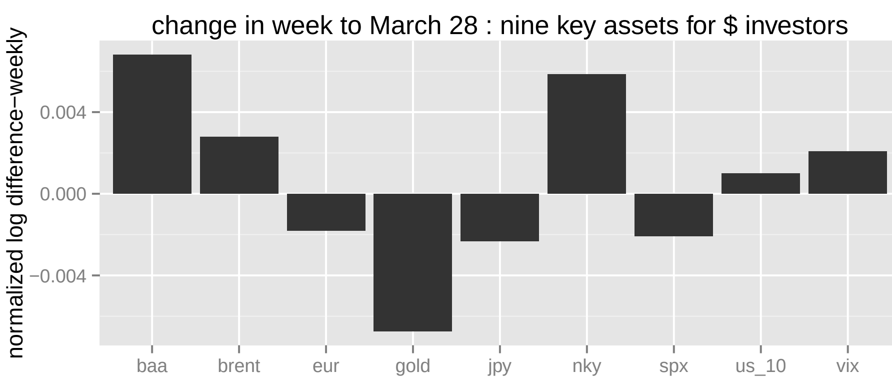
What Just Happened to Global Credit?

Lars J. Pedersen
lars23jacob@gmail.com

- **Out of the fire into Emerging Markets**
- **Much rides on March sales**
- **Is Ukraine a unifying event for Europe?**
- **China's directed spending plans**
- **Venezuela's dollar quotas**

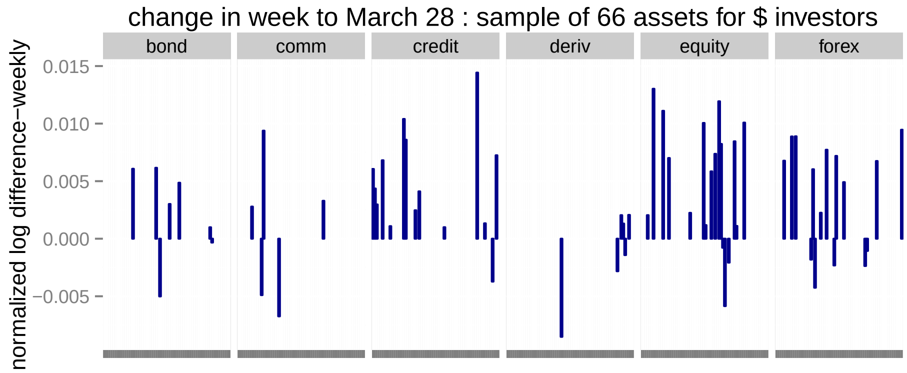
US equities had a choppy week as funds obviously shifted back into emerging markets. The move into emerging markets makes sense if you think a) high global liquidity levels have to find some favored home once US equities looked toppish amid slower growth, and b) that China is due for a wave of government-directed spending. Between the flows and the news all emerging market assets and US corporate credit rose in value.



Out of the fire into Emerging Markets. Equities outside the US did best among my asset classes as investor shifted their big balances from an ever-narrowing concentration on US paper to the wider world. Outsized gains in Brazil, South Africa, and Chile reflect a better outlook for all the commodity suppliers to China.

Next most favored was dollar credit, including the Ukraine sovereign debt most of all after announcement of the big $27billion IMF and EU support program. But the other fringe dollar sovereigns also all did well, such as Venezuela and Argentina. More about Venezuela below. In general, higher yielding did better than higher rated credit.

Lastly, the dollar went down and my sample of currencies rose with a few exceptions. Only the safest alternatives, like the euro and the yen went down, while every single emerging market currency in my sample went up.



Much rides on March sales. A recovery from bad weather is supposed to boost spending to catch up for the now fully documented slippage from December to February. Car sales coming out soon will be particularly important. Anything short of an heroic surge will point to a 1.5%-2.0% quarterly growth which, we are now pretty clear, will not end tapering policy but will certainly shift the first rate hike toward later in 2015 from the mid-year point to which Ms. Yellen referred. Several low inflation readings for the personal consumption deflator, due to lower energy, adds to the bias toward a long wait for easy hikes.

Political risks arising from possible US responses to Russian action in Crimea and the rest of the Ukraine seem to be reduced. But it is not completely clear yet how Mr. Putin will respond if a clearly Western oriented government is ratified by polls in in May, something he perversely made more likely by slicing off a big chunk of the impoverished and Russian-oriented voters in the Crimea.

Meanwhile, rising enrollments in the US Affordable Health Care program could put the Democrats in a slightly stronger position in the mid-term election coming up. That, in turn, makes the US marginally more likely to avoid two years of deadlock between the White House and a Republican House and Senate. Deadlock is not always bad for economic performance under benign conditions, but it increases risks if decisive stabilizing action were ever needed.

Is Ukraine a unifying event for Europe? Indicators of activity including heavy vehicles sales and a series of older confidence surveys in Europe, were all up. A recent Ifo survey, however, showed a drop in German business sentiment in the face of possible gas supply disruptions from Russia. Even before the stress with Russia, all was not well in terms of debt in Europe. Bank credit continues to fall despite every effort by the ECB to entice borrowers with thin promises of negative real interest rates, which can not materialize if prices fall. President Draghi's latest comments revealed a man wrestling with what he fears is a very dangerous debt-deflation situation, and these risks seem to have even gotten through to the Bundesbank, which now supports some form of asset purchases to offset threatened deflation.

Germany's Finance Minister thinks a Europe unified against Russia will make it easier to propose treaty change for a deeper economic union. He did not say it, but a joint military funded at the European level would be a prime candidate for unified spending. In the meantime, Greece is proposing to ride the wave of credit euphoria in Europe to sell public bonds in the second half of 2014. It is an interesting move because of the country's enormous debt load, mostly now in the hands of Europe's public sector. Can Greece persuade EU countries to convert public claims into nearly zero rate, infinite term debt and so make the private sector effectively senior for marginal new lending? Once you say it that way you realize what a bold move is brewing and what a gift from Europe it could be. All made possible, perhaps, by Mr. Putin.

United States

ACTIVITY	CREDIT	POLITICS
Consumer confidence rebounds Markit services bounces in March	Solid 4Q corporate pofits	Obama gains with AHC acceptance Russia strains ease for now
Capital goods orders flat Pending home sales down March car sales critical	Banks dispute opaque stress test	Russian troop movements

Europe

Markit ISM still rising e-coin monthly GDP up EC sentiment up	ECB considers anti-deflation policies Greece plans private bond Banks rebuy bonds sold ahead of AQR	Big IMF_EU package for Ukraine Schauble suggests Ukraine may allow reopening EU treaty change
Ifo expectations fall on sanctions	M3 cedit still contracting	Greeks plan public sector give-backs FN populists do well in France

China

Iron ore prices snap back	G4 telecom contracts coming Commodity funding panics stabilize Overnight rates inch back	New corruption targets More plans for Baoding move WB report on orderly urbanization
Lower business profits ISM 8mo low	Another steel company failing Rural bank run stopped Property survey widened to provinces	

China's directed spending plans. At least the commodity funding crunch seems to have eased up with a jump back up of iron ore and copper prices. But other financing strains continue to build. New trust products are under strain and another steel company defaulted on local bond borrowings. Most importantly, a real estate bust of some so far unknown extent seems to have started. Overbuilding in third tier cities has led to some huge inventory overhangs and emerging cut-throat price wars there. In Beijing, small price cuts from expected levels have been seen, bit to levels still higher than last year.

Reform means decentralized and smarter decisions. In the case of credit that must mean allowing some failures, most usefully in the overbuild solar, metals and shipbuilding areas. So far local government debt is subject to administrative control only, and banks, too, are not allowed to fail. But bonds, bank loans, and trust products are certainly at risk. To balance the shock of this new risk to investors, the apparent recipe is to deregulate in areas that can attract new borrowing. The latest includes announcement of a big move of central government offices to Baoding outside of Beijing, and publicizing the huge task of urban construction ahead in a joint World Bank-CDRC study.

Enormous cross forces are at play here that should lead to a modest dip in activity. Reformist leaders may actually be ready to take more downside economic risks as the undercover purge of opponents on corruption charges is moving to take in several key military leaders. Assured of their positions, these leaders may tolerate less growth than before to encourage more reform.

Venezuela's dollar quotas. SICAD II is a promising scheme to seemingly free Venezuela's exchange rate. Or is it? A policy of headlong domestic debt issuance since 2012 has finally turned into inflation of over 50% a year, and the "new" SICAD II rate may little more than a reshuffling of currency allocations to a new higher price in bolivares barely in line with inflation. In that alternative interpretation, the key is the overall shortage of foreign exchange in Venezuela. A crippling shortage includes failures to pay foreign airlines for tickets sold in Venezuela, and food shortages. One clue may be the dollar rates offered: over the 6 days the new system has been in place, the bolivar has steadily appreciated from 51.8 per dollar to 50.9 on Friday. While the government does not say how much critically short foreign exchange was transacted at these prices we can only assume it is small and is handled by (what else?) another queuing system.

In the presence of large and unstable flows, I now think the greatest risk building will be around the eventual reaction to a renewed US recovery some time in the next six months.

And I think this next iteration of risk might fall jointly on both equities and on corporate bonds that have gained so much from the indirect effects of quantitative ease.