The Silver Bullet

Trick or Tantrum?

"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."
James Carville, 1992

Bond market volatility is back, and it is scaring everybody. Just of two weeks of widening in yields have put years of secular stagnation and lower-for-longer mantra into question. Is it the beginning of the end for the great multi-decade bull run in bonds?

There are many reasons pointing us to believe that making money in long-dated bonds is no longer going to be an easy trade, as we have been arguing over the past few months (The Silver Bullet | Central bankers: the tide is turning, 7 September 2016).

1. QE infinity is broken. First, it is becoming clearer - to both central bankers and academics - that negative interest rate policy (NIRP) and prolonged quantitative easing (QE) have provided declining marginal stimulus and eventually resulted in several collateral effects. QE stimulus becomes particularly ineffective in regions were populations are ageing, and consumers faced with lower returns on investments end up saving more for retirement. The transmission of QE to the real economy is also hindered where banking systems are fragmented and unprofitable, like in the Eurozone or Japan. Low interest rates further reduce the banks' return to profitability. Finally *QE infinity* can create other collateral effects, including the potential creation of asset bubbles, the misallocation of resources to leverage-heavy economic sectors (real estate, finance, energy) and changes in the distribution of wealth.

For these reasons, it is clear that central bankers are taking their foot off the QE pedal. The BoJ started with its yield curve control. ECB President Draghi made it clear that QE "*cannot stay in place forever*", in his latest press conference. In part, it is a game of balancing expectations, in part, the ECB and the BoJ are also looking at banks' profitability, which improves if yield curves are upward-sloping, and in part this has also been driven by fears that with low interest rates, insurers and pension funds may eventually run into a shortfall.

2. Growth and inflation are not dead. The second reason why bond yields are normalising is the great fears of an immediate Brexit fallout on the European economy were exaggerated. We estimate a hard Brexit will cause a GDP loss of over 7.5% to Britain, but for the rest of the EU, the impact will be a lot lower. Rather than a sudden shock, this cost will be spread over multiple years of stagflation in the UK. It is clearer now that the shock absorbers will be currency depreciation and fiscal stimulus, both bad for nominal yields. Economic data is also slowly picking up in the United States, although the recent 2.9% GDP print may overstate actual growth.

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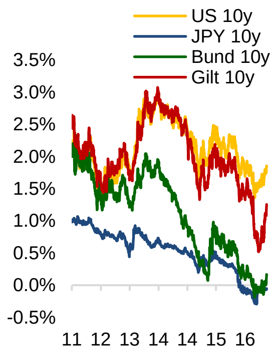
The end of the trend?
Yield to maturity



Source: Algebris Investments (UK) LLP, Bloomberg

3. Demand for duration has been at all-time highs. Supply is rising. Governments are issuing more and more long-dated debt. Think of Austria's recent 70-year bond or Italy's 50-year. The average duration of global bond portfolios has never been so high, according to analysis by the International Monetary Fund's latest Global Financial Stability Review. But while investors have been swallowing recent bond issues, there is a lot more supply to come as the UK and US embark on fiscal spending programmes post vote.

4. Fiscal stimulus is on the way. Austerity is dead. The new US administration, the UK, China and Japan are all implementing or moving to implement fiscal stimulus. In the US, both candidates are planning to spend more. The UK has discussed infrastructure investment. China is continuing on its private credit expansion plan. Japan's Abenomics is on the run. The EU is lagging behind, but could come out with a small fiscal surprise after German and French elections next year.

5. Populism and protectionism are inflationary. The fifth reason why bond yields are set to normalise is politics. We long argued that the current cycle of QE infinity and low interest rates could be broken by the result of prolonged rising inequality. Today, we can clearly see a global trend in protest votes, where citizens of the United States and European countries are increasingly demanding radical change, or falling prey to easy solutions without an underlying economic plan. Even without populism, the fight against inequality may mean higher inflation through higher minimum wages, a trend which is accelerating.

On November 8, the US will choose its next President. A populist election means risk-off and lower bond yields near-term: US treasuries have rallied each time Mr Trump has gained against Sen. Clinton. But in the medium term populist leaders are likely to opt for fiscal stimulus and more spending, penalising bond investors: this is part of Trump's economic plan in the US (and of the Brexit plan in the UK). Moreover, protectionism and de-globalisation, trade tariffs, buying domestic products – all of these trends can contribute to domestic inflation.

So, does this mean the end is near for bonds? We believe further normalisation is in the cards. The combination of shifting monetary policy thinking, fiscal stimulus and protest politics are likely to hurt investors who have been in a one-way long duration trade over the past quarters. That said, central bankers will be very careful in managing the process – no one wants a tantrum, at a time when easy monetary policy is just starting to bear fruit.

Long-term, the structural drivers of low real yields are still in place: low productivity growth, resource misallocation and industrial overcapacity, persistent debt overhangs and ageing demographics will continue to weigh on potential growth and inflation dynamics.

But from current levels, there is still plenty of room for further normalisation in yields, and for the bond market to intimidate everybody.

Trick or treat?

1. The Monetary Tide Is Turning: from QE Infinity to QE with Limits

Policymakers used monetary policy as the main tool to fight the aftermath of the crisis. It worked in the US, helping to kick-start growth by lowering funding costs for firms and boosting asset prices and consumer confidence. In contrast, monetary easing has worked less well in the Eurozone and Japan, where debt overhangs persist and bank lending stagnates. Yet until recently the response to QE not working had always been more QE.

This is no longer the case, in our view.

Central bankers are waking up to the limits and collateral effects of prolonged QE and negative interest rates policy (NIRP), including rising wealth inequality, misallocation of resources, a gradual erosion of bank profitability and asset bubbles. As a result, they are re-adjusting their strategy – moving from QE infinity to QE with limits, as we discussed in The Silver Bullet | Central bankers: the tide is turning.

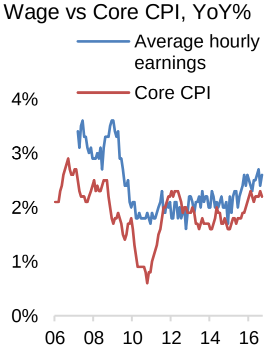
The Bank of Japan has been the first one to actually implement a change to the policy framework. At its September meeting, the central bank backed away from further asset purchase expansion or rate cuts but introduced a "*yield curve control*". This follows the BoJ's Comprehensive Assessment of its monetary policy, where Governor Mr Kuroda admitted that central bankers should weigh the benefits of QE and negative interest rates on corporates and consumers with negative impact on financial intermediation.

Similarly in the Eurozone, ECB President Draghi talked about the positive correlation between credit intermediation and bank equity prices at the July press conference. In early October, Bloomberg News also reported that the ECB may consider QE tapering. This was denied by Mr Draghi, who however highlighted the limits of QE in his latest press conference.

In our view, these signals show that the ECB is taking a more cautious approach towards monetary easing. While we think the ECB will maintain an easing bias, it is unlikely to cut rates further or significantly upsize asset purchases. Instead, it is likely to opt for more incremental changes to the length and flexibility of its QE programme, for example extending its duration beyond March 2017, but at the same time decreasing the size of monthly purchases.

2. Inflation: Some Positive Signs

Core inflation is picking up
Wage vs Core CPI, YoY%

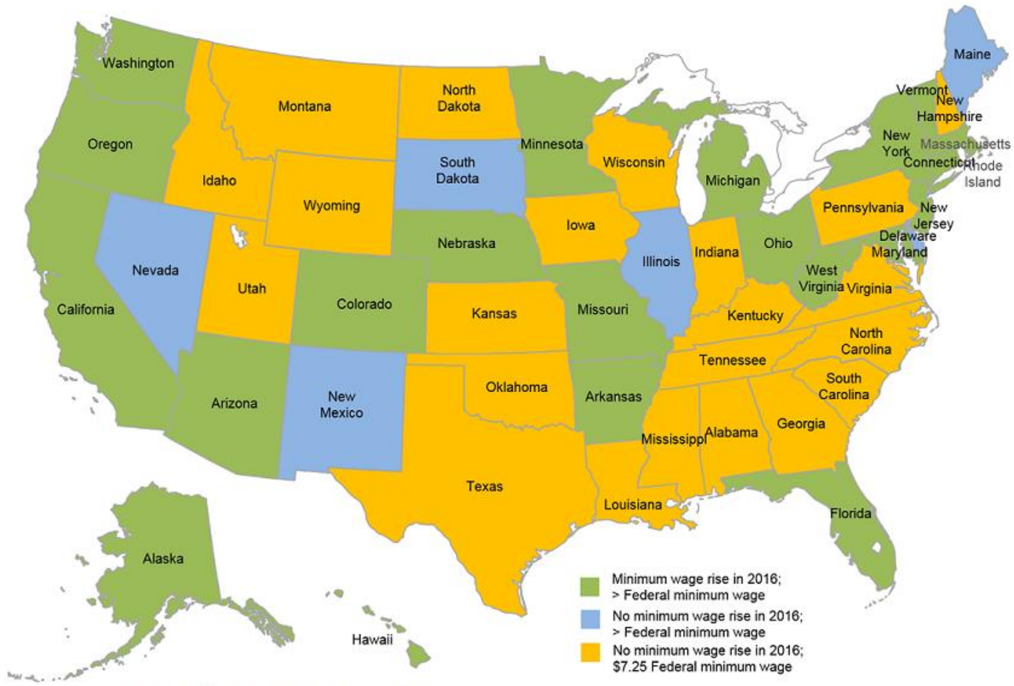


Source: Algebris Investments (UK) LLP, Bloomberg

Unlike in previous cycles, most developed countries since the last crisis have witnessed an asset-rich-inflation-poor recovery. There is a plethora of secular causes behind sluggish inflation globally, including ageing demographics, faltering productivity growth, declining money velocity and capacity overhangs in the commodity sector. As a result, inflation expectations had continued to decline and are currently still below 2% for 5-year in most developed countries.

However, recently there have been some signs of a build-up of inflation pressure, especially in the US. Thanks to deeper capital markets and more flexible bankruptcy laws, the US has been able to more quickly restructure its debt and re-start credit growth, supporting investment and consumption. The latest Q3 GDP print at 2.9% and personal spending data (+0.5% YoY in September) surprised to the upside, suggesting the economic recovery remains well on the track.

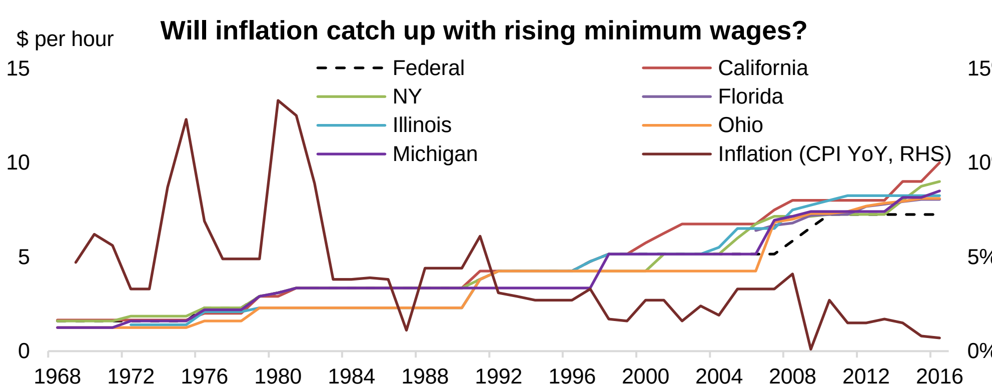
In addition, there has been a pick-up in US wage growth over the past months. In part, it follows the continued tightening in the labour markets. The October Fed Beige Book flagged signs of labour shortages and hiring difficulties in manufacturing, hospitality, health care, truck transportation and sales. These have led to upward wage pressure in Districts like Philadelphia, St. Louis, San Francisco, Boston and New York. In addition, the gradual phase-in of minimum wage rises presents another tailwind, especially if further increases were to be introduced after elections. An acceleration in wage growth could provide a strong support to core inflation, which has already been trending higher.



Source: Algebris Investments (UK) LLP, NCSL, US Department of Labor

The Eurozone remains on a weaker footing, as its reliance on bank financing and slow restructuring of the banking sector mean it takes much longer to re-start credit growth. Nevertheless, bank lending has stabilised and been gradually rising over the past 1-2 year, while PMIs have remained resilient. We have also seen some positive economic surprises recently, with October Eurozone PMI and inflation in Germany and Spain outperforming expectations.

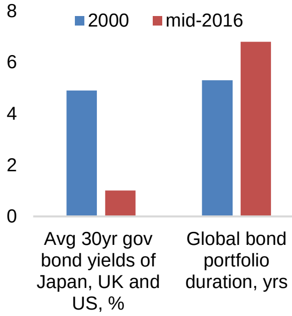
The biggest uncertainty still hovers over commodity prices. Undoubtedly the rebound in oil prices this year has contributed positively to inflation, but whether such price recovery is sustainable is questionable. Idiosyncratic factors or catastrophes have played a large part in the oil rebound this year, while any real cut to capacity is still lacking. The inconclusive OPEC meeting over the weekend again highlights the difficulties in getting the producers to agree on output controls. However, given current oil prices are already close or below the breakeven levels for many exporting countries, the room for further declines is much more limited compared to 2014. In other words, oil prices may not act as a tailwind for inflation, but they will not be as big a drag on inflation either.



Source: Algebris Investments (UK) LLP, FRED

Long bonds: a crowded trade

Average yield vs duration



Source: Algebris Investments (UK) LLP, IMF GFSR October 2016

3. Long Duration: A Crowded One-way Street

Long duration has been the trade of the decade, as yields declined and curves flattened on ultra-loose monetary policy. Issuers and fund managers have jumped on the duration bandwagon: over a $1tr has flowed into income funds (IG, HY, REIT and dividend) since QE began, and corporates have taken advantage of low rates to issue ultra-long dated bonds (Brazilian oil company Petrobras issued a 100-year bond in 2015, despite having only 11 years in proven oil reserves).

However, the duration-party is now over-extended. Savings are being eroded as real interest rates are negative in most developed markets, and central bankers are struggling to purchase bonds under their QE programmes. In our view, sovereign yields need to move higher, and a market correction may be ugly. This is especially as liquidity in the bonds markets has declined since the financial crisis in 2008, further exacerbated by the rise of Exchange Traded Funds which offer daily liquidity to their investors (IMF GFSR report, October 2015).

4. More Fiscal Stimulus Is on the Way

Another source of inflation pressure will come from a shift in global fiscal policy. Since the crisis, most developed countries have kept their purse strings tight given existing public debt overhangs. However, more fiscal spending could be on the way after elections.

This is already happening in Japan, with PM Abe announcing a ¥28.1tn stimulus package after a strong victory in the July Senate elections. Canada and South Korea also pledged extra budgets to step up public spending this year.

US Fiscal Stimulus: Clinton vs Trump

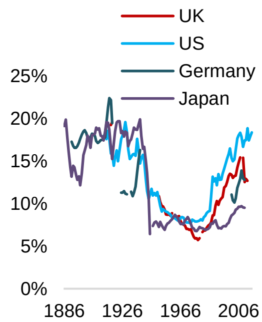
	Clinton	Trump
Infrastructure	Would boost federal investment by $275bn over five years with an additional $25bn to fund an infrastructure bank	"*At least double*" Clinton's infrastructure spending
Taxes	• Would largely maintain the current tax code, with some increases for wealthier taxpayers • Favours tax incentives for investment in hard-hit manufacturing locales • Tax credits for businesses of $1,500 per apprentice • 15% tax credit for companies that share profits with workers on top of wages and pay rises	• Lower taxes for everyone • Reduce dramatically the income tax • Limit taxation of business income to 15% for every business
Minimum wage	Would increase national to $12, with $15 in some locations	Wants states to set their own minimum wages
Others	Would increase funding for scientific research	

Source: Algebris Investments (UK) LLP, www.hillaryclinton.com, www.donaldtrump.com, Politifact

Fiscal stimulus should also come in the US after elections, where both candidates have promised more spending, and in the UK as a response to Brexit. Europe is still lagging behind, with the size and implementation of President Juncker's investment plan underwhelming. However, there is a better chance that governments could coordinate on a spending plan after the German and French elections in 2017.

While fiscal stimulus is also not the panacea to all existing structural problems, it could complement easy monetary policy and generate some positive growth shocks. In a good scenario, it could help to normalise interest rates.

Top 1% earn a bigger share
% total income for the top 1% earners



Source: Algebris Investments (UK) LLP, World Wealth and Income Database (line breaks = data unavailable)

5. Populism: A New Inflationary Force

History has seen multiple instances of when periods of populist governments were shortly followed by higher inflation. For instance, when democracy was being established in Latin America during the 1980s, inflation was on the rise as new governments implemented populist policies as a means to redistribute wealth and reduce income inequality. While inequality in Latin America in the 1970/80s is much higher than that of most developed markets (DM) today, wealth inequality in DM nations is now near all-time highs, exacerbated by the effects of easy monetary policy and QE.

We see three main policy channels through which policymakers may raise inflation:

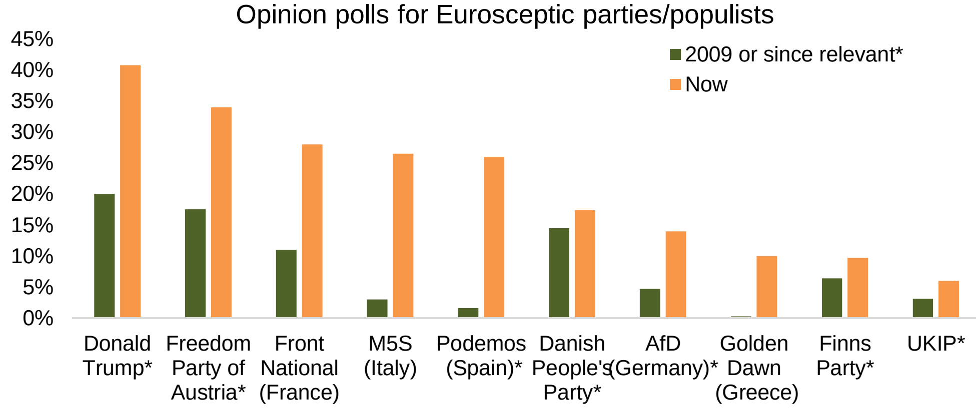
1. Currency debasement
2. Expansionary fiscal stimulus
3. Protectionist trade policies
4. Limits to migration / protectionist labour policies
5. Capital controls

History is full of examples of financial repression, where interest rates were kept artificially lower by governments trying to recover from recessions or wars, and bond investors reaped negative returns. The Roman Empire implemented the first version of currency debasement, shaving its silver coins to increase money in circulation. Britain used inflation to get out its public debt after the War of Independence. The US under President Roosevelt seized private gold holdings in 1933 to prevent hoarding, while cash savings were hurt inflation in the following years. The same happened after World War II for the US and Europe, where real interest rates dropped to less than -10% in countries with heavy loads of war debt.

Protectionism can also be inflationary. The ECB estimates that globalisation reduced inflation by 0.1-0.2% between 1995 and 2004. Lower trading barriers have been closely correlated with declining inflation since the 1990s, as governments lowered trade tariffs and manufacturers lowered costs by shifting operations to developing nations. The same is true for skilled migration: the UK, for instance, has benefited from the flow of incoming workers over the past decades, while it would faces shortages in various professions (doctors, nurses, plumbers, electricians) if it suddenly closed it borders.

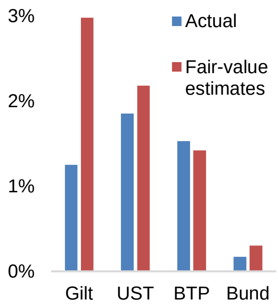
In the worst scenario, protectionist governments may not only limit the movement of people and goods, but also of capital. Capital controls may seem far from us, but they are already a reality in China, for example, Argentina, Brazil and Iceland – for different reasons.

Support for radical and populist politics is on the rise
Opinion polls for Eurosceptic parties/populists



Source: Algebris Investments (UK) LLP, Wikipedia. *Freedom Party of Austria: 2008 Legislative Elections; Donald Trump: mid-2015 when he first announced candidacy; Podemos: 2013 when it came into force; Danish People's Party: 2010; UKIP: 2010 General Election; Finns Party: 2010 Parliamentary Election; AfD: 2013 Federal Election.

Gilts: the most overvalued
10-year sovereign bond YTM



Source: Algebris Investments (UK) LLP, Bloomberg

Conclusions: Trick, not Tantrum

Investing in bonds is increasingly a tricky business. If history's lessons are valid, bond investors are set to reap poor returns in an environment where nominal yields are low and governments are likely to increase fiscal stimulus or embark on populist and protectionist policies. The first line of defense is to invest in assets which do better with positive, steeper yield curves: among these are banks and insurance companies, for example, which have been suffering over the past decades on NIRP and QE. The attack line instead is to position for a widening of those bond markets which are more overvalued – among these, we believe UK Gilts stand out the most. Gilts offer investors the most negative real yields amongst developed countries. Under a hard Brexit, the UK is likely to enter a prolonged period of stagflation: Britain will import inflation as Sterling depreciates. But while inflation expectations have already risen (5y-5y forward inflation is well above 3%), 10y Gilt yields remain relatively anchored at around 1.2%, held down by expectations of a potential further QE-expansion. In the past, the BoE has raised its volume of purchases in tandem with issuance by the Debt Management Office. But this may become challenging to do as inflation rises and the government implements a fiscal expansionary plan. We believe the combination of a depreciating currency, lack of a coherent economic plan for Brexit and fiscal stimulus make Gilts the bond market with the worst downside risks.

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