the US economy. Inequality and lack of opportunity called for long-due reforms and provided fertile ground for populism, while at the same time taking away attention from foreign policy. The abrupt retreat from Afghanistan during the Biden administration confirmed this. Today, we face a world increasingly polarised in two. On the one hand, developed economies who import commodities and have outsourced manufacturing, where central banks keep interest rates well below inflation. On the other hand, emerging economies which own commodities and production lines, where policymakers still offer positive returns on capital – but where financial isolation threatens return of capital.

2. De-globalisation and polarisation mean the investable universe is shrinking.
Investors in government debt have two options. They can lose money *slowly*, buying government debt yielding well below inflation in developed economies, or they can lose money *quickly*, going into emerging economies where real yields are positive, but the rule of law might be challenged. What happened to Russia's local bonds, which currently pay coupons only in the domestic market, is a potential exam-

ple of what China and other emerging economies are preparing for. In a world where the historically dominant US is retrenching domestically, Ukraine's war might appear as a test in the context of a broader attempt to propose an alternative to the US dollar. China, too, has been working to promote a digital Yuan across belt and road countries, and has taken severe actions against foreign investors – for example pushing over half of its high yield market into default.

3. Inflation will be more persistent than market thinks, as a result of de-globalisation, persistent supply constraints, geopolitical tensions – e.g. in China-Taiwan – and adverse demographics reducing the supply of labour in emerging economies. In this context, central bankers fall from a goldilocks paradise into an inflationary inferno. Some will have the ability and willingness to react, like the Fed. Others will lack one or even both, like the Bank of England. Holders of paper assets like government debt will continue to be taxed: holding Gilts for ten years means losing over a third of capital against inflation.

4. With more geopolitical volatility and persistent inflation, credit alpha and a top-down/bottom-up combined approach are key to generate returns.
We have been net short Russia since January, and continue to be short issuers with high funding sensitivity, particularly in emerging markets. We believe recession fears in the Eurozone have been overstated, and that firms in developed markets will benefit from both shareholder and state support, offering strong returns for investors. While the bond market as a whole faces headwinds, volatility and fear usually offer a good environment for credit opportunities.

Notes

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Authors

Davide Serra
Founder & CEO

Sebastiano Pirro
CIO & Financial Credit Portfolio Manager

Gabriele Foà
Global Credit Portfolio Manager

Silvia Merler
Head of ESG & Policy Research

Tao Pan
Head of AI and Big Data

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