The Silver Bullet

ALGEBRIS INVESTMENTS

A Fragile System: The Return of Volatility

For some, the events of the past few weeks represent a standard correction, after which markets will return to normal. We think differently. We believe this is the start of a change in regime for markets.

Central bank policy supported markets to boost wealth and consumption, through the so-called "wealth effect" transmission mechanism. It worked: consumer confidence held up and spending rose over the past few years, albeit led by the wealthiest. But like a patient who has been given a powerful anesthetic for a long time, the same markets today appear unable to start walking again on their own, as central bankers' withdraw their support.

Over the past decade, investors have relied on QE and the so-called Fed put option, reiterated around the two taper tantrum events, as well as on low inflation and rising growth. The result has been a search for yield which targeted government bonds, corporate debt, stocks and finally short volatility strategies.

Today, we face persistent distortions across markets. Equity valuations are at record highs in the U.S., credit spreads and interest rates at record lows and despite the shakeout in equity markets, the level of implied volatility across other asset classes is falling again.

This goldilocks equilibrium has been sustainable thanks to loose monetary policy, muted inflation and support from Asian investor to fund the US deficit. But these elements of support are wobbling. There are signs of rising inflation across labour markets, with the U.S. undertaking a large fiscal stimulus at a time of already-low unemployment. Central bankers have finally shifted their attention to policy rates, which guarantee little buffer to withstand another crisis. China is moving towards a stronger currency and a consumer-led economy, slowly diversifying from supporting low inflation and low long-end treasury yields.

Timing a change of regime in markets is difficult. Central bankers have reassured markets that the transition from QE and low interest rates to normalisation will be gradual and orderly. But will it?

As we explained in our 2018 Silver Bullet, we believe the structure of risk markets has become increasingly fragile. The first layer of QE-induced distortion is its direct impact on bond yields, with \$21tn in central bank balance sheets and \$11tn of near-zero yield sovereign bonds. The second is investment grade and high yield bonds, not all directly bought by central banks, but used as substitute by investors. The layers stack up into high-dividend equities, high growth equities, cash-park assets like property, art, collectibles and cryptocurrencies and finally in short volatility strategies in equities, credit and rates, a second-derivative bet that the current status of the world will remain the same tomorrow as it is today.

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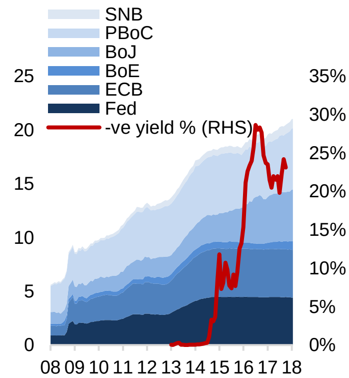
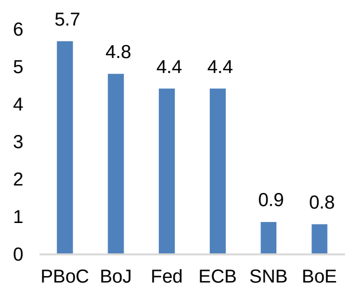
The central bank-induced bubble
Central bank balance sheet size, $ tn vs % negative yielding assets



Source: Algebris (UK) Limited, Bloomberg, BAML

Central bank balance sheet size
$ tn



Source: Algebris (UK) Limited, Bloomberg

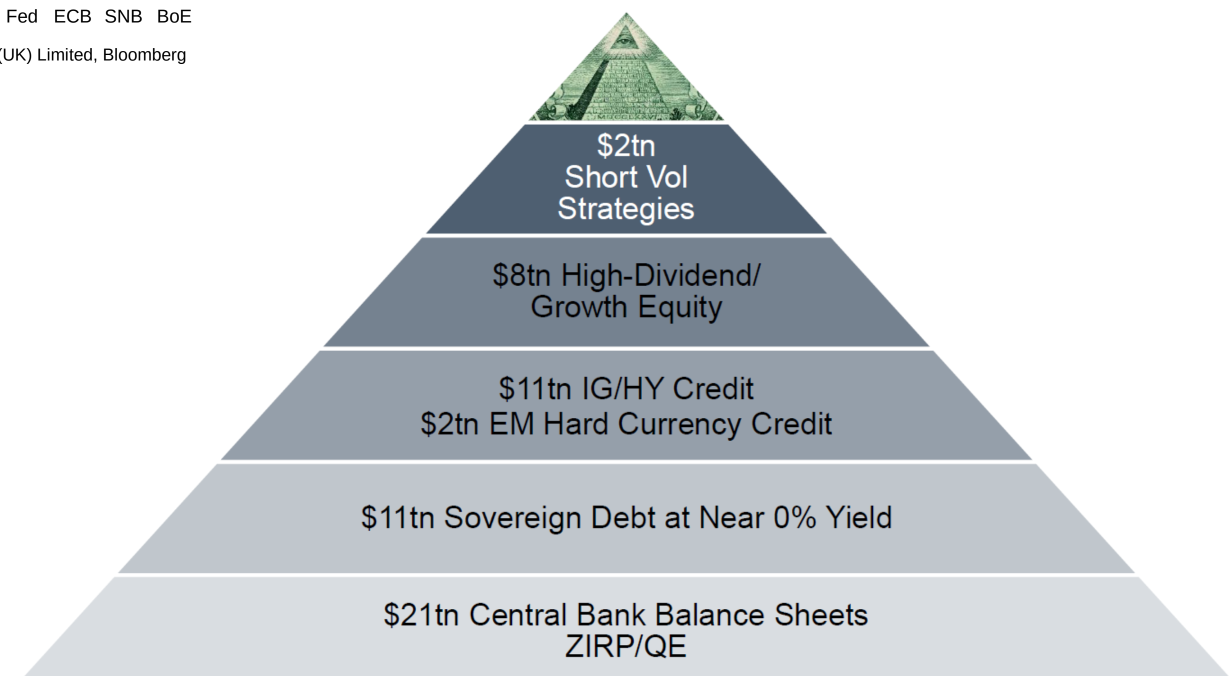
The Pyramid of Carry Trades

The Federal Reserve has so far managed to raise interest rates without causing too much trouble in markets. W. Dudley defined the recent selloff as "*small potatoes*", and small potatoes so far it is – compared to what could happen with a larger unwind of the strategies mentioned above. That said, the Fed has an advantage, having been the first to implement QE, and the first one to unwind it: the ECB and the BoJ together now hold the fulcrum of global central bank balance sheets.

This means the music is, slowly, stopping. Mr Kuroda has been recently re-nominated as BoJ Governor. Mr Draghi and some of the most prominent Governing Council members, however, will leave the ECB over the next 24 months. Fiscal stimulus and signs of inflation are spreading also in Europe and Japan. What will happen when even the ECB and the BoJ start reducing their balance sheets?

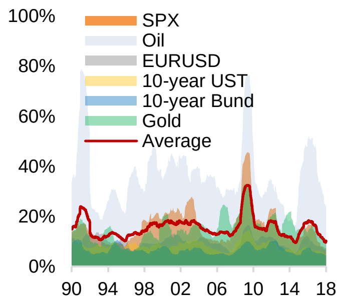
Some argue that higher interest rates may not be indeed sustainable, given low productivity and demographics – and that higher interest rates may be essentially mean-reverting. However, imagining an orderly transition from a low to a high interest rate world and back may be wishful thinking, without passing through the unwind of some of the investment strategies which have been put in place in the meantime.

Among the asset classes which would underperform the most in a non-gradual unwind of QE trades are government debt, which would return to higher term premia on inflation volatility, but also investment grade and high yield bonds, where companies have re-levered over the past few years, incentivised by low interest rates. Similarly, short volatility strategies in interest rates and credit would also suffer a hit, as happened to short volatility strategies in equities.



Source: Algebris (UK) Limited, Bloomberg

Realised Volatility Is Still Low
250-Day Trailing Realised Volatility across Assets



Source: Algebris (UK) Limited, Bloomberg

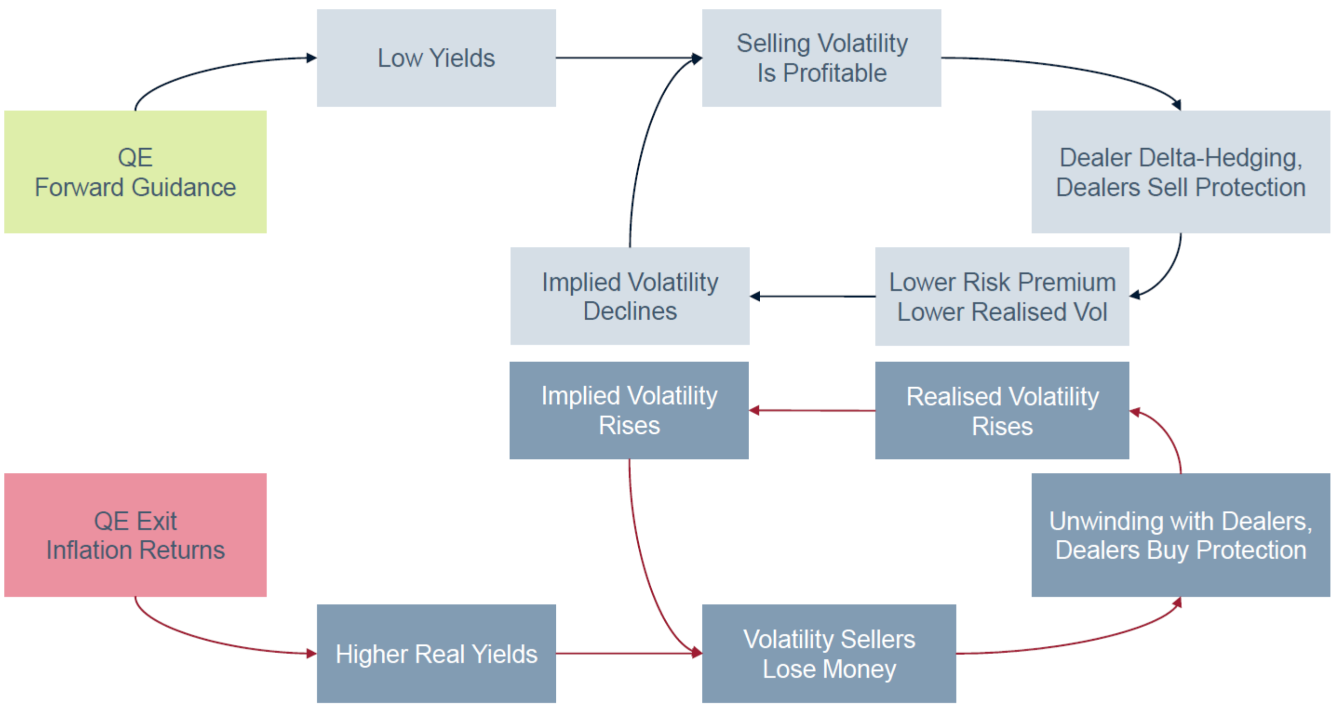
QE, Short Volatility and Negative Feedback Loops

We argued last year that QE and low interest rates have pushed investors to sell volatility for yield, creating the risk of a sharp repricing when the equilibrium of stable volatility and correlation is disrupted. The recent "vol shock" and blow-up of short-VIX ETFs are manifestation of this risk. However, ETFs that explicitly short equity volatility only account for a small portion of vol-selling strategies, which we estimate are over $2tn. On top of that, there are also strategies that implicitly short volatility through rates, credit and FX, for example, by selling out-of-the-money payers on credit default swap (CDS) indices.

With central bank QE capping range and volatility of interest rates, such strategies are profitable as realised volatility stays below implied volatility. Further reinforcing this trend is dealers' need to delta-hedge their books, which push risk premium and realised volatility lower. For example, dealers who have bought those CDS payers from investors need to sell protection with the same amount of delta elsewhere, driving credit spread tighter. This makes short volatility strategies more profitable, encouraging more selling.

However, the same feedback loop also kicks in when the QE trade unwinds, just in the adverse way. With monetary policy tightening and the return of inflation, real yields could start to rise, pushing up realised volatility and causing a breakdown of asset correlations. Short volatility strategies that suffer losses could be forced to unwind their positions, propelling dealers to buy protection and exacerbating a sell-off.

Short Volatility: A Feedback Loop



Source: Algebris (UK) Limited

The End of Goldilocks: Inflationary Boom or Bust?

In our [2018 outlook] we highlighted that the goldilocks period of inflation-less growth acceleration is most likely behind us. As growth decelerates our concerns appear more real. Recent data across the developed world point towards a continued expansion, but at a slower pace and with increasing inflation. Are we heading towards a high-growth high-inflation environment, or towards stagflation?

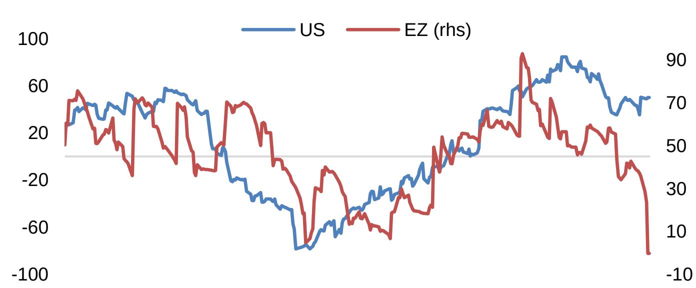
In the US, Trump's fiscal plans may boost inflation more than growth. The tax plan and increase in budget caps may increase GDP growth by up to 1pp over the next two years. However, as this stimulus is coming at a time when the economy is already growing above potential and labour markets are at or near full-employment, the stimulus may be more inflationary than stimulatory. Firstly, as the IMF has discussed, fiscal stimulus has a lower stimulatory effect during an expansion than a downturn. The IMF has found that during an expansion every $1 spent may result in less than $1 of economic stimulus. Secondly, spending is likely to be debt-financed. This means that domestic savings may be locked-up in purchasing debt rather than being spent on purchases or capital expenditure. The result is fiscal stimulus could "crowd out" private investment in the long-term, as Banque de France research has found. Finally, a high debt burden and large fiscal deficit at this stage of the US's economic cycle may limit the government's ability to combat the next slowdown through fiscal expansion. Put differently, fiscal expansion may be inflationary today, but deflationary long-term.

The UK's current period of weaker growth and high inflation is likely to persist. Firstly, inflationary pressures are likely to remain high both due to tightness in the labour market, and as Sterling weakness vs its top trading partners continues to support import-led inflation. Secondly, the Bank of England will likely maintain its hawkish rhetoric on raising rates in order to support Sterling and combat import-led inflation, as well as to prevent a further build-up in consumer debt. Thirdly, while a transition agreement may be agreed before the end of the year, uncertainty on the nature of the UK-EU relationships post Brexit will likely continue and therefore weigh on more private capital spending.

In Europe, growth continues to appear firm but may decelerate. Whilst growth remains, the scope for acceleration from current levels is limited, especially as the economy is already growing above potential. Additionally, Euro strength over the past fourteen months may dampen output from the manufacturing sector, despite improvement in domestic demand. The Citi Economic Surprise Index for the Euro Area fell into negative territory as of 22 February, for the first time since 2016.

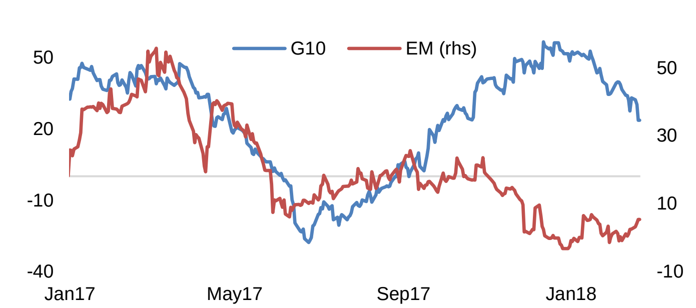
An environment of disappointing growth, higher inflation and lower potential future growth will likely make a normalisation in monetary policy more difficult.

Eurozone Economic Surprise Lowest since 2016
Citi Economic Surprise Indices



Source: Algebris (UK) Limited, Bloomberg

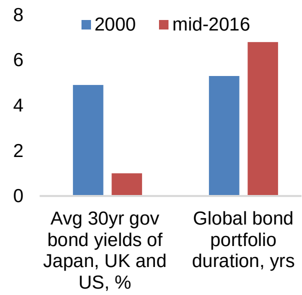
Developed Markets Economic Surprises are Falling
Citi Economic Surprise Indices



Source: Algebris (UK) Limited, Bloomberg

Long bonds: a crowded trade

Average yield vs duration



Source: Algebris (UK) Limited, IMF GFSR October 2016

Conclusions: Monetary Policy, Incentives and Fragility

We believe ten years of loose monetary policy have made our financial system more fragile.

While regulators have focused on bank capital, they have so far ignored risks building up in financial markets. A fragile system is one that is more vulnerable to shocks, has little checks and balances and limited dry powder for stimulus in an emergency. Markets today appear increasingly similar to this definition: ten years of herding into search-for-yield in long duration, credit and short volatility trades today produce negative feedback loops, which if unwound, would make markets more vulnerable to volatility.

The bad news is that most policymakers and regulators – let alone politicians – appear worried about fragility. A reason for that is the nature of their incentives: these are tied to mandates lasting a few years, while financial stability overhangs build up for decades. An exception to that has been the Bank for International Settlements, who has issued several warnings.

The good news is we can still avoid fragile assets, especially the ones which combine the following characteristics:

1. High valuations: record high P/E, record low credit spreads
2. Crowded positioning: retail holders, QE-driven inflows, passive strategies
3. Fragile structure: asset-liability mismatches, leverage, financial engineering, complexity, assets representing a large size of the underlying market

High yield, loan ETFs, short volatility notes and other volatility linked products are among the ones that raise the most red flags.

The long-term question remains open on whether a return of volatility would disrupt or even reverse a normalisation in interest rates and inflation. In other words, if monetary policy has worked its way through the economy with a positive wealth effect – can a negative market shock reverse these effects?

Indeed, there are arguments why high real interest rates may be neither sustainable nor desirable by policymakers, given current levels of public debt, stagnant demographics and low productivity. Italy or Portugal would not be able to sustainably fund at 4%, for instance.

But the risk from a market shock is also that fewer central banks will have the dry powder to deal with it. At that point, the answer will likely come from politics, and it may be extreme: populism, excess fiscal spending and protectionism (The Silver Bullet | Investing in the Time of Populism). In conclusion, asset bubbles and a financial boom-bust cycles produce instability in markets. In a capitalist democracy, financial instability can ultimately translate into political and social instability. As long-term investors, this remains our deepest concern.

The Silver Bullet is Algebris Investments' macro letter.

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Additional reading:

Is Monetary Policy Less Effective When Interest Rates Are Persistently Low?, BIS, April 2017

Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections, IMF, September 2014

Fiscal Policy Discretion, Private Spending, and Crisis Episodes, Banque de France, December 2011

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