The Silver Bullet

ALGEBRIS INVESTMENTS

Have Central Banks Missed the Exit Train?

After a decade of monetary stimulus, central banks have pledged to exit loose monetary policy. Except for the Fed, their attempts appear to be failing.

The Federal Reserve has been raising interest rates, bringing 2-year yields up to around 2.5% and reacting to the Trump Administration's fiscal stimulus, the largest on record during a peacetime expansion. However, long-end Treasury yields remain flat to the short-end, while Bunds, JGBs and Gilts stay near record lows. Eurozone CPI YoY inflation has fallen to 1.3%, below the ECB's year-end forecast of 1.5%; Bank of England Governor Carney dropped the ball on a rate hike in May; and the Bank of Japan removed its 2% inflation target for 2019. While the Fed was supposed to lead policy normalisation, it now looks like it has driven the train out the station before the other central banks could get on it.

One explanation is that a slowdown in Europe and other developed economies was overdue after a strong 2017. But we suspect there are other structural factors hindering growth and policy normalisation outside of the United States.

First, while the U.S. restructured its bad debts in bond markets during the crisis, debt overhangs still loom large elsewhere. Europe and China hold over 10% of GDP in non-performing loans, according to the ECB and IMF. Italy's sovereign debt is just shy of 132% of GDP. Around six percent of Eurostoxx firms have interest coverage below 1%. Asset bubbles and debt overhangs have also developed in countries which were spared by the crisis, like Australia, Canada and Sweden.

Second, financial markets have become increasingly fragile and subject to negative feedback loops, also due to the shift towards passive investing and short volatility strategies.

Third, the Trump Administration's fiscal stimulus is likely to push inflation up in the U.S., pushing the Fed to hike faster, but this will also tighten financial condition elsewhere. Some Emerging Markets like Turkey and Argentina, are already feeling the pinch.

Fourth, geopolitical turmoil is on the rise, with rising risk of trade conflicts in Asia and potential military conflicts in the Middle East.

Our economy and markets have broken from last year's goldilocks synchronised expansion. Economies no longer move in lockstep, and the U.S. is the only which continues to outperform. This poses a dilemma for central banks: hiking following the Fed may end the recovery too soon. Waiting may leave them without any dry powder when the next crisis comes.

We don't know when the next slowdown will happen, but we know that our economy and financial system remain fragile, despite the recovery. What could drive a potential slowdown, and what would policymakers be able to do in response?

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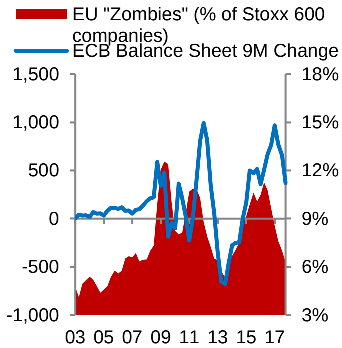
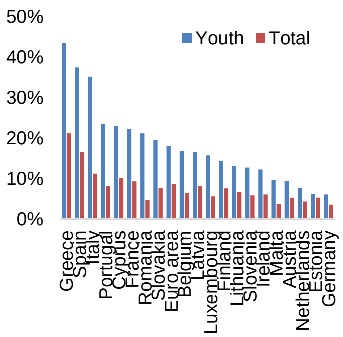
Europe's weak corporate tail



Source: BofA Merrill Lynch. ECB balance sheet change 9M (LHS), Eur bn. Zombies defined as companies with interest coverage < 1x.

Youth unemployment is still high
Unemployment rate %



Source: Algebris (UK) Limited, Eurostat

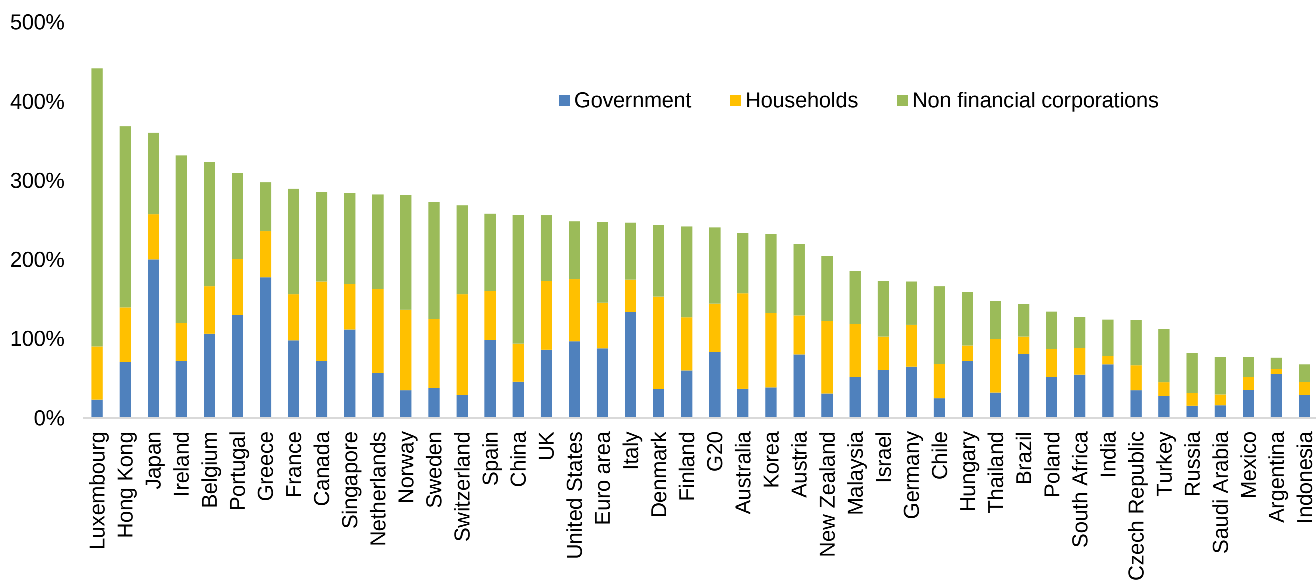
1. Debt Overhangs Loom Large

Former Fed Chair Yellen said that "*it's a myth that expansions die of old age*". But it is also a myth that a recession could only be triggered by an exogenous shock or central banks hiking too much. The fact is, while cyclically global growth is still strong thanks to years of QE and low rates, such easy monetary policy has failed to reduce the stock of structural imbalances across economies. Debt levels are elevated, Eurozone banks still have €1tn of non-performing loans (NPLs) sitting on their balance sheets and one in five young Europeans are unemployed. This means the current economic expansion is fragile, with several potential breaking points.

Public and private debt overhangs mean higher bond yields are not sustainable. Over the past decades, the developed world has witnessed a debt super-cycle, with credit outgrowing GDP by 2-3 times. Post-crisis policy responses have been QE and rate cuts, which helped to ease financial conditions and reduce refinancing costs for borrowers, but failed to encourage deleveraging. In addition, QE in the developed world has propelled investors to look for yield, diverting funds into emerging markets and fueling a rapid EM credit expansion.

The endgame is more fragile public and private balance sheets, which are vulnerable to a tightening in financial conditions. In the US, public debt and deficit figures are growing with the latest fiscal stimulus, while corporates and consumers have re-levered since the crisis. In the UK, the Office for Budget Responsibility forecasts household debt to income ratio to rise to 146% in 2022 from 139% now, propelled by the rapid growth of consumer credit – a risk warned by the Bank of England. According to the BoE, a consumer credit impairment rate of 20% in a stressed scenario would result in a £30bn loss in the banking system, equivalent to 150bp of bank capital. In the Eurozone, while corporates are not re-leveraging as much as their US peers, there is a weak tail of "zombie" companies with very thin margins and interest coverage. Public debt levels are also still high in the periphery. In some countries rising debt levels are also accompanied by rapid house price appreciation, like in Australia, Canada and Sweden, increasing systemic vulnerabilities. Such fragile debt dynamics means policy and bond yield normalisation will be challenging, with the risk of tipping the economy into a slowdown.

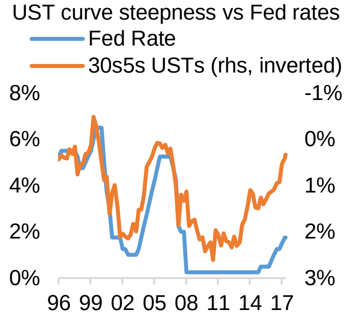
Public and private debt overhangs are still standing
Total non-financial debt by segment of the economy, % GDP



Source: Algebris (UK) Limited, BIS

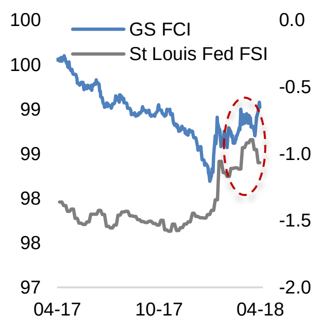
European banks still have to resolve their NPL problem, and time is scarce. Thanks to low funding costs and strengthened capital positions, European banks are starting to expand

Is the Fed rate at neutral already?
UST curve steepness vs Fed rates



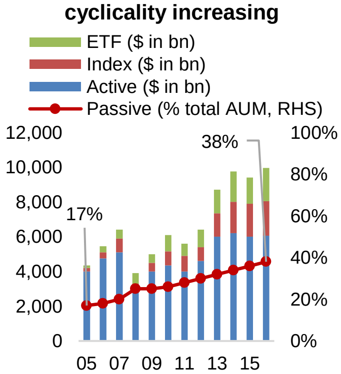
Source: Algebris (UK) Limited, Bloomberg, Citi research

Financial conditions till loose, beware of shocks



Source: Algebris (UK) Limited, Bloomberg, Goldman Sachs Research, St. Louis Fed.

Lack of market liquidity and pro-cyclicality increasing



Source: Algebris (UK) Limited, Goldman Sachs Research.
Note: Data for U.S. equity markets.

credit and to ease lending standards, according to the latest ECB Bank Lending Survey. However, an NPL ratio of 6.2% is still much higher than in other developed countries. High NPL levels might be less of a problem when the economy is still growing, but could exacerbate a slowdown by impairing credit transmission. The challenge for European banks is that the next slowdown may be earlier than their current expectations, which means the time to resolve the NPL issue is scarce.

2. Fed Hawkishness May Hurt Rest of the World

"It's very difficult to know where that so-called neutral rate is. […] Essentially you get down to the point that we will not know it until we're actually there." – Fed Chair, Alan Greenspan

With the global economy cooling, central bankers run the risk of over-hiking and causing a recession. We see a number of reasons why they may hike pre-emptively: to have enough room to cut rates for the next crisis, overestimating the strength of the economy, miscalculating the economy's neutral interest rate, or even to fight inflation caused by exogenous factors such as trade wars or protectionist policies. While every global central bank today runs the risk of making at least one of these mistakes, none more so than the Fed. Aside from the chance that the Fed may need to hike to fight late-cycle inflationary pressures, there's a risk that the Fed may have overestimated the neutral interest rate. Mr Greenspan's point is that one might not know the neutral rate until one sees the impact that rate hikes have had on an economy. Put differently, the Fed risks only realising where the neutral rate is, after hiking past it. The flatness of the US curve may suggest that market is already worried that the Fed may hike past the neutral rate and cause the next recession in the not too distant a future.

The US may have created too much fiscal stimulus, while Europe hasn't created enough. In the US, President Trump's tax and infrastructure plan will essentially front load its stimulus in the next few years, and may be fiscally contractionary in the following years. In effect, the years when fiscal stimulus is needed the most, is when it will be least available. Furthermore, the Byrd Rule under which the tax plan was passed, severely restricts Congress' ability to release another fiscal plan over the next 10 years. Contrary to the US, Europe runs the risk of not doing enough. Growth momentum in Europe has slowed. Despite this, the ECB may be required to curtail stimulus both due to physical limitations in the bond buying programme and to build monetary ammunition. A fiscal boost in Europe could help shift the stimulatory onus away from the ECB while also help kick start growth momentum.

3. Feedback Loops Can Accelerate Market Corrections

Market imbalances may spill-over to the real economy: Financial market conditions have a direct impact on economic activity over time. These remain loose compared to last year despite the Fed's hiking path, but shocks such as the synchronous February sell-off can rapidly alter economic conditions. The February shock occurred against a backdrop of strong and accelerating economic data across the world, which is now slower in Europe, stable but no longer accelerating in the US, and has tangible new risks to its outlook via trade wars and protectionism. The causes for the selloff, which included (among others) a combination of cycle-high valuations, poor liquidity, one-sided positioning and strategies reliant on low volatility remain unaddressed.

Imbalances that increase market fragility have consolidated in the QE era, as we have noted in our recent Algebris View presentation and as the IMF highlights this year in their latest GFSR. These imbalances include excess borrowing and covenant weakening in corporate debt via high-leverage underwriting, but also changes in the architecture of financial markets, with the proliferation of short-volatility strategies and passive ETFs, some of which have a mismatch between liquid liabilities vs illiquid assets. The combination of accumulated carry trades, excess borrowing and liquidity mismatches in markets will likely increase investor downside when the cycle turns.

Only the U.S. economy is still firing on all cylinders

Country	Retail Sales		Industrial Production		Manufacturing PMI		Idiosyncratic Ind.		Confidence		Average	
	Latest	Momentum	Latest	Momentum	Latest	Momentum	Latest	Momentum	Latest	Momentum	Latest	Momentum
US	0.9	0.3	1.8	0.2	2.2	0.5	1.8	0.2	2.6	1.3	1.9	0.5
EZ	-0.4	0.1	0.3	-0.2	0.5	-0.4	0.3	-0.3	-0.4	0.1	0.1	-0.1
UK	-1.2	-0.1	0.5	0.3	0.6	0.0	-1.4	-0.1	-0.5	0.3	-0.4	0.1
Germany	-2.3	-1.2	0.3	-0.6	0.7	-0.2	0.6	-0.3	1.3	-0.1	0.1	-0.5
Italy	-0.4	0.6	-0.1	-0.5	0.3	-0.3	1.2	-0.1	0.8	0.1	0.4	0.0
Spain	-0.5	-0.1	0.1	0.0	0.6	-0.3	0.6	0.0	-0.8	-1.1	0.0	-0.3
Brazil	0.8	-0.1	1.0	-0.2	1.7	0.0	1.0	0.1	0.6	-0.2	1.0	-0.1
Mexico	-1.0	0.1	-0.6	-0.1	0.4	0.3	-0.4	0.2	-0.9	-0.1	-0.5	0.1
Turkey	1.1	0.0	0.7	-0.4	0.4	-0.5	0.9	-0.1	0.7	-0.2	0.8	-0.2
China	-0.7	0.9	-0.5	-0.3	0.7	-0.1	-0.7	-0.5	1.6	0.0	0.1	0.0
South Korea	0.3	0.4	-1.4	-0.5	-0.1	-0.4	-0.1	-0.2	0.9	-0.1	-0.1	-0.2
Australia	-0.5	0.3	-2.1	0.0	-0.5	-0.3	2.1	0.7	0.2	-0.7	-0.2	0.0
Canada	-0.7	0.2	0.5	-0.1	1.3	0.0	0.0	-0.5	0.8	-0.4	0.4	-0.2

Source: Algebris (UK) Limited, Bloomberg.
Note: Numbers are standardised vs. 3yr average. Momentum refers to difference between latest number and 3MMA. Heat map highlights difference for indicator between countries. Relevant Idiosyncratic indicators vary by country.

Still fragile EU sovereign debt dynamics

Italy debt to GDP ratio in 5 Years in different growth and yield scenarios
Red cells = debt to GDP ratio > 130%

Yield Change	Average Annual Nominal GDP growth								
	-5%	-4%	-3%	-2%	-1%	0%	1%	2%	3%
-1.0%	187%	177%	168%	159%	151%	143%	136%	129%	122%
-0.5%	188%	178%	169%	160%	152%	144%	137%	130%	123%
0.0%	189%	179%	170%	161%	153%	145%	138%	131%	124%
0.5%	191%	181%	171%	162%	154%	146%	138%	131%	125%
1.0%	192%	182%	172%	163%	155%	147%	139%	132%	126%
1.5%	193%	183%	173%	164%	156%	148%	140%	133%	127%
2.0%	195%	184%	175%	166%	157%	149%	141%	134%	127%
2.5%	196%	185%	176%	167%	158%	150%	142%	135%	128%
3.0%	197%	187%	177%	168%	159%	151%	143%	136%	129%
3.5%	198%	188%	178%	169%	160%	152%	144%	137%	130%
4.0%	200%	189%	179%	170%	161%	153%	145%	138%	131%

Source: Algebris (UK) Limited, IMF, Bloomberg.*Assuming an average annual primary surplus of 1.47% of GDP (long-run average for Italy since 1988); assuming 10% of total debt will be refinance every year.

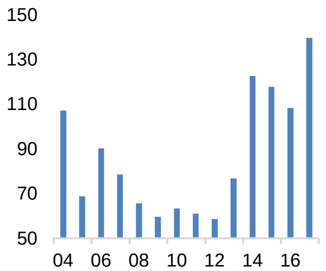
Spain debt to GDP ratio in 5 Years in different growth and yield scenarios
Red cells = debt to GDP ratio > 130%

Yield Change	Average Annual Nominal GDP growth								
	-5%	-4%	-3%	-2%	-1%	0%	1%	2%	3%
-1.0%	154%	146%	139%	133%	126%	121%	115%	110%	105%
-0.5%	155%	147%	140%	134%	127%	121%	116%	111%	106%
0.0%	156%	148%	141%	134%	128%	122%	117%	111%	106%
0.5%	157%	149%	142%	135%	129%	123%	117%	112%	107%
1.0%	158%	150%	143%	136%	130%	124%	118%	113%	108%
1.5%	159%	151%	144%	137%	130%	124%	119%	113%	108%
2.0%	160%	152%	144%	138%	131%	125%	119%	114%	109%
2.5%	161%	153%	145%	138%	132%	126%	120%	115%	110%
3.0%	161%	154%	146%	139%	133%	127%	121%	115%	110%
3.5%	162%	155%	147%	140%	133%	127%	121%	116%	111%
4.0%	163%	155%	148%	141%	134%	128%	122%	117%	111%

Source: Algebris (UK) Limited, IMF, Bloomberg.*Assuming an average annual primary surplus of -1.43% of GDP (long-run average for Spain since 1988); assuming 10% of total debt will be refinance every year.

4. Geopolitical Risk Is Rising

Geopolitical risk at multi-year highs
GPR, annual average



Source: Algebris (UK) Limited, Caldara, Dario and Matteo Iacoviello, "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve Board, January 2018

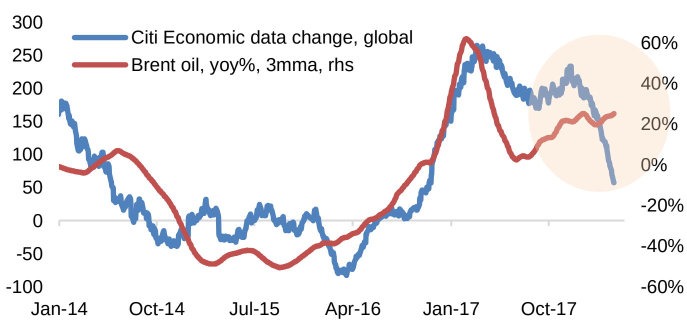
Another key cause for the next global downturn could be a supply-shock driven surge in oil prices, on rising political risk and conflicts in the Middle East. Brent crude has already had a strong year, up more than 10%, despite global growth momentum starting to wane. The recovery in oil prices since early 2016 has been driven by a combination of growth bouncing back and OPEC/non-OPEC compliance with production caps. From here, supply-side factors are likely to act as a dominant factor in the march higher for oil prices. Such a scenario could result in higher oil prices combined with lower equity prices at end-2018.

Oil prices are not pricing in higher geopolitical risk. Geopolitical tensions may be easing in the Korean peninsula, but there is no sign of de-escalation in the oil-rich Middle-East. The situation in Syria continues to draw regional and global powers into ever-closer risk of direct military conflict. Tensions between Iran and Saudi Arabia – two of the world's largest oil producers – are close to all-time highs and have manifested themselves on multiple fronts already. A measure of geopolitical risk (GPR) constructed by economists at the Fed, shows that GPR was at its highest annual average in 2017 in more than 14 years. We estimate that oil prices per unit of GPR remain close to historic lows, despite the sharp increase in oil prices over the past twelve months. The market may be underpricing the impact that GPR can have on actual supply in the next 6-12 months.

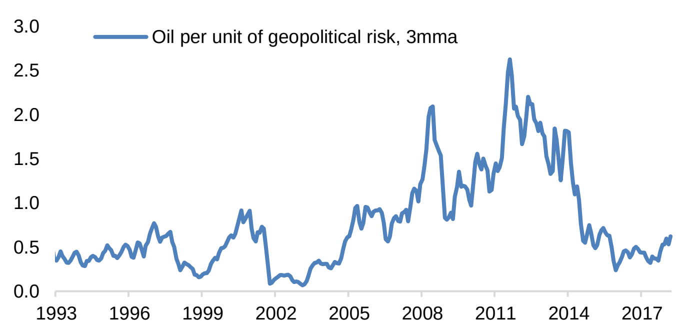
It is probable that the Trump Administration will not recertify the Iran deal. The next near-term catalyst to watch for is the 12th May self-imposed deadline for the Trump administration to recertify the nuclear agreement between Iran and the P5+1. President Trump has previously vowed to tear apart the agreement in the absence of significant changes. Despite sustained pressure from European allies, it seems highly likely that the US will pull out of the deal, potentially triggering Iran to re-engage in nuclear enrichment activities. Beyond the geopolitical risk impacts, a resumption of sanctions could negatively affect Iran's oil supply capacity, which has increased by 2mn barrels a day since the nuclear agreement – significantly surprising analysts to the upside. The market seems too complacent on a potential negative impact on Iran's supply in the next 12 months.

A supply-driven shock to oil prices is negative for growth, especially for developed markets. Higher oil prices feed through to annual price increases, squeeze real wages and hit consumption. This is primarily the case when the shock is supply-driven. Cashin et al (2014) find that oil importers typically face a prolonged period of loss in economic activity following a supply-driven shock to oil prices. Specifically for the US and Eurozone, they find that a supply-shock driven 12% rise per quarter in oil prices can shave off 0.1%-0.15% from economic growth per quarter after one year, with the negative impact persisting over several years.

Oil prices rising despite weaker demand
Change in oil prices vs. change in global economic data



Oil prices still too low compared to geopolitical risk
Correlation with 10y UST yield volatility, 1-year horizon



Source: Algebris (UK) Limited, Bloomberg, Citi, Caldara, Dario and Matteo Iacoviello, "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve Board, January 2018

Conclusions: From Synchronised Growth to Divergence

What's great for America isn't always as great for the Rest of the World.

It is clear to us that last year's goldilocks environment of synchronised global growth is over. What we expect instead is more divergence in growth and policy between the US, benefiting from the Trump Administration's fiscal stimulus, and the rest of the world, where trade wars are hurting growth.

Our base case scenario is now one of a hawkish Federal Reserve hurting the recovery through a global tightening of financial conditions, before other central banks have time to normalise their policy. In this context, the U.S. economy is currently having its cake and eating it – as the upward momentum from fiscal stimulus has been offset by US Treasury issuance expectations, therefore not pushing the Dollar up and not sharing the benefit of faster growth with countries exporting to the U.S.

What will policymakers do? In his last press conference before leaving office, ECB Vice-President Constâncio left us with a worrying clue about the future: *"I have doubts that on the other hand, one can go back to the simple life of monetary policy as it used to be with very small central bank balance sheets and just policy targeting the overnight money market rate."*

In this environment, we position for divergence in rates markets – short US vs long Euro duration – for a stronger Dollar, and for outperformance across European credit markets, where we think the ECB will remain relatively dovish. In the UK, Brexit uncertainty is starting to bite, making policy normalising much more difficult for the BoE, as we wrote in the FT last year. Given the tightening impact on the rest of the world, the Fed may be already driving the normalisation train out of the platform, before other central banks are able to hop on, as we anticipated in a previous Silver Bullet. We are wary of more turbulence in emerging markets due to positioning, even though fundamentals remain strong.

Long term, our concern is that monetary stimulus will only delay the debt overhang problem, not solve it. Our financial system was thought in the context of post-war growing demographics and a materials-hungry industry, both supporting inflation. Today's technology optimises resource sharing and goods substitution while demographics are stalling, making the consensus two percent inflation target no longer realistic. The US has showed that exiting a balance sheet recession requires a prompt restructuring of debt imbalances. China's streamlining of wealth management products as well as the ECB's pressure to consolidate bank balance sheets are steps in the right direction. Another one is the introduction of flexible debt to absorb future shocks, including CoCo bonds for banks and growth-linked debt for sovereigns, like the ESM-French mechanism proposed for Greece. But the window of time is closing and most debt overhangs remain unchallenged. Without action, the risk is a Japan-style environment of QE infinity, which will further distort resource allocation, asset prices and boost the wealth of asset owners against younger generations.

The Silver Bullet is Algebris Investments' macro letter.

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