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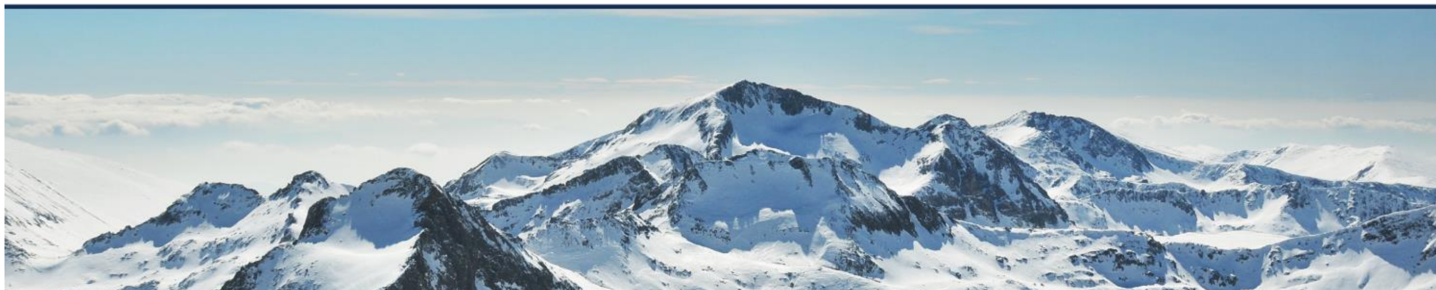

The Silver Bullet

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The Bond Bull Run: Is This It?

"I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody."
James Carville, Clinton administration advisor, 1993

The specter of a bond market selloff has been circling around investors since the beginning of last year. After many false starts over the past few quarters, we now have Bund yields over 0.7% and Treasuries over 2.7%. So far, the move has been gradual and controlled by careful central bank talk. But more monetary policy normalisation lies ahead, and fiscal stimulus in the US and Europe may add to late-cycle reflationary forces, which so far have been tenuous. Is the multi-decade bull market in bonds nearing its end?

There are reasons to believe that more yield widening is coming. The question is whether central bankers will be able to control the spill-over to risk assets.

A key driver of bond underperformance is likely to be inflation. First, fiscal stimulus is coming in the late stage of the US economic cycle and could arrive in Germany too, with a likely new coalition between the CDU and SPD. Second, the credit transmission channel of monetary stimulus is finally working, with banks lending again to businesses, including in Europe. The US administration's deregulation of the financial sector is also likely to boost lending. Third, wage negotiations in the US, Germany and Japan are gaining momentum, as labour markets tighten. Finally, a late-cycle acceleration in emerging market growth means a weaker Dollar and higher commodity prices may boost import inflation in developed economies: China may move from exporting deflation to becoming the primary exporter of global inflation.

Are bond markets prepared for a reappearance of inflation? We think not. Investors have been hoarding duration over the past few years, according to IMF data. Buying corporate bonds generated capital gains in 7 out of the last 10 years. And so far, the impact of monetary policy normalisation has been gradual, as expectations of a hawkish Fed have been balanced by a still-dovish ECB and BoJ. As a result, long-end yields have remained flat, producing little spill-over on broader risk markets – unlike in the 2013 and 2015 tantrums.

If a return of inflation is the trigger, then investor long positioning is the dynamite. Signs of euphoria – or irrational complacency, as we named it – are abundant. Retail buying, chasing of market performance, increases in sell-side analysts' earnings forecasts and continued selling of volatility premium are among the signs of fear-of-missing-out behavior we are monitoring. Many of these carry strategies depend on a stable and low interest rate environment. If you are sure that interest rates normalisation will happen gradually and without hurting risk asset, then prepare for a Wile E. Coyote moment.

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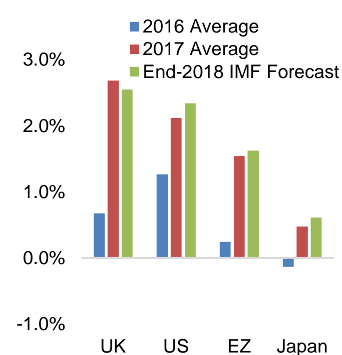
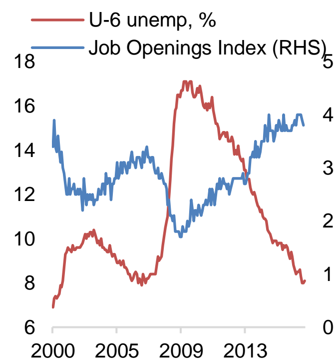
Inflation is slowly coming back
CPI YoY %



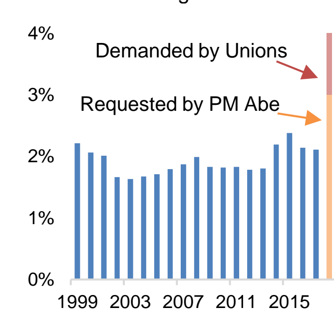
Source: Algebris (UK) Limited, Bloomberg, IMF

US: tightening labour markets



Source: Algebris (UK) Limited, Bloomberg

Japan: PM calls for wage hikes
Annual wage hikes



Source: Algebris (UK) Limited, Ministry of Health, Labour and Welfare

Beep Beep! Inflation Is Back

"Allow me to introduce myself. My name is Wile E. Coyote, genius. I am not selling anything nor am I working my way through college. So let's get down to cases: you are a rabbit, and I am going to eat you for supper."
Wile E. Coyote, Operation: Rabbit, 1952

There are four reasons why we think inflation is coming back this year, and it could be faster than you think:

1. Fiscal stimulus is coming in the late stage of the US economic cycle and could arrive in Germany too. In the US, the tax plan's stimulatory impact may be front loaded with around a $600bn net revenue cut or stimulus over the next three years. That is, a stimulus of up to 1pp of GDP per year until 2020. The plan's provision to allow 100% expensing of capex over the next five years may also incentivise corporates to front-load capex, which has lagged the US's broader economic recovery. In Germany, fiscal spending may rise too. We think that a grand coalition deal between the CDU and SPD could include a commitment to more fiscal stimulus including partly spending the approximately €45bn in surpluses accumulated over the past years, potentially worth up to 1.2pp of GDP.

2. A tighter labour market and growing political support will push for higher wages. In 2017, with accelerating global growth, European and US unemployment fell sharply and Japanese unemployment reached record lows. While last year these gains did not lead to faster wage growth, this year could be different. First, labour market slack may have been eroded to the point at which further reductions in unemployment now generate wage inflation. In the US, the level of underemployment has fallen to pre-crisis lows while unfilled job vacancies are near all-time high. Similarly, in Europe, while the unemployment rate remains above pre-crisis levels and indicates a need for further reduction of slack, regional labour markets are starting to show signs of overheating. Second, and perhaps more importantly, there is growing political support for higher wages. In Japan, PM Abe openly calls for at least a 3% increase in wages at March's annual Shunto negotiations. While this increase falls short of the 4% demanded by the Japanese trade unions, it would be 1pp higher than the roughly 2% granted at Shunto since the early 2000s. In Germany, IG Metall amongst other labour unions are calling for a 6% rise in wages for nearly 20% of the country's workforce. While the 6% demand is broadly in line with previous years', there is more scope this year for corporates to heed given the country's stagnating real wage growth and rising political support for higher wages, notable from SPD leader Schulz.

3. Global drivers are likely to exert upside pressure on headline inflation in the coming quarters, driven by Renminbi strength, Chinese reflation, and resurgent oil prices. Whilst much of the inflation should be classified as 'transitory', forward-looking inflation expectations have displayed strong correlation with spot oil prices in recent years. This makes central banks responsive to factors that should normally be largely discounted in policy-making.

China: the engine of global reflation? One of the key elements of global disinflationary pressures from 2012 to 2016 was Chinese deflation. Producer prices fell for almost five consecutive years, exerting significant downward pressure on price of goods globally. The impact was amplified in 2015 and 2016 as the renminbi experienced sharp depreciation, resulting in an 'export of deflation' to the rest of the world. Looking forward, this currency-effect is likely to be reversed. The renminbi has strengthened at its fastest pace in ten years over the past twelve months, and shrinking spare capacity has resulted in surging producer prices. It is arguably time to worry about China 'exporting inflation' to the rest of the world. To identify the countries which may be the largest importers of Chinese inflation, we compare the share of imports from China as % of GDP, as well as currency depreciation experienced vs. the renminbi. Australia, Japan, New Zealand and the US stand out as being the most vulnerable to higher inflation, by this measure.

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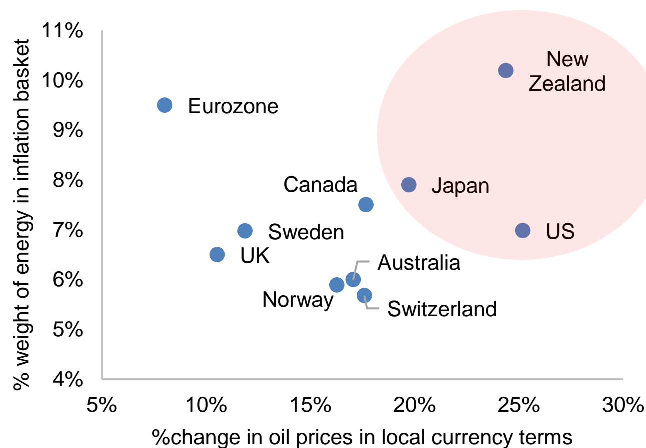
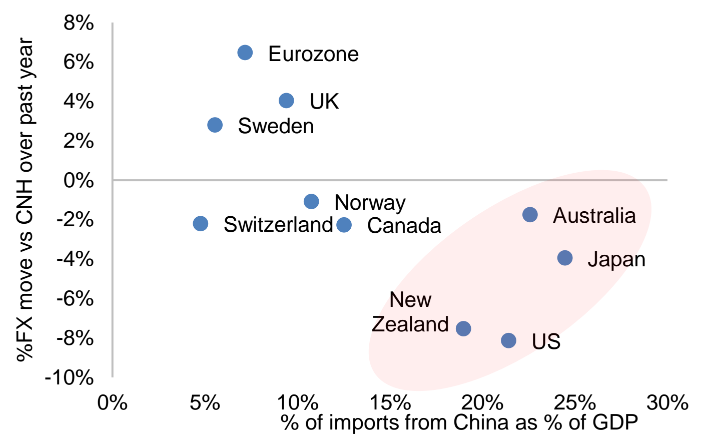
Oil prices: Japan, US, New Zealand to get the most inflation pass-through. The move higher in oil prices won't be felt equally across the world. The sharp USD weakness of the past twelve months implies significant discrepancy in the extent of oil price rise in local currency terms. Amongst G10 countries, the euro area stands out as the country facing the smallest oil price increase once we account for recent euro strength. The relatively high share of energy in the Euro area's CPI basket, however, may amplify the effect felt on headline inflation. New Zealand, Japan and the US stand out as the countries most likely to import the most commodity-led inflation given that they have experienced the highest oil price increase in local currency terms, combined with a sizeable weight of energy in their respective inflation baskets.

Where will we see oil-driven inflationary pressures?
oil price change vs. share of energy in inflation basket



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

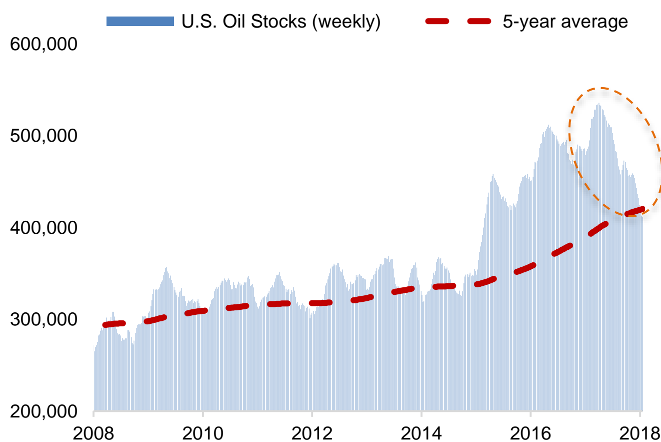
Who will import most inflation from China?
Share of China imports vs. renminbi effect



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

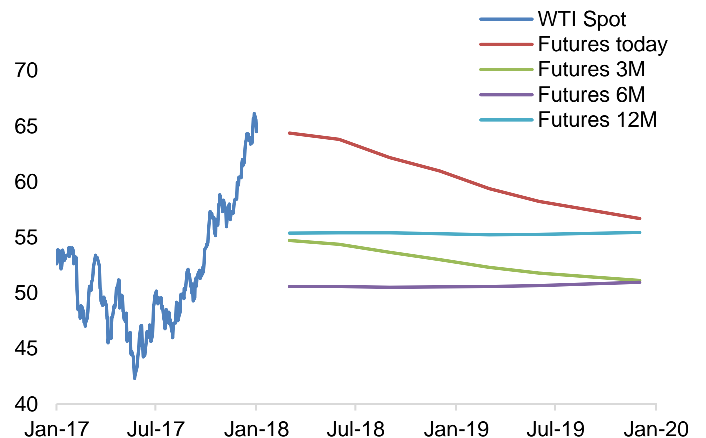
OPEC has beaten market expectations. Unlike at the beginning of 2017, the continued recovery in oil prices has been caused not only by OPEC and Russia supply-cut guidance, but tangible sequential reduction in inventory levels. Oil futures have capitulated although the mid-term outlook remains anchored roughly below current spot levels.

U.S. Oil Inventory trending towards 5-year average
in thousand barrels



Source: Algebris (UK) Limited, DOE

Oil market futures have capitulated
$bbl



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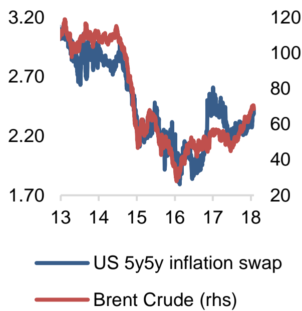
Spot oil prices affect long-term inflation expectations



Source: Algebris (UK) Limited, Bloomberg

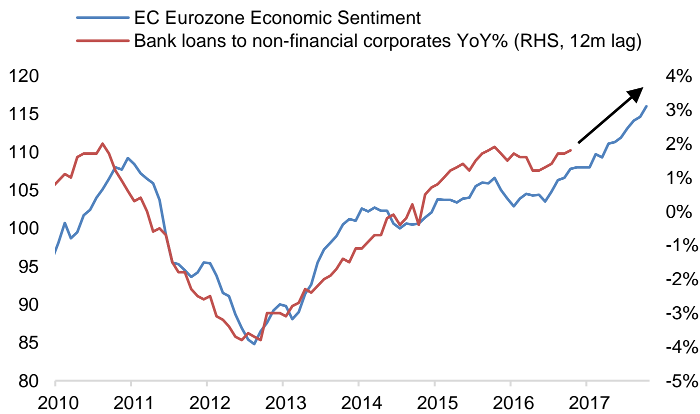
The sustainability of the oil rally is still questionable. U.S. oil and gas rig counts rebounded strongly in 2H'17 (947 as of Jan 26 vs.712 a year before) and the Energy Information Administration expects non-OPEC production to accelerate significantly in 2018.

We expect a one-off headline inflation impact, but another argument in favor of wage growth. A stable oil price is expected to drive a one-off headline CPI boost, particularly in 2018, as Mario Draghi commented on his January 24th press conference. We think however, that a second year of energy-related inflation, will not be easily brushed off across European wage hike negotiations.

4. The credit channel has started working again, which should support inflation. Since the crisis, bank regulators globally have been focusing on de-risking and capital raising. Now the regulatory tide may be finally turning, having reached the peak. In the US, financial deregulation under the Trump administration should support lending. In Europe, despite low interest rates and QE for years, banks are only now starting to re-grow lending to the real economy. This is because, on the one hand, banks are finally more willing and able to lend, having delevered significantly. Eurozone banks over the past few years have reduced their balance sheet size to below 300% GDP from the peak of over 350%, and on average raised common equity tier 1 ratio by around 3pp. On the other hand, credit demand is recovering together with improving economic sentiment. As noted by the ECB's latest Bank Lending Survey, net demand for loans continued to increase across enterprises and households in Q4 2017, with banks expecting a further pick-up in Q1 2018.

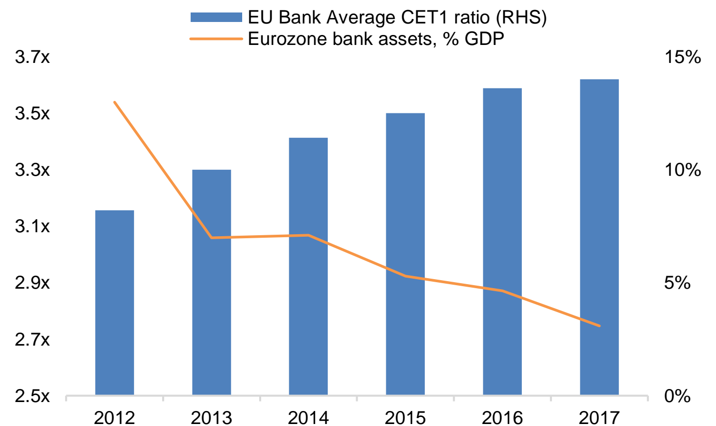
The re-activation of the bank credit channel is particularly important to Europe and should be supportive of inflation: over 60% of European small and medium enterprises rely on bank financing and SMEs generate over 80% of new jobs. With faster job creation and tighter labour markets, we could eventually see faster wage growth.

Banks are lending again
Eurozone Economic Sentiment vs Bank Loan Growth



Source: Algebris (UK) Limited, Bloomberg, ECB

European banks have delevered and raised capital
Bank Balance Sheet Size vs Capital Ratio



Source: Algebris (UK) Limited, ECB, Eurostat, EBA. * EU Data: BIII CET1 ratios were introduced in 2010; 2009 data reflects the early stages of BIII framework (EBA Comprehensive QIS report); 2011-2015 show fully Loaded BIII CET1 ratio (EBA BIII Monitoring exercise).

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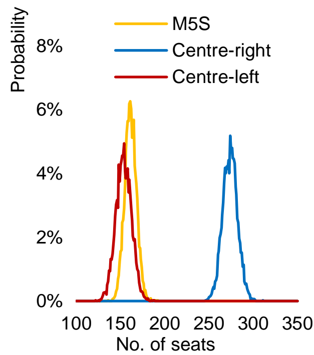
Bond Investing in a Late Cycle, Reflationary World

Centre-right likely to win in Italy
Simulated probability distribution of seats



Source: Algebris (UK) Limited, Wikipedia. Methodology: We estimate the probabilities based on Monte Carlo simulations. We assume that voters' preferences follow a normal distribution and ran 5,000 simulations based on polling data since Jan 2017 to compute the probability distribution (using poll means and 1x poll standard deviations for party).

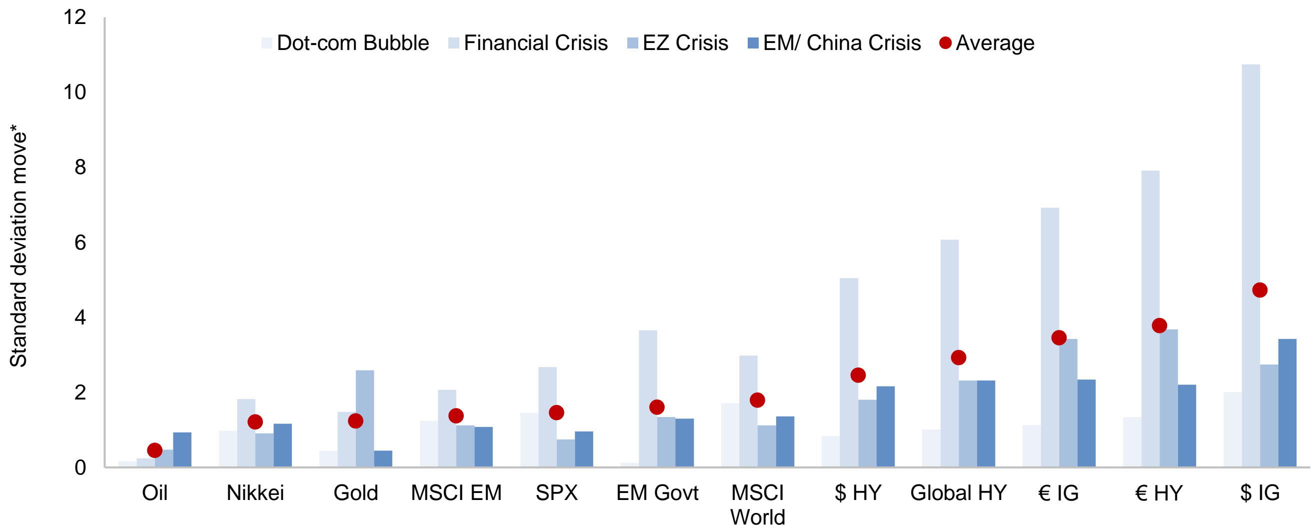
As discussed in our previous *Silver Bullets*, we positioned for 2018 with extra caution, for three reasons. First, bonds and credit markets offer intrinsically little upside, at these levels. Second, macro fundamentals point to a widening for interest rates, as inflation rises, as well as for credit spreads, as higher interest rates will likely squeeze levered firms in the high yield market. Third, we think investor positioning remains too complacent, especially in volatility strategies across rates, equity and credit as we have highlighted before.

What we are watching: the ECB's stance will be key over the coming months. The Eurozone grew 2.5% in 2017 and is likely to beat that in 2018, according to our estimates. Following the formation of a government in Germany and elections in Italy – where we see the populists Five Star Movement losing – a change of tack in ECB language will become overdue. The Bank of England will find itself in a binary situation: 2-3 hikes behind the curve in a soft Brexit, but with the possibility of a hard Brexit still in the cards. We believe markets will price in a soft Brexit scenario with a confirmation or extension of the transition period – even though the UK's problems remain deeply structural. The BoJ will be the ultimate reflation test, which could lift global yields with a change in stance.

How we are positioning: since the end of 2017, we have positioned with an underweight on assets which may suffer asymmetric losses in a correction – rates and credit – at the same time buying upside optionality on asset classes which may benefit from reflation, and a rise in geopolitical risk: energy, financials and emerging market equities and commodities. In bonds and credit, we think Europe remains a better place to hide, with the periphery and Greece still poised for a reduction in tail risk and benefiting from a reallocation of global fixed income portfolios. In equities, our preference is for the US and emerging markets, as European firms are likely to be capped by a stronger Euro – with the exception of financials.

If complacent investors running carry trades are Wile E. Coyote, then Road Runner is inflation. We think markets are unprepared for a reappearance of Road Runner, and volatility and credit spreads are likely to creep higher as a result. We prefer hedging now, then facing a Wile E. Coyote moment later.

Negative Convexity for Credit
Standard Deviation Move across Assets in a Crisis



Source: Algebris (UK) Limited, Bloomberg. *Standard deviation move is calculated based on the last two years history. EM Govt is EMGB, $ HY is H0A0, EUR IG is ER00, EUR is HY HE00, $ IG is C0A0 (BAML indices). ** Credit is spread return, not total return.

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The Silver Bullet is Algebris Investments' macro letter.

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Additional reading:

The Euro Area Bank Lending Survey, ECB, January 2018

World Energy Outlook 2017: A World in Transformation, International Energy Agency, 14 November 2017

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