

The Silver Bullet

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2018: Irrational Complacency

*"Your loving give me such a thrill
But your love don't pay my bills
Now give me money
That's what I want"*
Money – Barrett Strong, 1959

Ten long years after the crisis, volatility and fear seem to have disappeared from financial markets. A synchronous global expansion coupled with persistently loose monetary policy has produced a goldilocks environment for all assets. Will it work for another year?

We have reasons to be cautious. Investors are not only searching for yield in bonds and stocks, but increasingly betting that volatility in asset prices will stay as low as it is today. Several economists and strategists have called this an environment of *rational exuberance*. Volatility and asset prices are justifiably low, they say, given healthy macroeconomic conditions. Believers in rational exuberance think central banks will continue to provide stimulus and that inflation will remain contained.

Yet there are chances that investors may instead be in a period of *irrational complacency*.

The signs of complacency and irrational behavior are widespread. Stock market realised volatility is at a 50-year low. The yield on European high yield debt has fallen below the one of US Treasuries (although it is still higher, including hedging costs). Developed and EM countries have issued 100-year bonds. The market cap of Facebook, Amazon, Apple, Netflix and Snapchat combined exceeds that of the DAX. Financial leverage is back, extending to collateralised debt obligations on bonds. Cash-park assets including property in large cities, art, collectibles and cryptocurrencies are soaring with a parabolic slope.

There are chances that tomorrow will be just as good as today. Markets have so far focused on the stock of \$20tn in central bank assets rather than the flow of purchases, which may turn negative next year. Even though central banks are withdrawing stimulus, growth is positive, financial conditions are still easy and liquidity is still flowing into risk assets.

That said, we believe the risks of a rise in volatility are growing, given the crowded one-sided positioning of investors in the same bets relying on market calm and tight yields.

This is why we believe investors must be cautious entering the New Year. We see three main risks which may break the current goldilocks environment: a return of inflation, a hawkish turn in central bank policy and geopolitical risk.

1. Inflation Surprises: The Fast and The Furious

Leon: "We got cops, cops, cops, cops!"

The Fast and The Furious, 2011

Inflation has remained elusive in 2017, despite continued monetary stimulus and disappearing output gaps. Stable inflation, long-end interest rates and term premia underpin a number of carry trades in rates, credit and currencies – a fast and furious return of inflation could bring volatility back.

How could it happen?

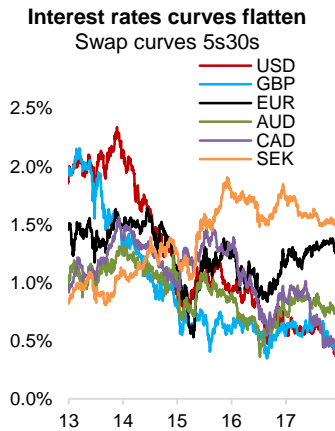
A first driver is fiscal stimulus. Over the first half of 2017, we saw a build-up in expectations on US corporate tax reform, which faded over the summer. This month, we are finally close to getting an economic boost from tax cuts. In Europe, the Merkel-Macron alliance post French elections provided a similar outlook, but recent negotiations in Germany have thrown cold water on the prospect of imminent fiscal and political integration. In the second half of 2018, however, and especially in the scenario of a grand coalition with CDU and SPD, who has been more vocal on European integration, we believe the final result will be more positive than markets fear. Finally, China was the big engine of global disinflation from 2012 to 2016. Continued price increases, similar to 2017, coupled with further Renminbi strength could translate into rising export inflation, which the world has not seen in quite some time.

Many investors fear a China debt crisis, as public reserves (\$3tn) start to be overshadowed by the amount of bank non-performing loans, shadow banking defaults and other losses by state-owned enterprises (\$1.5-2tn). But this analysis doesn't include China's private wealth amount, which at \$23tn is more than enough to support growth and economic rebalancing. Finally, **Japan** is showing tentative signs of inflation awakening; the government has recently considered declaring victory on inflation, albeit that may not come until later in 2018.

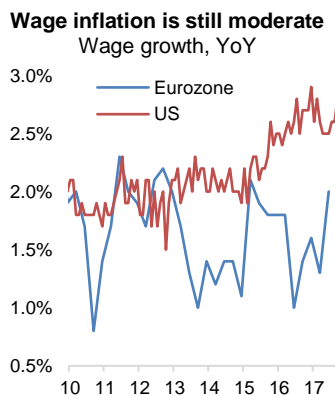
Aside from fiscal stimulus and supply-side inflation, demand could accelerate: even though interest rates have been low for years, the bank credit channel is only now starting to accelerate and lending to the real economy in Europe. Bank regulators across the world have been focusing on raising capital over the past few years, and this process may have finally reached a peak. Eurozone bank balance sheets have now declined to below 300% of GDP to €30tn from €35tn and over €250bn equity has been raised. The credit channel, more than market conditions, is what matters for small and medium businesses which generate nearly 80% of new jobs in the Eurozone, and more jobs mean eventually higher wages.

Finally, commodities may stage an unexpected comeback, despite persistent overcapacity. Fears of a Chinese deleveraging remain overdone, as discussed above, and OPEC members are as in need as ever to boost oil prices, given higher political tensions in the Gulf. This could see oil moving towards \$70 per barrel.

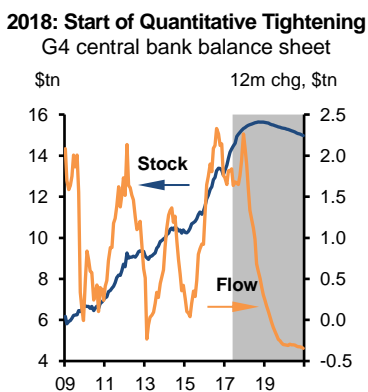
Our base case isn't an aggressive spike in inflation. However, the political push for fiscal stimulus across the US, Europe and Japan could be significant, if coordinated. This, coupled with increased bank lending and higher commodity prices could shift core inflation closer to 2% and move expectations higher, at a time where central bankers have almost thrown the towel on inflation and have become more hawkish regardless of it.



Source: Algebris (UK) Limited, Bloomberg



Source: Algebris (UK) Limited, Bloomberg



Source: Algebris (UK) Limited, J.P. Morgan Research

2. Central Banks Change Tack: Ocean's Thirteen

"Back to macro. What is your exit strategy? The players won't be in on the scam, so they'll all think it's their lucky night. But you'll never get them out the door with all their winnings. They'll dump it all back. That's Vegas, and that's your problem."

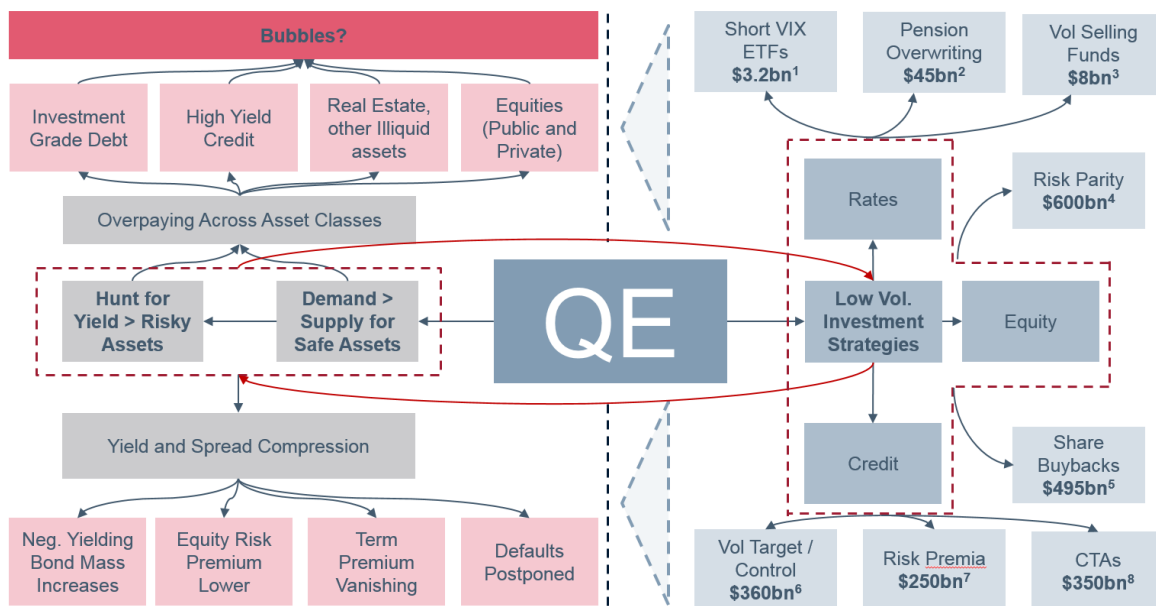
Ocean's Thirteen, 2007

What if central bankers decide to bring volatility back?

One reason to do so is financial stability, with the risk that persistent loose policy may be encouraging a number of collateral effects on the economy and markets. These include asset bubbles in interest rate sensitive assets, like bonds, high dividend stocks or property; but also a misallocation of resources to asset-dependent and leverage-heavy industries, like real estate or energy. The Bank for International settlements has long argued about these [collateral effects](#), and the potential *deflationary* consequences of keeping interest rates too low for too long, causing an asset bubble-burst cycle.

Another reason why central banks may be more cautious is politics. While monetary stimulus supported the recovery and job creation, it has also boosted inequality and disparities between the haves and have-nots, across geographies and between small and large corporations. As a result, continuing QE is becoming increasingly difficult, as shown by the political pushback in Germany, for example, or across the US.

The Magic Money Tree: How Investment Strategies Have Implicitly or Explicitly Benefited from QE



Source: Algebris (UK) Limited, *See Notes at the end for data sources on referenced strategies.

A final reason for central banks to withdraw stimulus is to build a policy buffer for a future slowdown. In light of upcoming changes in leadership at the Fed in 2018 and future changes at the European Central Bank and at the Bank of England, we think investors should prepare for a more out-of-the-money central bank put option.

In the movie Ocean's Thirteen (2007), Danny Ocean's team simulates an earthquake under the Casino they are trying to rob – prompting gamblers to run out from the exit door. This is how markets could look like on a sharp central bank policy change of tack.

3. Political and Geopolitical Risks on the Rise: WarGames

David: "Is this real or is it a game?"

Joshua: "What's the difference?"

WarGames, 1983

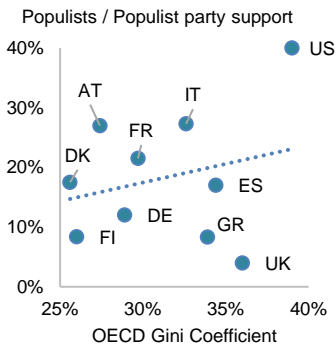
The most important risk we worry about long term isn't market positioning but politics.

Rising inequalities between the haves and have-nots across society and geographies are fuelling a polarisation in politics. The result is populist regimes, which generally carry three common elements: they pursue a dream, create an enemy to point people's angst at, and pursue unsustainable economic policies.

The Trump Administration's dream to revive America's past industrial success, or the UK's dream of a global Britain are both attempts to defy economic gravity in a world of global supply chains. Similarly, calls for independence across European regions to revive their past glory, ignore the need to pay for government infrastructure and security.

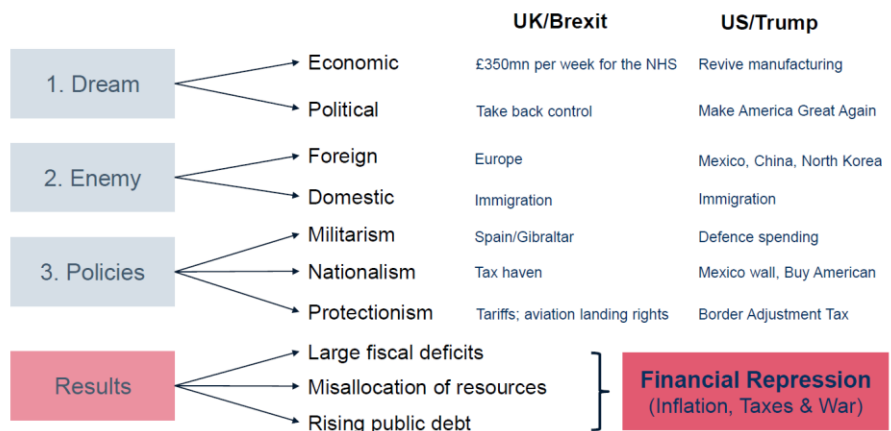
But even if political slogans are shifting further away from reality, the resulting policies are likely to have a real impact on the economy. Looking at historical examples, fiscal spending, protectionism and military activity are the most likely outcomes of populist regimes in the medium-term. All of them would be destabilising for markets used to low volatility and low inflation.

Higher inequality, stronger populism



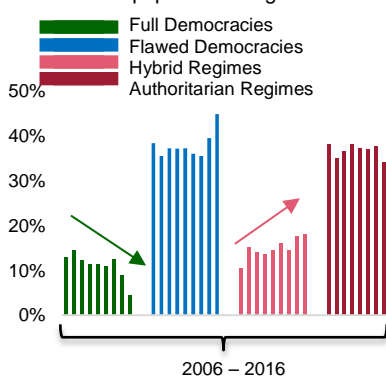
Source: Algebris (UK) Limited. OECD, Wikipedia. Populists/populist parties: Front National (France); M5S (Italy); Freedom Party of Austria; Donald Trump; Podemos (Spain); Danish People's Party; UKIP (UK); Finns Party; AfD (Germany); Golden Dawn (Greece)

Three Common Characteristics of Populist Regimes



Source: Algebris (UK) Limited

Full democracies are decreasing



Source: The Economist Intelligence Unit. Note: Population from country aggregates as measured by the EIU's Democracy Index

Brexit's disruption to the UK's trade, or the Trump Administration's threat to exit NAFTA are two examples of protectionist policies. The bigger, fundamental question remains open around the future sustainability of neoliberal capitalism, as we wrote recently on the [World Economic Forum](#). Capitalism has been incredibly successful at generating resources, but has failed to redistribute them. Absent policies to improve social justice and to redistribute opportunity, the drift from democracies to flawed democracies or authoritarian regimes is likely to continue (see left).

Polarised politics in turn can generate geopolitical conflict. We look at three hotspots where tensions could escalate in 2018: China, who continues to expand its projection of power in the seas of South East Asia; Eastern Europe, under the shadow of Russia's infowars and guerrilla tactics; the Middle East, where the Saudi Kingdom is fresh out of an internal purge and tensions with Iran continue to rise.

United States: Late Cycle Euphoria

*“Some folks are born silver spoon in hand
Lord, don't they help themselves, oh
But when the taxman comes to the door
Lord, the house looks like a rummage sale, yes ”*

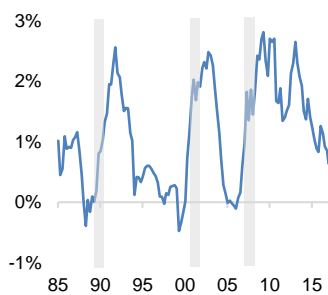
Fortunate Son – Creedence Clearwater Revival, 1969

We think the Congress will pass tax cuts by Q1 2018, despite the risks of President Trump's impeachment. Senate Republicans hold a fragile majority and are in disagreement with their House counterparts on the components of the tax bill. While we appreciate these challenges, we believe Republicans are aware of their need to demonstrate progress to their constituents ahead of mid-term elections, especially in the face of an unpopular President and the risk of losing seats to Democrats or more populist Republican candidates. Therefore, we expect Republicans will elect for the tax-path-of-least resistance, and the tax cut will cost less than \$1.5tr over 10 years (or \$1tr if existing cuts are extended), in [line with the Byrd rule](#). Therefore, the stimulus to the economy would be \$100bn per year or, maximum, 0.5pp of GDP.

We expect three Fed rate hikes next year in our base case. The Fed's current hiking path has been the shallowest in post-war history and is now potentially behind the curve. We therefore expect that next year, as with this year, the Fed will hike in line with its projections, even if inflation fails to accelerate. This bias towards over-hiking, rather than under-hiking is as: the economy is growing above [potential growth estimates](#), labour markets are at or near full employment, tax cuts have not been factored in to the Fed's rate hike projections and represent an upside risk to growth, the Fed needs to achieve an adequate rate-buffer before the next recession so as to avoid cutting into negative territory, and while the Fed has not labelled financial markets a 'bubble' it has indicated that prices are 'elevated'. In our view, for the Fed to hike fewer than its projected path in 2018, we would need a meaningful slowdown in wage growth, markets signaling a high likelihood of a recession in the near-term (e.g. a complete flattening of the yield curve), or for political risks to impair economic confidence or inflation expectations.

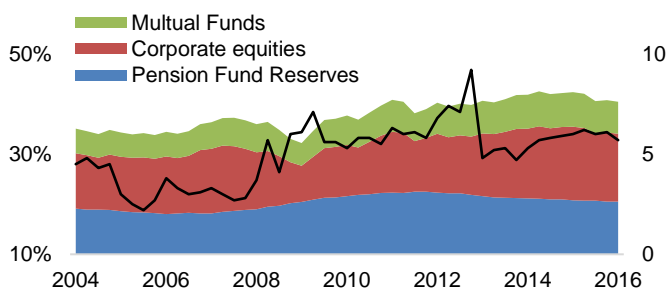
Tax cuts will support growth in 2018, acting as a tailwind to both consumption and capital spending. [By most measures](#), the economy is at the beginning of the late-cycle. Traditionally, this would imply that growth should start to moderate, though remain above [potential](#) of around 1.7-1.8%. [Over the last two years](#), the US had a strong tail-wind from consumer spending, which rose with falling savings rates. Consumer spending may have further legs, as a tax cut boosts disposable incomes, raises financial asset prices, and consequently household wealth. Tax reform may also incentivise capital spending, which gradually recovered from the lows of 2015 when profits of commodity and exporting companies were squeezed by a stronger dollar and weaker prices.

UST curve: recessionary signal?
2y10y yield curve, recessions



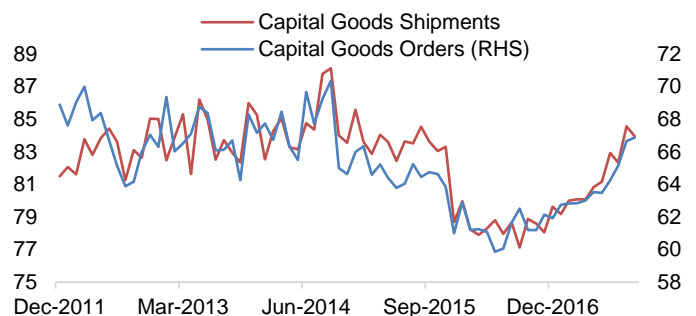
Source: Algebris (UK) Limited, Bloomberg

Lower taxes, higher asset prices, higher net income
Financial assets as % of HH assets



Source: Algebris (UK) Limited, Federal Reserve

Corporate tax cuts, may boost capital spending further
bn, \$

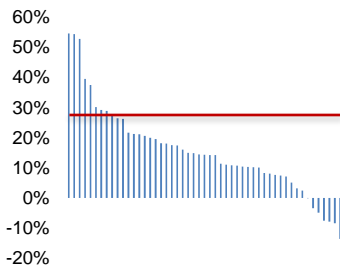


Source: Algebris (UK) Limited, Bloomberg

After 2018, slower economic activity and an ageing cycle may outweigh the benefits of a tax cut. Firstly, with fewer job gains and potentially only moderate wage growth, consumer spending is likely to slow. Secondly, [MIT research](#) has highlighted that corporates invest when they see an economic opportunity rather than because of lower interest rates, taxes or easily available credit. Therefore, higher capital investment from lower [taxes](#), may only be temporary. Finally, the Fed is likely to have hiked three times before year-end, and as a San Francisco Fed member [illustrated](#), economic expansions don't die of old age, they're murdered by rate hikes.

Wage inflation may rise only gradually next year, constrained by a recovery in workforce participation rates. This year, unemployment declined but wage growth decelerated. This deceleration may be as labour slack still persists in the economy. A proof of this slack is in the low participation rate of 25-54 year olds. According to [Fed data](#), nearly 2.6pp was shaved off this demographics' participation rate from 2008 to 2015. But since 2015, over a third of this participation has recovered, signifying almost 1.3m working-age individuals re-entering the workforce and looking for jobs vs around 3.5m of total jobs created. In other words, a third of labour demand was met by new supply, thereby lowering the need to raise wages. Therefore, wage growth's evolution depends on whether the outstanding 1.5-2pp of participation slack will re-enter the workforce or not. Next year, there is potential for some participation recovery, and therefore slower wage growth, if higher capital expenditure and [better wages for low-skill jobs](#) entices some men back into the workforce, who have lagged women in returning to the workforce.

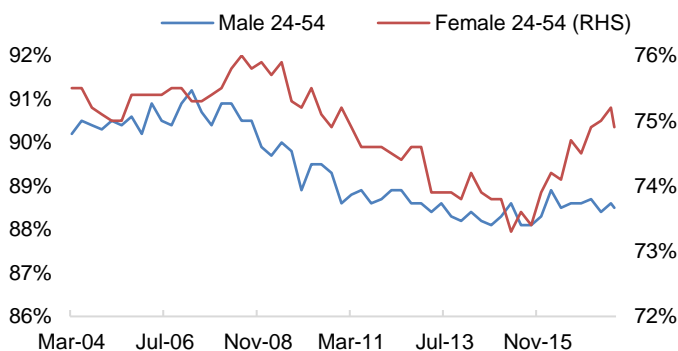
An unequal asset recovery
House px change since '08, by state



Source: Algebris (UK) Limited, Federal Housing Finance Agency

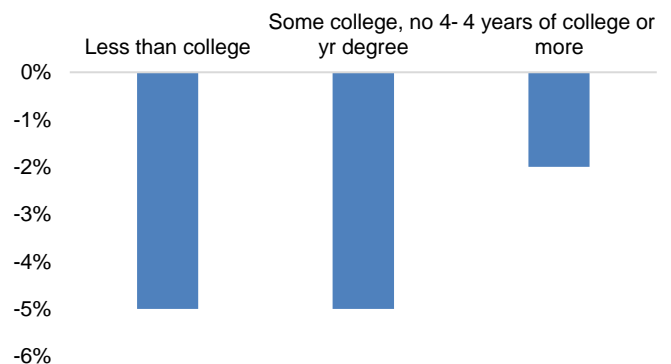
Fundamentally, a lower working-age participation rate is likely to persist unless structural inequality is addressed. While inequality has been high in the US for the last three decades, it has been further exacerbated by central bankers' response to the financial crisis. Global QE helped fuel an asset price recovery which increased the divide both between asset-owners vs income-earners, and also amongst asset owners (e.g. since 2008, house prices are up 20% in San Francisco, down 15% in Camden, NJ). One consequence of this growing inequality may have meant [fewer opportunities to access education](#). As low skill jobs face growing competition from technology, the inability to attain a college degree may have been a key contributor to a lower participation rate as this demographic has dropped out of the work force the fastest. With [nearly 2/3rd of jobs estimated to require a college degree by 2020](#), a policy response may be needed to tackle this structural driver of declining participation.

While women are returning to work, men are not..
Participation rate, %



Source: Algebris (UK) Limited, Federal Reserve, Brookings Institute

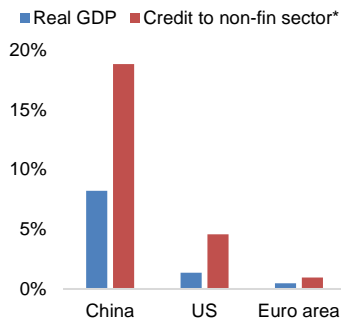
... Especially men without a college education
Participation rate, %



Source: Algebris (UK) Limited, Federal Reserve, Brookings Institute

Europe: less credit growth post-crisis

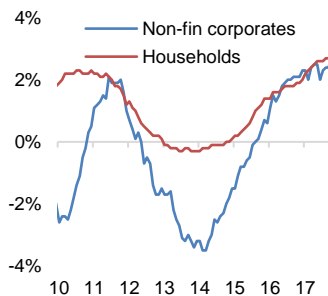
Annualised growth rate, 2008-17



Source: Algebris (UK) Limited, ECB, Fed, BIS, IMF. *Credit to non-fin sector: estimated using the sum of the size of aggregated bank balance sheets and corporate bond market size for the US and Euro area, and using BIS estimates for China.

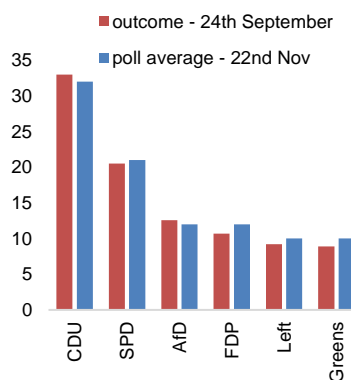
Banks are increasing lending

Eurozone bank loans, YoY%



Source: Algebris (UK) Limited, ECB, Bloomberg

Early elections in Germany may not change the outcome



Source: Algebris (UK) Limited, Bloomberg Poll of Polls.

Europe: Onwards and Upwards

The Eurozone has consistently beaten growth expectations over the past quarters, despite elevated political uncertainty in 2017 around major elections and Catalonia's push for independence. We expect the strong growth momentum to continue into 2018, as the Eurozone benefits from a still young credit cycle, slow ECB policy normalisation and an improving political backdrop.

Compared to other economies, the Euro Area has relied less on the credit lever to shore up growth post-crisis, which means there is more upside room from now. We are starting to see an acceleration in loan growth, as continued improvements in economic sentiments support loan demand and banks are finally more willing to lend, after years of deleveraging and capital preservation. This could be the start of a positive feedback loop, as better credit flows lend support to growth.

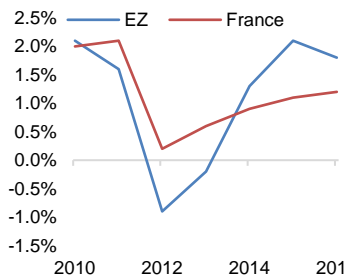
Monetary policy remains accommodative. Despite growth acceleration, the Eurozone still has a negative output gap and inflation is subdued with core CPI growing only 0.9% YoY in November. We are likely to see a modest pick-up in inflation as continued labour market tightening pushes up wage growth. However, the dilemma for the ECB is that there is a widening inflation gap between economies: the German economy is running hot with unemployment rate at record-tight and inflation close to 2%, yet others are lagging behind. This means the ECB is likely to stick to the slow normalisation path it [outlined](#), with QE extension until September 2018 and a rate hike much later, most likely only in 2019.

Political risks are subdued. Unlike this year, the Eurozone has a much quieter political calendar in 2018, with the Italian general election likely the most significant event. We also expect positive outcomes for the German coalition talks and the Catalan regional election. A lack of near-term election pressure may allow politicians to focus more efforts on pro-growth policies, and more importantly on strengthening the European institutions, which the Eurozone needs for long-term growth beyond the current cyclical upturn.

European Views by Country

Germany: Merkel weakened, but not out. Growth strong enough to withstand political noise. The disappointing election outcome for the Christian Democrats, and the subsequent breakdown of coalition talks with the FDP has significantly reduced Angela Merkel's political standing inside Germany, if not also internationally. Nevertheless, our base case is for the re-emergence of a 'Grand Coalition' between the CDU and SPD, especially given the latter's softening opposition to such an outcome. Opinion polls since the elections show little material change, reducing the incentive of parties involved to opt for early elections, and makes coalition formation more likely. Nevertheless, all this delays the Franco-German agenda to further the cause of EU integration. But it does not derail it. The political malaise also makes the adoption of a more expansionary fiscal policy in Germany less likely in the near future. This does not make us bearish on German growth. Private consumption and investment both look strong, and we expect them to provide support for the economy in 2018. Although headline inflation has increased to near 2% on higher energy prices, core remains subdued close to 1%. Despite economic strength, it is difficult to see core inflation increasing sustainably and substantially. The upcoming round of wage negotiations should give an indication of how core inflation may evolve in the next twelve months. The Metal and Steel sector has kicked off the process with a 6% wage increase demand from IG Metall. The final outcome has settled at 50% of the initial demand on average over the past twenty years. That points to a 3% final settlement. Better than previous years, but not enough to change the calculus on overall inflationary dynamics in Germany.

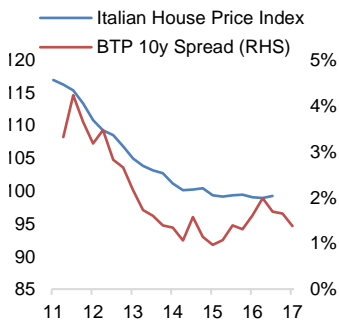
France's recovery lagged the EZ's Real GDP growth, YoY %



Source: Algebris (UK) Limited, Bloomberg

France: Macronomics to the rescue: Since 2013, the French economy has benefited from a cyclical recovery in the Eurozone, without doing much of the heavy lifting. As a consequence, France's economy grew but lagged the sharp recovery in the rest of the Eurozone. This dynamic may change over the coming years if President Macron delivers on his policy agenda as outlined in his [2018-2022 budget plan](#). We see a high chance of the budget passing, given President Macron's majority in the more powerful Assemblée Nationale, and as we see think the constitutional court is unlikely to block these budget measures. We think the President will implement the plan as outlined, despite his lower approval ratings since being elected and [higher dissatisfaction from poorer and younger voters](#). The budget aims to tackle France's structural uncompetitiveness by converging corporate and individual tax rates to their EU averages, and reducing labour market rigidities which have kept unemployment elevated at above 9.5%. The budget anticipates faster growth as a result of these policy measures and estimates a reduction in the fiscal deficit to below the threshold as defined under EU deficit rules of -3% of GDP; France has only been under this threshold for a third of the time since 2000. Maintaining these deficit targets would demonstrate France's respect for EU fiscal rules, strengthen its leadership position at the EU level and, ultimately, help further President Macron's European integration agenda with his German allies.

Italy: Stabilizing risks, economy Italy House Prices, 10y Italy Spread



Source: Algebris (UK) Limited, Bloomberg.

Italy: light at the end of the tunnel. Italy has been one of the laggards, not only in the recent Eurozone recovery, but over the past decades. At the root of the problem are issues which include a slow and uncertain legal framework, an inefficient public administration and banking system, which have failed to support small and medium businesses, and a lack of access for firms to capital markets and other economies of scale. Today, almost one third of Italians are at risk of poverty, according to Eurostat.

That said, there is some hope of a broadening recovery. House prices have bottomed. UniCredit, Italy's largest bank by assets, [sold around a tenth of the country's stock of bad loans](#) in July, in one transaction alone. Investment in real assets and businesses is starting to come back. The IMF forecasts real growth at 1.5% in 2017 and 1.1% in 2018. The current government, even though relatively slow on reforms, implemented measures which have helped firms to get more efficient funding, including a still-in-progress consolidation of the *Popolari* banks, and the launch of *PIR* funds, which allow citizens to gain tax-free investment in Italian small and medium businesses – utilising the country's conspicuous savings, over 8x incomes, to fund local businesses and jobs.

Greek debt – ready to fly alone? 10yr GGB spread to Bunds, bps



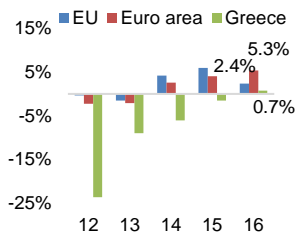
Source: Algebris (UK) Limited, Bloomberg.

Recent regional elections in Sicily have seen a potential return of the centre-right party (PdL). The [outlook for national elections](#), yet to be announced, is uncertain. However, the most likely scenario remains a coalition potentially with the centre-left (PD) and the PdL. While coalitions have proven fragile in the past, the track record of the Renzi-Gentiloni government remains above the previous average. Italy's challenge will be to reform its legal system, improve the profitability of its medium and small banks, and unshackle its manufacturing and services sector by giving small businesses room to grow and consolidate.

Greece: A successful debt exchange and review add momentum for a bailout exit. We have been long the Greek sovereign throughout 2016 and 2017, as we discussed in our February Silver Bullet – ["Greece: More Melodrachma, No Default"](#). In the past few months PM Tsipras has acted more like an EU pragmatist than the head of the Continent's erstwhile most firebrand populist party. In our view his motivation, aside from staving off default, has been the recognition that to achieve a political solution on debt relief, Greece would first have to build political capital to make its case, by meeting the minimum of its creditors expectations. The changed approach to budget adjustments and tax reforms has been strongly reflected in

Greece: Lack of capital investment

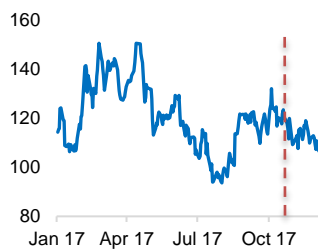
Gross fixed capital formation, current prices, % yoy change



Source: Algebris (UK) Limited, Eurostat.

Spain spreads near pre-ref. levels

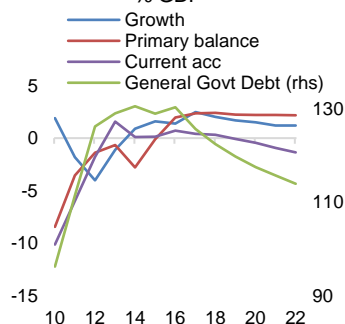
10yr SPBG spread to bunds, bps



Source: Algebris (UK) Limited, Bloomberg.

Portugal: broad based Improvement

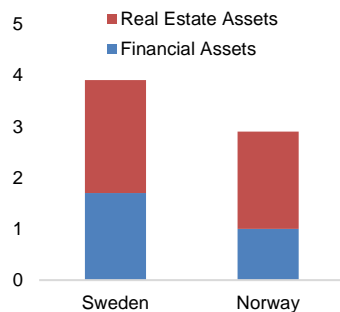
% GDP



Source: Algebris (UK) Limited, Bloomberg

Scandinavia: real estate wealth

Household assets to debt, x



Source: Algebris (UK) Limited, GS Research

Greece's primary surpluses – the Government is on target to meet its [2.2% goal for this year](#) – and obtained a credit market payoff, with GGB 10 year yields trading below 5% for the first time in November since 2009, following the successful €30bn [private debt exchange](#).

Greece's 2018 will be the defining year for its debt restructuring odyssey. By [January 11th](#) the Greek Government must legislate to implement dozens of structural sector reforms, a requirement to obtain the next €5.5bn disbursement of funds in the program. After years of savings destruction and capital flight we think these reforms are critical to stimulate FDI into Greece and generate above-replacement rate investment, which it will need to deliver the additional growth required to meet ambitious 2019 ECB targets for [NPL reduction](#) – progress to date should be visible in stress tests [due June](#). Owing to the PM's drive to deliver a bailout exit, we think Greece will meet the January deadline. However, the bigger uncertainty will come in form long-term debt relief discussions with creditors. These are a necessity to [enlist IMF support](#), and we think will dictate market sentiment *vis-à-vis* a bailout exit, as well as any potential inclusion of [Greek debt into QE](#).

Spain: Beyond the fog of December's Catalan Election... a Spanish General Election?

Spanish government credit spreads have recovered from October's turmoil following the application of article 155. We expect political normalization in Catalonia after the December 21st election, however investors are too optimistic in pre-pricing the loss of a [Catalan independentists majority](#). Should the Independentist block fail to reach a majority, we think far left *Podem* may join them as a coalition partner, although the resulting government may not pursue the radical independence agenda with the same fervour as seen in the past three months.

2018 however, may bring into focus the long-term structural implications of Catalonia's political developments. The [promised Constitutional reform](#) review could raise the possibility of a deep overhaul of Spanish regional financing models, which might ultimately lead to concerns over the Central Government's ability to reign-in spending. Due to the lack of consensus over any such constitutional measures however, we think there is a chance for early elections to be called in 2018, more so due to the recent strengthening of both PSOE and Ciudadanos in the polls at the expense of Podemos (and PP, to a lesser extent). This should undoubtedly tempt party leaders Sanchez and Rivera if they can see a path forward to a coalition.

Portugal: More of the same in 2018 to elevate Portugal to full IG. We expect much of the improvement in macro balances observed in 2017 to be continued into the year ahead. Growth momentum is likely to wane, but should remain healthy at around 2%. Domestic demand shows signs of resilience, boosted by improved consumption and investment, whilst external demand conditions should continue acting as a tailwind. More importantly, the improving trend in fiscal discipline is likely to continue unabated. The IMF forecasts debt to GDP will stand at 122% of GDP by end-2018, marking an 8ppt decline over three years. In September, S&P became the first agency to restore Portugal's rating to investment grade after its fall from grace in 2011. We expect Moody's and Fitch to follow suit over the next 12 months.

Scandinavia: Monetary tightening and property overvaluation. Swedish and Norwegian central banks pursued easy monetary policy following the crisis, in line with their global peers. Both economies have benefited, with [inflation and growth estimated near 2%](#) next year (IMF). However, this monetary easing has contributed to a nearly 50% increase in house prices over the last four years and household indebtedness is now among the highest in the world. A rate hike and possibly weaker housing market could dampen domestic consumption and growth, as while Swedish and Norwegian households are wealthy (over 3x assets to liabilities), nearly 2/3rds of that wealth is in property. Both central banks have previously signalled the risks from the housing market, but highlighted a '[leaning against the wind](#)' approach. We expect they will maintain this hawkish bias next year, though signal a gradual monetary tightening.

United Kingdom: Walking a Tightrope to Nowhere

Billy Ray Valentine: "Yeah. You know, it occurs to me that the best way you hurt rich people is by turning them into poor people."

Trading Places, 1983

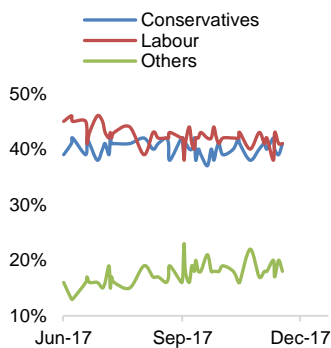
Brexit negotiations will exacerbate government stability worries. The UK managed to eke out an [agreement](#) that should ensure Brexit negotiations move on to trade discussions by end of December. There has been, for now, no surprise House of Commons revolt by Conservative MPs or the DUP to topple PM Theresa May despite her willingness to [make ample concessions](#) in pursuit of moving forward the negotiations. Both of these groups have made enough [dire warnings](#) for there to be binary risks to government stability throughout 2018. We think their willingness to tolerate concessions bodes positively for the political survival of PM May, subject to the generosity of the EU's trade proposals. Outside of a breakdown in EU/UK negotiations, we believe no wing of the Conservative Party wants to risk [a general election](#) by challenging the PM, owing to a lack of consensus candidates who may command full support of the Party, as well as the Conservative's minority in Parliament.

Downward revision to future productivity growth will revive inflation-control vs stimulus debate. The Office of Budget Responsibility ("OBR") downgraded its estimates for growth and productivity after [years of undershooting forecasts](#). Market sentiment, however, continues to find support on hopes a trade deal will be struck now.

Bank of England leadership uncertainty in 2018. The BoE's November rate hike lent credibility that policy makers would be willing to move to tackle rising inflation despite a slowing economy and Brexit risks. We worry however whether Carney's successor, due to be selected in Q4 2018, will have the same credibility to manage expectations as well as he has. A transitional agreement, whilst critical for business and consumer confidence, will generate years of uncertainty over the UK's long term outlook. The next BoE Governor will have to navigate with above-target inflation and a weaker economy.

Labour the next likely Government if real income crunch continues. Whether an election is called in 2018 or at its scheduled date in 2022, we think that Labour's spending [campaign promises](#) will continue to resonate with voters. The conditions that allowed for their strong performance in 2017 will only grow over time, as the generational wealth divide continues to widen – with housing affordability decreasing, real incomes being squeezed and the unwinding of [UK consumer leverage](#) magnifying the impact of a potential downturn. We believe markets currently do not price in the tail risk of extreme Labour policies.

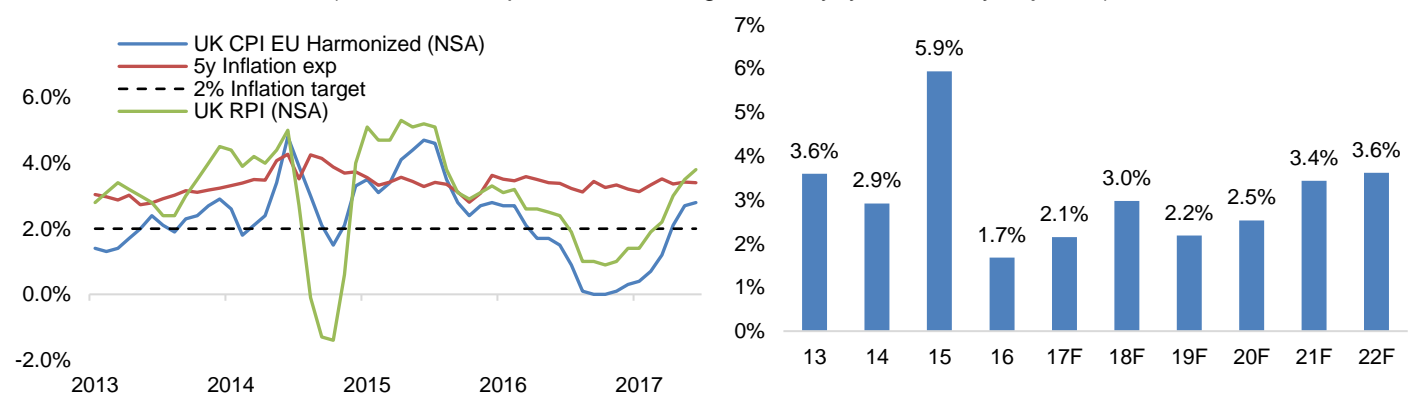
Labour gains maintained
UK general election polling



Source: Algebris (UK) Limited, Wikipedia.

Current and forward inflation expectations leave households with barely any real income relief

(Household disposable income growth, % yoy seasonally adjusted)



Source: Algebris (UK) Limited, OBR, Bloomberg

Source: Algebris (UK) Limited, OBR, Bloomberg

Japan: Too Early for Policy Normalisation

"Time solves most things. And what time can't solve, you have to solve yourself."

Dance Dance Dance – Haruki Murakami, 1988

Japan enjoyed robust and balanced growth in 2017. A subdued trade-weighted currency and stronger global trade growth have supported net exports, domestic demand has picked up thanks to improving consumer and business sentiment, with private consumption and investment contributing to over half of GDP growth in Q1-Q3.

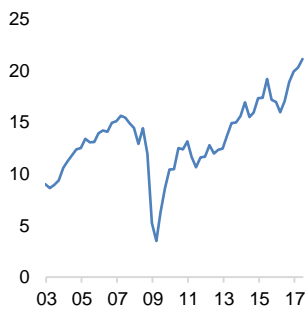
Positive growth is likely to continue into 2018, with continued policy support from the Abe administration post a successful re-election. A tight labour market and rising income will likely support consumption. Companies are stepping up capex on productivity-enhancing investments like IT and automation. After winning a majority in the lower house in October, PM Abe reaffirmed economic stimulus pushing a ¥2tn FY2017 [supplementary budget](#) focusing on educational aid for low-income households and elderly care. Abe aims to stay in office until fall 2021, meaning he needs to win a third term as chief of the Liberal Democratic Party next year. Strong economic performance will be key to keep approval ratings up.

The BoJ will continue monetary easing, given below-target inflation. Recent [comments](#) by BoJ Governor Kuroda on a "reversal rate" has sparked [speculation](#) about an earlier than expected policy lift-off. However, inflation remains subdued with core CPI (ex. fresh food) growing 0.7% YoY in September and the BoJ's new core CPI (ex. fresh food and energy) a mere 0.2% YoY. This is despite that Japan has been growing above potential since mid-2015 and unemployment rate is at decade-low of 2.8% as of September. In our view, the BoJ will not risk moving prematurely without a more substantial strengthening in inflation. It could become more flexible about yield curve control targets, if growth and inflation momentum continue, but it is still too early to talk about an exit from QE or negative rates. We expect no change to the BoJ's policy stance after Governor Kuroda's current term ends in April 2018.

Spring wage negotiations could create inflation surprises. Demographics aside, a rigid wage system has also prevented a faster transmission of growth overheating into inflationary pressure. In Japan, wage rises are negotiated between trade unions and big businesses in the annual [Shunto](#) in spring, and a large part is based on seniority increase and inflation of the previous year. This creates a negative feedback loop, where low inflation in the past leads to low future wage rises. There could be positive surprises at the next [Shunto](#) in spring 2018, as firms become willing to increase the discretionary part of pay rises following continued profit growth: PM Abe called for a 3% wage rise in FY 2018 vs around 2% over the past four years.

Corporate profits continue to rise

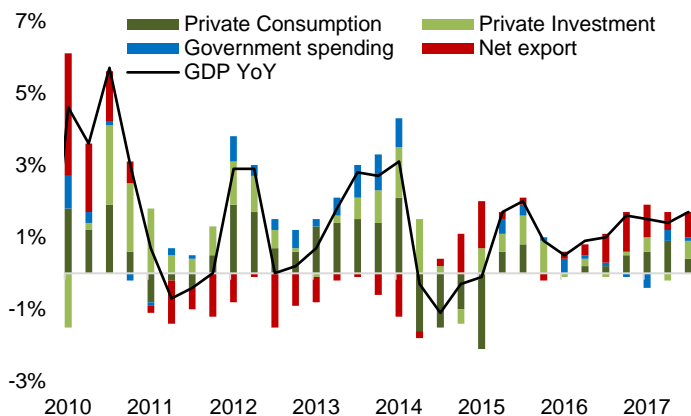
Japan Quarterly Corporate Current Profits, ¥tn



Source: Algebris (UK) Limited, Ministry of Finance Japan, Bloomberg

Japan: A well-balanced recovery

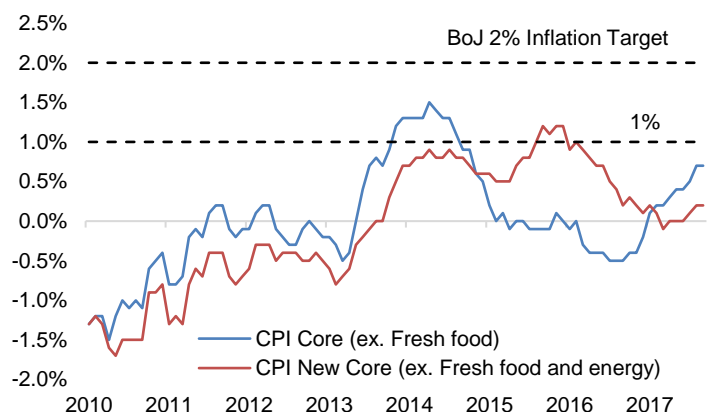
Contribution to real GDP growth by segment



Source: Algebris (UK) Limited, Japan Cabinet Office, Bloomberg

Inflation: Still a long way to go despite positive signs

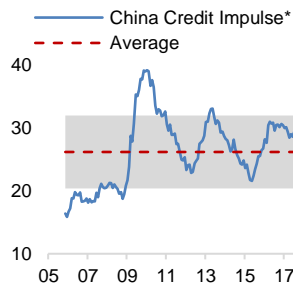
CPIs adjusted for 2014 Consumption tax hike



Source: Algebris (UK) Limited, Japan Cabinet Office, Bloomberg

China: Targeted Tightening to Continue

Credit growth is moderating
Grey area = +/- 1 s.d.



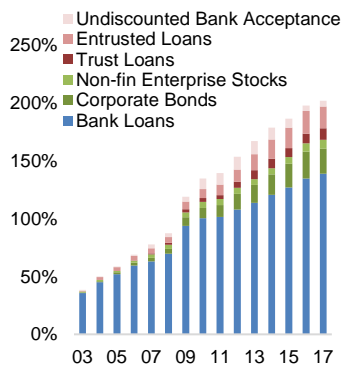
Source: Algebris (UK) Limited, Bloomberg. *Bloomberg China Credit Impulse, measured by new credit as a percentage of GDP.

“The principal contradiction facing Chinese society has evolved, as socialism with Chinese characteristics has entered a new era. What we now face is the contradiction between unbalanced and inadequate development and the people’s ever-growing needs for a better life.”
Xi Jinping at the 19th NPC, October 2017

China defied market expectations in 2017 by delivering stronger than expected growth without adding too much to its existing debt pile. On the one hand, fiscal stimulus introduced in 2016 led to a rebound in investment growth in H1 and consumption growth has stayed robust. GDP grew 6.9% YoY for Q1-Q3 vs annual growth of 6.7% in 2016. On the other hand, stable capital flows and moderate inflation have enabled the PBoC to focus on financial deleveraging and tighten financial conditions, albeit cautiously. Total Social Financing (TSF) as a % of GDP rose by 4pp in Jan-Oct, below an average of 12pp annual growth for the previous five years.

Into 2018, we expect China growth to decelerate as stimulus effects fade and the government prioritises “quality growth” over “quantity growth”. At the October National Party Congress (NPC), President Xi [re-affirmed](#) the commitment to economic transition and deleveraging. Specifically this means continued efforts to cut industrial overcapacity, stepping up environmental protection and stemming speculative activities in the real estate markets. In addition, the PBoC is likely to continue its cautious tightening to guard against financial risks, as confirmed by [recent comments](#) by Governor Zhou on a “Minsky moment”.

Shadow bank lending has slowed
TSF breakdown, % GDP

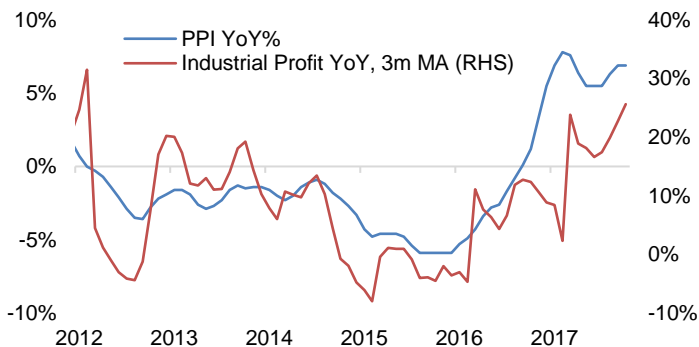


Source: Algebris (UK) Limited, NBS, Bloomberg

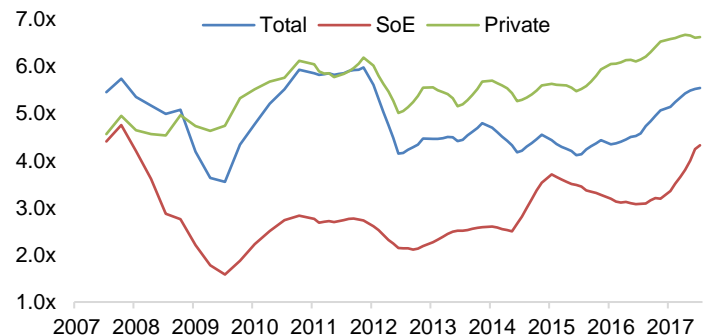
Despite deleveraging progress this year, China’s overall debt remains too high at 298% of GDP, almost twice its pre-2008 level (IIF). Historical examples have shown that such rapid pace of debt accumulation was often followed by periods of sharp credit and economic contractions. It is even trickier in China’s case as it needs to avoid growth falling off the cliff as the economy transitions to a consumption-driven model.

However, we think China may prove more resilient in juggling between deflating its credit bubble and managing a controlled slowdown. First, macro policy has been moving in the right direction. From the government’s side, a defocus on absolute growth targets and continued supply-side reforms should help further reduce industrial overcapacity. China’s overall industrial capacity utilisation rate for Q1-Q3 2017 is 76.6%, up 3.5pp vs 2016 ([NBS](#)). From the PBoC’s side, the new double-pillar framework consisting of monetary policy and macro-prudential policy has worked well so far in tackling the high-risk sectors without aggressively tightening overall financial conditions. Measures taken so far include changes to banks’ off-balance sheet lending through entrusted loans, tighter regulations to online consumer financing and a planned overhaul of the asset management industry to stem risky shadow-banking lending. As a result, we have seen a notable slowdown in shadow bank activities this year.

PPI recovery has helped to boost industrial profit

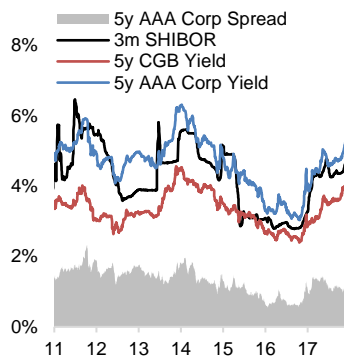


Rising profit improves firms’ ability to service debt
Industrial enterprise profit/financial costs*



Source: Algebris (UK) Limited, Bloomberg, NBS. *Total also includes firms other than SoEs and private firms.

PBoC tightening: more to come



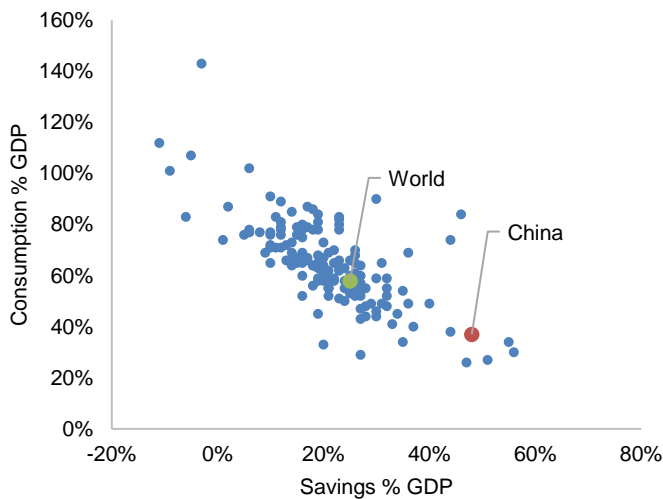
Source: Algebris (UK) Limited, Bloomberg

Second, the majority of China's debt is concentrated in corporates which have been deleveraging, even though China's overall debt level rose slightly this year. As of Q2 2017, non-financial corporate debt as % of GDP declined for the first time since 2008, to 165% vs 167% a year ago. Moreover, rising producer prices thanks to capacity cuts have supported industrial profit growth, improving corporates' debt-servicing ability.

Third, new growth engines are developing fast to support the economic transition. Consumption's contribution to GDP growth has been above 60% for seven consecutive quarters by Q3 2017, thanks to a tight labour market and rising wages. While higher labour costs means China could be losing competitive edge to other emerging countries in traditional manufacturing businesses, there are also signs that China is moving up the value chain and strengthening productivity. R&D spending as a % of GDP has increased from sub-1% in the 1990s to 2% in 2015, surpassing the UK and EU. As a result, China's global share of high value-added exports [rose](#) to 15% in 2016 from 8% a decade ago.

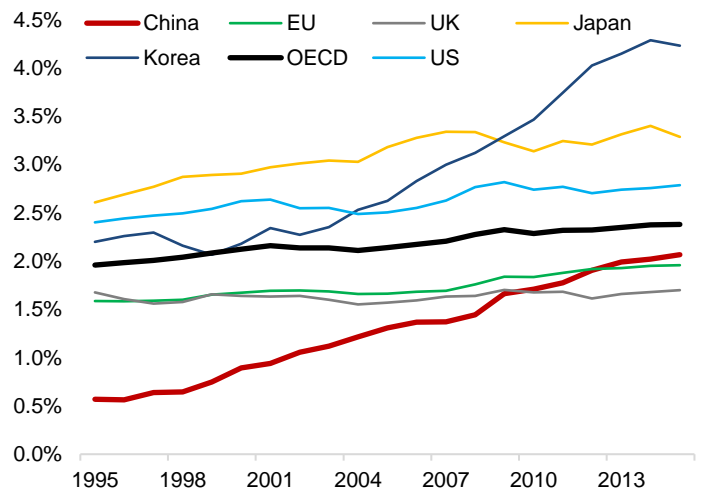
In our view, the main risk to China's deleveraging path is a policy misstep where an over-tightening causes a faster domestic slowdown or a liquidity crunch. This could trigger a bigger global shockwave on renewed China fear, as happened in August 2015 following a sudden devaluation of the Yuan. So far tightening measures adopted this year have not led to aggressive market corrections. However, the pick-up in interbank rates and onshore bond yields, as well as November's equity sell-off following the announcement of new macro-prudential policies are warning signs against existing complacency.

High savings, still low consumption
Consumption % GDP vs Savings % GDP



Source: Algebris (UK) Limited, World Bank, OECD

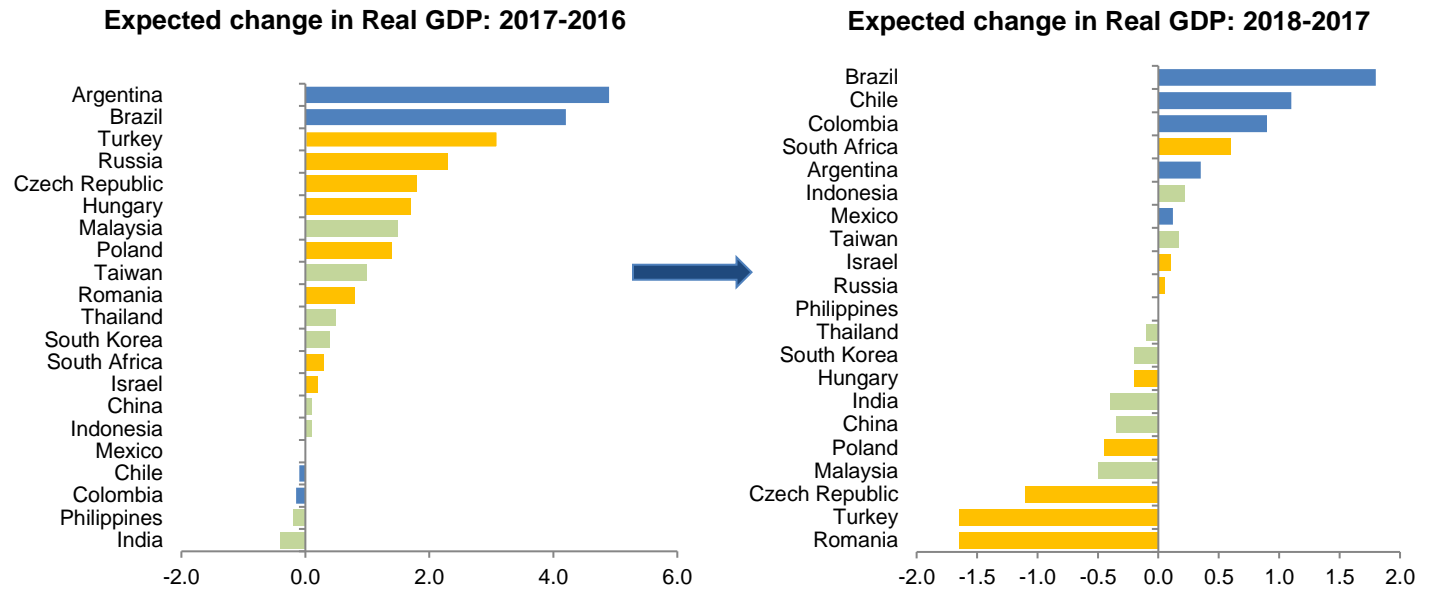
A catch-up on R&D should help boost productivity
Gross domestic spending on R&D, % GDP



Source: Algebris (UK) Limited, World Bank, OECD

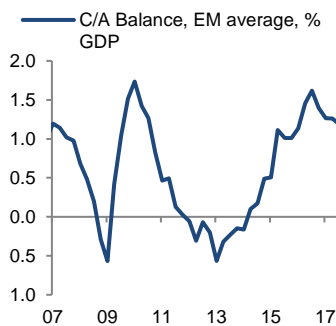
Emerging Markets: The End of Goldilocks

The 2018 outlook for EM is one of diminishing returns. The past two years have been represented by higher growth and lower inflation: the definition of goldilocks. We think this will end in the year ahead. Growth will likely tick higher, but so will inflation – albeit modestly. This can challenge EM Fixed Income, but should be more supportive of equities.



Source: Algebris (UK) Limited, Bloomberg

Current accounts declining

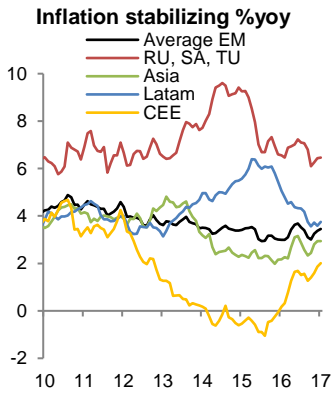


Source: Algebris (UK) Limited, Bloomberg

Macro momentum will likely slow down. An almost universal **growth** improvement in 2017 compared to 2016 will give way to diverging trends in the year ahead. Latin America will likely enjoy the last legs of growth acceleration as other regions will likely see their positive output gaps of 2017 shrink. Meanwhile, disinflation has been an important source of returns for local EM assets. The 2017 downward **inflation** trend was driven by strong adjustments in a number of typically high inflationary countries such as Brazil, Russia and South Africa, where bulk of adjustment is now behind us. A similar picture holds for **current account balances**, where a sharp tightening is already showing signs of running out of steam. Furthermore, the USD 100bn of **inflows** into EM bond markets year-to-date is unprecedented, and unlikely to be matched next year.

EM countries will have to walk a tightrope without a safety net. By the end of 2018, net G4 central bank asset purchases will move towards negative territory, triggering the withdrawal of the crucial safety net that has buoyed market confidence in the post GFC period. Whilst the improvement of EM current account balances has meaningfully reduced their vulnerability to DM monetary policy swings, volatility in EM assets is likely to rise as we enter the post-QE era.

After a 'relatively' benign political environment in 2017, risks will re-emerge in 2018. We see material risk of disruption from **identifiable political risks in 2018**: this is most pronounced in Latin America. In **Brazil**, Michel Temer has done well to stabilise macro conditions in Brazil since early 2016, but there is a serious risk that former President, Lula, runs a populist campaign based on undoing much of Temer's gains. Polls show him well in the lead for the October Presidential elections. Likewise in **Mexico**, the slow pace of NAFTA negotiations has kept investment growth at bay, boosting the chances of left-wing candidate,

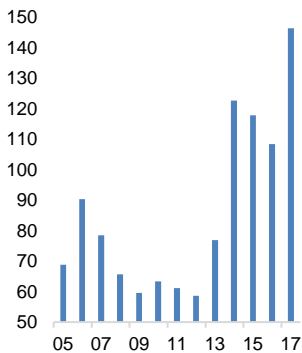


Source: Algebris (UK) Limited, Bloomberg

Lopez Obrador winning the presidential election in mid-year. **Colombia** will also face a stern test for the economic reforms and peace efforts carried out under President Santos, with Presidential elections of its own. Even if none of these negative outcomes ultimately materialise, the lack of clarity into these events will keep markets anxious and in poll-watching mode ahead of the scheduled elections. In **South Africa**, ANC – the ruling party – braces itself for a new leader to be determined in late December. The market is hopeful that Ramaphosa wins the leadership election, brings forward transfer of Presidential power from 2019 to 2018, and carries out reform. We see room for disappointment on all three fronts, especially the latter two.

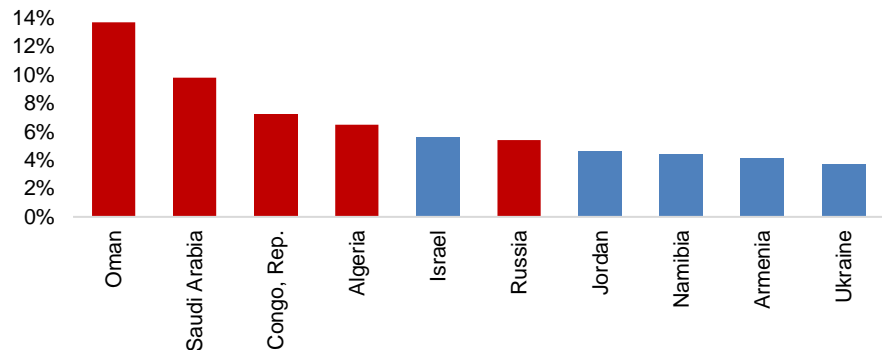
Geopolitical hotspots are likely to be even more heated going forward. Political risks in 2018 are not contained to domestic electoral issues. Two geopolitical hotspots in particular should be watched closely. One is the ever-evolving tensions with North Korea. The risk of military conflict can affect EM assets in two ways: firstly by triggering a flight to safe haven behaviour, and secondly by raising tensions between the US and China, resulting in a hit to global trade. The second hotspot is, as ever, the Middle East. Albeit not our base case, the risk of direct military conflict between Iran and Saudi Arabia has been increasing. Such an outcome would result in an aggressive spike in oil prices. Typically, a supply-shock driven spike in oil prices tends to be recessionary for the global economy, and can be an important risk-off trigger.

Global Geopolitical Risk on the rise
Global Risk Index



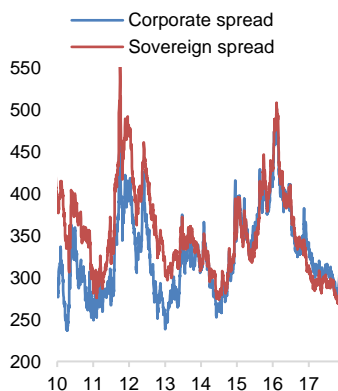
Source: Algebris (UK) Limited, Dario and Matteo Iacoviello, "Measuring Geopolitical Risk"

Oil exporters spend disproportionately on 'defence'
World's top 10 – Military expenditure as % of GDD, 2016



Source: Algebris (UK) Limited, World Bank, data as of end-2016

EM Spreads at multiannual tight despite weaker credit ratings



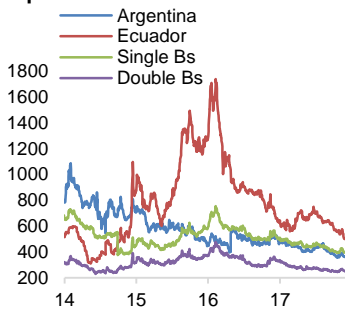
Source: Algebris (UK) Limited, Bloomberg, JP Morgan Indices

Valuations are getting tight. Local debt more attractive than external. The average spread on EM Corporates is at its lowest level since the GFC, despite the average credit rating having dropped by two notches. EM sovereigns fair better, still trading 30bp above the 2014 tight, which we think is a reasonable target for the index into 2018, but at which point valuations become extremely difficult to justify on fundamental grounds. The valuation picture is brighter on local duration in Emerging Markets. The 380bp yield differential between EM local debt and US Treasuries remains 60bp above the post-crisis low. But once we account for inflation developments, forward-looking interest rate differentials between EM and G10 remains close to historic highs! The bigger problem for EM local debt will be currencies which remain susceptible to higher USD funding costs and a shift in US policy vis-à-vis global trade.

Expect positive, but modest returns. Whilst the improvement in EM macro is likely to be marginal in 2018, a broad-based deterioration is unlikely in our view. This should be sufficient to bring about **modest returns** in the year ahead. But we are increasingly worried about reasonably **fat tail risks** that can swing returns into negative territory. These include the withdrawal of the G4 central bank safety net, as well as the return of electoral risk to major EM economies.

Inflection Points: Argentina, Ecuador, Brazil, Turkey

Argentina to compress towards BBs; Ecuador cheap relative to single-B rated peers



Source: Algebris (UK) Limited, Bloomberg, JP Morgan Indices

Argentina is crowded, but we're happy to share the love. There is plenty of cause for cautiousness in EM into 2018. But opportunities are still aplenty. Argentina is a popular trade, but that doesn't sap our appetite for exposure to the country. Positioning represents an important risk to Argentine assets, and weak hands may seek to exit on external events such as a backup in US rates, or even negative political developments in Brazil. We saw the latter play out in May 2017 with the Temer tapes. But we would view Brazil-driven sell-offs in Argentina as a buying opportunity. President Macri navigated political risks well in 2017, and with no elections scheduled in 2018, Argentina actually stands out as a political 'safe haven' in Latin America for the year ahead. Who would have thought! President Macri is using his reinforced political mandate to speed up the reform progress. The government is set to meet its 4% primary deficit target for 2017, and with growth set to accelerate in 2018, the 3.2% target for 2018 is also very much within reach. Further rating upgrades can be an important trigger for the final leg of spread compression. We see Argentina as a top candidate amongst EM sovereigns to move up a notch in rating buckets over the next 12 to 18 months. We see value in Argentina across the different asset classes, in both the sovereign and the provinces.

In Ecuador, political consolidation by the President can drive turnaround story. We also see value in Ecuador's external debt. The sovereign trades at one of the highest spreads in all of EM. Reforms have been slow to come since the presidential election, but we see room for progress in 2018, especially if President Moreno succeeds in consolidating power following a referendum in Q1 2018. Since coming to power, the new president has shown a surprising willingness to tackle fiscal imbalances. The 2018 budget incorporates lower spending and higher taxes, with the aim of reducing the deficit from 5.6% of GDP in 2017, to 3.9%. We think that's an ambitious target, but the direction of travel is correct. The budget submitted to parliament for next year is a good start, but more needs to be done. A rapprochement with the IMF could be the biggest trigger for outperformance.

2018: intra-EM monetary policy divergence

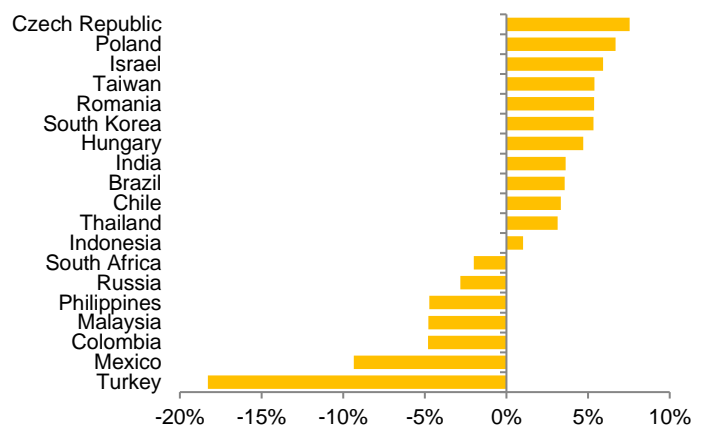
Inflation expectations vs. targets



Source: Algebris (UK) Limited, Bloomberg, Barclays, National Sources

Lira cheapness, but for good reason

Deviation of real effective exchange rates vs. 5yr ave.



Source: Algebris (UK) Limited, Bloomberg, Barclays, National Sources

Brazil's vulnerabilities have been reduced significantly, but value has run out in external debt. Still attractive in local. Brazil has enjoyed a remarkable turnaround since early 2016. But amidst the improving story, fiscal deterioration has continued almost unnoticed. The IMF estimates that Brazil's gross debt to GDP will increase from 73% when Temer first came to power, to 88% by end-2018. The primary balance, the reduction of which has been a constant target of the government, will likely stand at a 2.3% deficit by the end of next year, higher than the 1.9% printed at end-2015! This leaves us cautious on current valuations in external debt

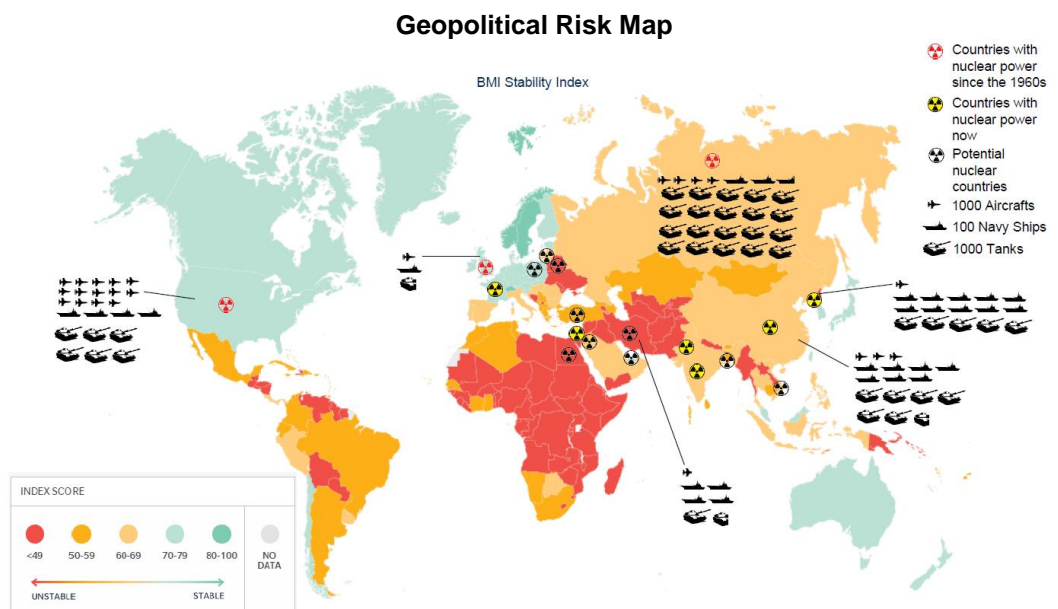
space, especially in the run up to a vote on a significantly diluted pension reform package. The prospect of a Lula presidency is also likely to limit room for further spread compression from current levels. In Brazilian debt complex, local bonds have more cushion against risks in our view. With 10yr local bonds yielding more than 10%, and forward looking inflation very well-anchored around 4%, investors are left with attractive real return prospects.

Overheating economies in CEE present opportunity for having negative duration exposure. Elsewhere in local markets, inflation trends will continue to diverge across EM in the year ahead, demanding different central bank responses. We expect local duration to come under pressure in Central & Eastern Europe in 2018 as inflation converges to and in some cases exceeds targets. The likely end of ECB asset purchase in Q4 of 2018 could add further pressure on the region, presenting opportunities to pay rates.

Will Turkey float or sink in 2018? Over the past few years we have seen a number of major EM economies go through a roller-coaster performance year-over-year. Typically politically-driven blow-ups have cheapened asset prices significantly, pushed central banks towards aggressive tightening, and opening the door for strong performance in the subsequent period. We saw this play out in Russia during 2014/2015, in Brazil during 2015/2016 and in Mexico during 2016/2017. The biggest underperformer of 2017, especially on the local currency side, has been **Turkey**.

Despite a sharp credit-driven increase in growth, President Erdogan's increasingly strained relations with the EU and US has further dampened market confidence. An ongoing investigation in US courts risks adding to the tense environment. Meanwhile, the central bank has been reluctant to keep liquidity sufficiently tight given inflation dynamics, further weakening confidence in its independence and credibility. Amongst 2013's 'Fragile Five', Turkey has seen the least adjustment on its external vulnerabilities.

All these make it difficult to see the light at the end of the tunnel for Turkish assets. But valuations are becoming attractive across rates, FX and credit. Our metrics show that Turkey is already offering 200bp more risk-adjusted forward-looking real interest rates than it has done over the past 4 years. This is substantial, but the Brazilian and Russian central banks did even more to support assets during their time of crisis. Turkish assets are no gem, but if the monetary authority steps up to the plate and delivers an aggressive conventional tightening, 2018 could be their year.

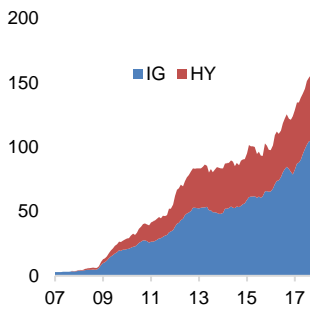


Source: Algebris (UK) Limited, BMI Research, Marsh & McLennan Research; Wikipedia, World Nuclear Association, Global Firepower (GFP)

Conclusions: Portfolio Construction in a Frothy Market

Passive strategies are growing

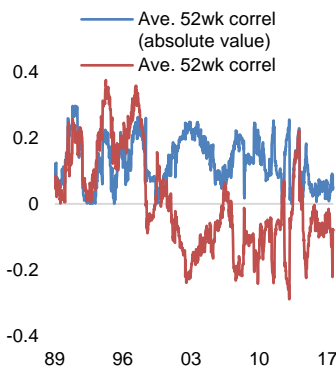
Top credit ETFs' AUM, \$bn



Source: Algebris (UK) Limited, Bloomberg. IG ETFs included are LQD, VCSH, VCIT, CSJ, CIU, SPSB, SPIB, VCLT and CRED; HY ETFs included are JNK, HYG, BKLN, SJNK, SHYG and SRLN.

Correlations have declined

Average global cross asset correlation



Source: Algebris (UK) Limited, Bloomberg.*Equities = MSCI World Local, Credit = Barclays Global Corporate Excess Return, Rates = Barclays Global Treasury (USD Hedged)

Timing the consequences of a withdrawal of central bank liquidity has proved difficult. However, as asset prices continue rising to new highs, investors need to be increasingly cautious about asymmetry, liquidity and correlation.

Asymmetry of returns is particularly evident in long-dated government bonds trading at negative yields or below inflation, like UK Gilts; or in high yield markets where the credit cycle is turning for the worse, like US high yield.

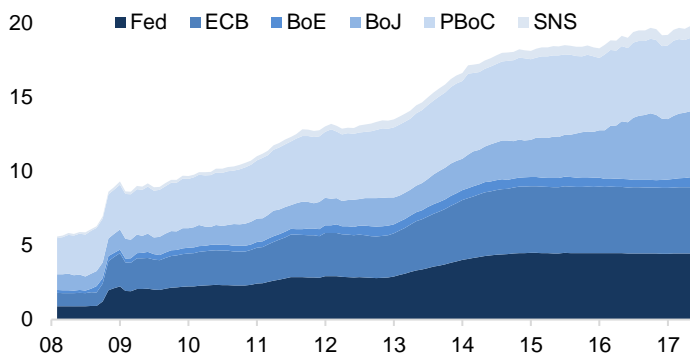
Trading **liquidity conditions** remain scarce at points of increased market volatility. Passive investing has grown, which means increasing one-sided risk and herding, as confirmed by [IMF data](#). In addition, passive structures like high yield ETFs embed a mismatch between liquid liabilities vs the less-liquid assets they buy. Finally, banks are unlikely to become the liquidity providers of last resort, as regulatory pressure remains high.

Asset **correlation** has declined over the past years – we are far from the days where a crisis in one European country would lead to a read-across in others, or a high yield default would make the whole sector widen. Today, markets' reaction to shocks remains generally idiosyncratic.

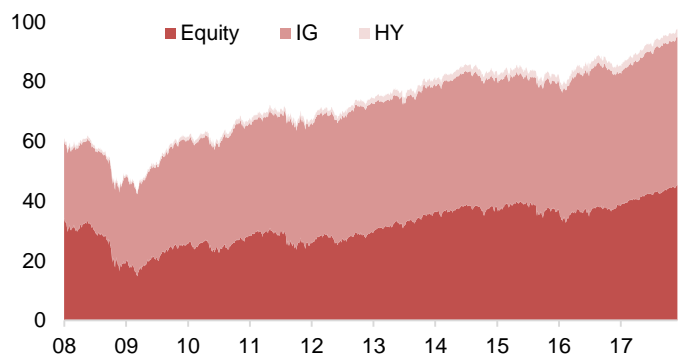
These observations bring us to position our macro portfolio in the following way:

1. **Improving the liquidity profile:** for example reducing the portion of corporate credit held in cash form and adding to synthetic positions as substitutes. This brings a double advantage: cash credit has tightened more as directly targeted by central bank purchases, so it may reverse with more widening if they stop abruptly. Synthetic credit is also more liquid and can be more easily unwound in a downturn.
2. **Positioning in assets that provide symmetric risk-returns:** only a few niches of credit markets remain cheap – including Greece, bank subordinated debt in Europe, some Emerging Markets (Argentina, Ecuador), and a few high yield sectors. That said, credit still brings limited upside to investors. Equities, on the other hand, while generally not cheap, can provide more upside in a re-pricing and rotation scenario. The rotation from technology stocks to financials over the past few days provides an example of what could happen, should our inflationary or hawkish central bank risk scenarios materialise.
3. **Hedging for rising inflation expectations, tighter monetary policy and higher political risk.** It is an expensive strategy to hedge on a systematic basis; however, there are ways to position for increased correlation across assets, or a change in regime between asset correlations which may be cheaper, after many months of stable markets. In credit, our favourite way of doing this is to extract yield from jump-to-default risk in junior tranches and hedging spread volatility with mezzanine or senior tranches.

Global central bank balance sheet size, \$tn



Global bond and stock market capitalisation, \$tn*



Source: Algebris (UK) Limited, Bloomberg, Central bank websites. *Stock market capitalisation estimated using the MSCI World Index and bond market capitalisations estimated using Barclays Global IG and HY indices.

Economist Rudi Dornbusch used to say that crises take longer to come than you think, but when they do, they happen much faster than you would have thought. This has been my experience in 2007-2008 and later on with the European crisis, starting in 2011.

Today, we believe the largest risks are not in banks, sub-prime debt or excess balance sheet leverage. While regulators have been focusing on strengthening bank capital over the past decade, investors have been incentivised and guided to take more first and second-order risks on the level and volatility of asset prices. These risks are harder to quantify and lie in financial markets rather than in banking institutions under the direct supervision of regulators – yet, they exist, and can become a threat to financial stability.

Left unchecked, another financial boom-bust cycle could have unprecedented political consequences. Persistent central bank easy policy has stimulated job creation but also increased inequalities between the haves and have-nots, the young and the old, between large financial centres and the peripheries which were left out of the recovery. The [American Dream](#) that many aimed for over the past decades appears broken, and in this context, another round of QE will be politically difficult, should the economy slow down in the future.

Rising inequality may provide fertile ground to populist politics, as it already has done in the United States and the United Kingdom. History shows us that periods of monetary debasement go hand in hand with social and political crisis, as we wrote recently in the [Financial Times](#). The late Roman Empire shaved silver coins as it disintegrated; the British Empire allowed double-digit inflation to erode bondholders' wealth following the War of Independence; the Weimar Republic precipitated an inflation spiral. Populism means excess spending, higher public debt, inflation and losses – particularly for fixed income investors.

Investors will need to navigate this environment carefully: avoiding asset bubbles, positioning for monetary policy normalisation and protecting themselves against a change of political and fiscal regime at the end of the QE era.

We look forward to guiding you in these dangerous waters.
Good luck for 2018, and thank you for your business this year.



The Silver Bullet is Algebris Investments' macro letter.

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