What Just Happened in Global Credit?

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- **Tapering but no rate hike**
- **Dollar credit products surged**
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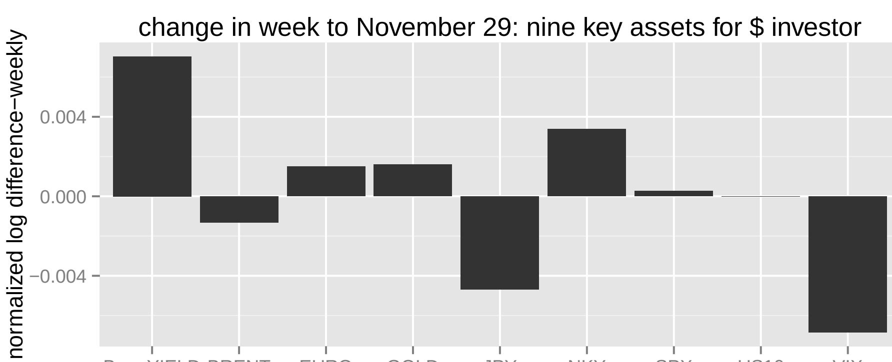
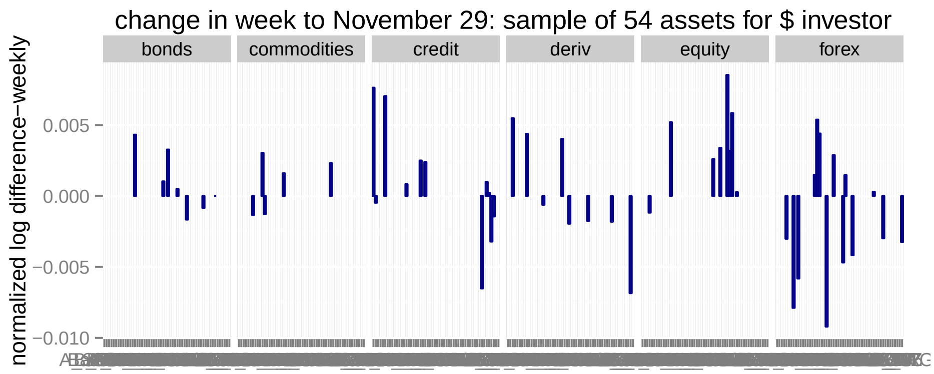
Markets kept working toward a future of tapering and a long wait for rate hikes. In particular, equity volatility rose (a holder of a portfolio of options would have lost value), and corporate bonds did very well. Assuming early tapering, less cash will spill over into less equity buying which creates risk in that market. As we increasingly assume no rate hikes for a long time to come, the rate risk in corporate bonds falls.



Dollar credit products surged. Sovereign bonds did broadly better across our sample, rising in value most in Germany and Japan, where tapering is not an issue. Higher quality US corporate bonds did much better, because risk free rates account for a large proportion of their yield. Their spreads to US treasuries were down to levels last seen in May.

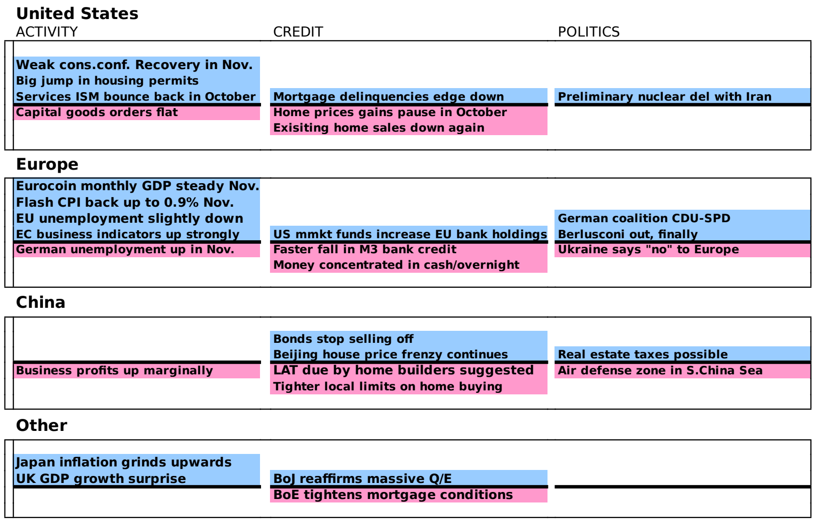
China's growth unleashed by reform attracted local investors in China, and foreign investors into India. US equity investors, emboldened by the recent rush up in their own markets were visibly buying into German and Japanese markets, too. In foreign exchange, the pound was up sharply on the discovery that Great Britain is in full recovery. Perhaps surprisingly under these conditions, emerging market foreign exchange fell under renewed pressure, including Indonesia, but also Brazil and, Canada.



US housing survives higher mortgage rates. An upward bias in US indicators after the twin budget and mortgage rate shocks remains intact. We see it in all the most concrete secondary data: initial unemployment claims, income taxes paid, and gasoline deliveries. Housing matters because this grinding recovery has depended so far on replacement of aging cars after a buyers-strike in late 2008 and 2009. Now that car replacement cycle may be peaking and the best hope for a cyclical kick next is from a long-delayed recovery in home construction. Despite higher 30-year mortgage rates, a recovery cycle seems to have begun as new home building begins a long-overdue recovery to meet basic, replacement, needs that have been long foregone.

Europe's credit cycle is necessary. Activity is grind forward in Europe as in the US, but with greater financial risks in Europe. Economic and business sentiment indicators were up sharply, and the Eurocoin index of European monthly GDP is rising more than the disappointing 3Q report would indicate. Unemployment came down a tiny amount from all-time highs in October, and even deflation seemed slightly less risky as European inflation picked up. But the risks due to high debt and still undecided politics of fiscal union remain. Neighbors could reasonably choose to keep outside of so troubled a system as this, as did the Ukraine in failing to sign a free-trade agreement with Europe as a step toward closer links.

Banking data confirms the ongoing credit stresses in Europe. This is basic: a unified money with uneven public and business borrowing will only correct when banks refuse to lend to the overborrowed. But, in this process, some of the credit extended earlier will have to be written off. Struggling to avoid these upcoming losses, banks will cut down lending to all borrowers in high-debt countries at risk. Hence the collapse in bank lending in Spain and Italy, while overall bank loans fell by 2.1% in October. This is not an accidental distortion but a necessary adjustment process in a monetary union, if you choose to keep it.



Real estate taxes in China. Reforms in finance continue to roll out. Clearly, a bank deposit placed in the interbank market and then picked up by a smaller bank or non-bank financial intermediary for final (risky) lending puts depositors at unwitting risk and evades the purpose of capital and portfolio rules for banks. So the CBRC is considering new rules for the wholesale lending market.

The favored official alternative to shadow banking is bond issuance, which creates a concentration of information reflected in trading prices. How this can work to transmit pressure was visible last week as news report claimed companies that delayed making real estate tax payments have created big accounts payable obligations. Their bond and stock values reacted quickly, including those in Hong Kong and in offshore dollar bond markets.

UK and Japan: alternative QEs. The UK and Japan chipped in last week with important variants on quantitative ease. In the UK, a form of marginal tightening was announced after a strong GDP print was coupled with an apparent overheating in real estate markets. Governor Carney proposed notching back the Bank's funding for lending scheme for housing and will consider further loan underwriting conditions. Macroprudential tightening in one sector like this to avoid a bubble is an alternative to raising general interest rates. But it is a minimial response, arguably in good time to head off a renewed housing bubble.

In Japan, quantitative ease proceeds full-bore. BoJ money base is increasing at a ¥50-60 trillion pace while general government bond sales are projected at ¥40 trillion. A domestic shortage of duration means local portfolios are forced abroad to buy yield. Meanwhile inflation, at 1.1% in October, is creeping into the system, following the yen's drop. But concerns about the upcoming consumption tax hikes are keeping this program solidly in place, even as real interest rates turn negative.

Markets continued to position for US and Chinese recoveries that should lead to gentle tightening: tapering in the US and a higher Shibor rates in China.

In this context, the UK and Japan offered two observations on handling quantitative ease. In the UK, special mortgage credit measures were taken to head off a potential bubble, while keeping overall quantitative ease in place. In Japan, aggressive quantitative ease remains in place, driving down bond yields and and the yen. Policy makers are reluctant all over the world to stop these policies once they have started.

Even so, I still think we are overdue for a taper by the US Fed in December or March. Most vulnerable to the announcement when it comes may be corporate bonds, where spreads have priced no room for error, and equities.