What Just Happened to Global Credit?

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- **The balance shifts to growth**
- **Ms Yellen fights a rear-guard action on rates**
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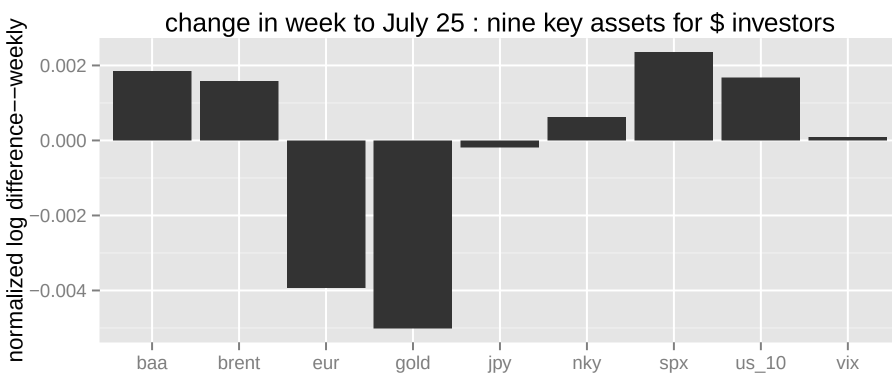
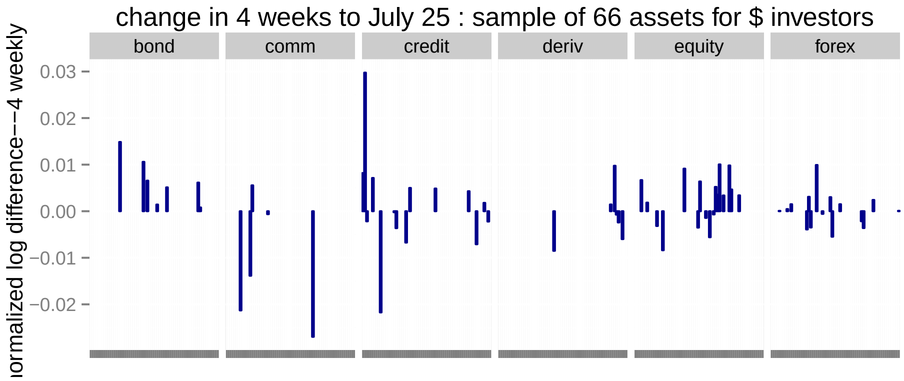
Secular stagnation is giving way to spotty signs of global recovery. US growth will likely look better after historical date is revised and the dubious drop in IQ falls into context. China seems to be compensating for its mini-housing crash to an unexpected degree. In Europe, however, the unknown effects of escalating sanctions over the destruction of a Malaysian Airlines plane may slow investment decisions. Its a spotty but overall improving picture.



The balance shifts to growth. As they raised their estimate of recovery, investors began to rotate out of credit bonds, with their extremely narrow spreads and limited historical upside, into equities, with their greater potential for gain. Some sovereign wealth funds were reported to be making this long-term portfolio shift. Higher yielding corporate bonds were sold while better quality bonds and low-risk government debt were bought.

Meanwhile, volatility came to credit land: my sample of normalized credit returns had some of the highest and lowest returns among assets I track. In an already stressed asset class, the possibility of a default or, if not, a settlement with hold-out creditors created unprecedented gyrations in Argentine sovereign bonds.

The expected global recovery, while increasingly likely, is so far seen to be without strong momentum, as reflected in lower commodities and lower government, risk-free, yields. While the Ukraine situation has heated up, violence in oil-producing Iraq seems quiescent so oil prices fell over the month. Other commodity price falls also seem more linked to specific accidents, including credit difficulties in China, than to global demand.



Ms Yellen seems to be fighting a rear-guard action. An unusually foggy US growth picture should begin to clear, starting with the revision of historical GDP, as large estimation errors are smoothed out. Behind the fog of errors, manufacturing seems to be in a clear expansion, in line with the end of an inventory adjustment phase. Initial unemployment claims and ISM surveys all confirm a US, and possibly global inventory refilling cycle is now getting underway. But, housing is having a tougher slog getting back to normalcy, possibly because buying to rent may be slowing down as rising home prices and higher yields. But personal home buying will eventually come back if incomes revive, as seems inevitable with this pace of jobs growth. In fighting for time before raising rates, Ms Yellen refers both to the slow housing recovery and also to the absence of consumer or wage inflation as as signs of ongoing weakness in demand. If she is disproved by the data, particularly on wages, markets will respond immediately.

Ms. Yellen, in what looks increasingly like a rear-guard action to delay raising interest rates, also claims it is safe to ignoring signs of financial instability because big banks are so much safer now that any financial crisis will be easily contained. Her claim may depend on a limited reading of financial stability at a time when balance sheet variety is exploding all over the system, with the use of corporate balance sheets for active financial engineering, in both developed and emerging markets, and the evolution of new instruments such as total return swap vehicles to leverage trades using non-bank funding from long-term asset managers. Companies are not investing in the real world but, worryingly, in financial engineering. And, by some measures, such as total equity market value to GDP (from the flow of funds), we are now at a speculative equity peak today very comparable to 1999 and 2008, although other Fed measures may be more benign.

So, plans to implement rate hikes must be moving ahead even as the timing of any moves remains uncertain. Basic institutional changes are needed, and underway, to make this possible. Historically, US interest rates are controlled by the supply of Fed Funds created on the Fed's balance sheet. Banks bidding for the fixed amount of these funds would push up interbank interest rates. Now, of course, we have a colossal excess of these funds, so rates can hardly be raised in the old way. So far, the Fed's solution seems to be to pay a floor interest rate on funds deposited with it against securities collateral(reverse repurchases). Banks and money market funds can participate equally well, and both will seemingly be included in this facility. So the Fed is migrating to an approach that manages the shadow banking system symmetrically with banks. These are deep changes: we should never underestimate official preparations for profound changes, in this case the inevitable move up overnight rates.

Europe pulled together by Putin? Tragic violence in the Ukraine, and the risk that brings of trade sanctions with Russia, might tip Europe into a slow-down. We will at least have a flavor of this possibility for the next quarter as unusually warm winter that boosted first quarter growth means pay-back in a slower second quarter pay-back. So, we will not know the extent of damage to European engineering companies'contracts in Russia until later on, and for the moment business surveys remain buoyant and several countries show early jobs gains. But the risk remains because Europe's leaders may feel compelled to react to Russian actions in providing low-grade militants with high-tech weapons, with tragic consequences.

If the European political leaders can pull together to implement sanctions, that could be an inspiration to work for effective economic action, as well. One key to live better within a currency union is to create a trans-European investment budget that would be the joint obligation of all. That would allow counter-cyclical spending without ceding control to irresponsible local elites. J-C Junker's inaugural address as European Commissioner opened the door here, and he will certainly be supported in this by the most popular new leader in Europe, Matteo Renzi. Even in Germany, the idea that a measure of higher demand is needed to accommodate weaker peripheral nations is at least getting a hearing in some unlikely corners.

Meanwhile, the eruption of credit rollover problems at the Banco Espiritu Santo group points out the lingering credit stress across wide swathes of the European economy. Bank credit all over Europe continues to shrink, as lenders try to avoid losses in systems like Portugal's. Strains are visible in rising public debt, crushing real interest rates, and resulting credit stress in much of Southern Europe. But the good news is that where really necessary, as in Bulgaria, EU funds were immediately available to stop a bank run. A lingering credit malaise still troubles Europe but it can be offset by decisive public action.

United States

ACTIVITY	CREDIT	POLITICS
	Yellen opposes rate hikes for financial stab.	
	Plan money fund gates or penalties	
	Covenant Light loans surging despite Fed	
	Bank credit up, mostly for share buying	
Another strong month for car sales	Total return swaps for non-bank leverage	
Solid payroll report	AbbVie tax inversion deal, with debt	Calls for action on tax-evading "inversions"
Possible strike at W.Coast ports	Taper will end in October with $15b move	US may shut Russia out of bond markets
Home prices rise less quickly	Puerto Rico to allow public sector restructure	
	Fed prepares repo and deposit payments	

Europe

ACTIVITY	CREDIT	POLITICS
		Junker calls for EU investment fund
	Portugal, Ireland sell govt. Bonds	Renzi pushed for flexible fiscal rule
	Irish recovery replaces austerity in budget	EU bails out Bulgarian banking run
Strong ISM indicators	Lower rate and TLTRO questioned	Renzi protests BBK critique of budget
Euro confidence weakens	Portugal, Cyprus, Greece debt climbing	Banking sanctions on Russia considered
German IP, capital goods orders fall	Bank credit falls more sharply	Airbus lobbies for weaker euro
German unemployment rises	UK mortgage limits slow lending	
	Espiritu Santo problems in Portugal	

China

ACTIVITY	CREDIT	POLITICS
Rebar prices jump		
Exports rise in May-June	Lower required reserves for small borrowers	
ISM up sharply	Surge in offshore bank bond issues	
7.5% y/y China GDP	Faster credit growth	BRIC bank to set up in Shanghai
	Fake commodity, including gold, financing	
	Drop in gold imports	

Public sector borrowing in China. Activity picked up a little earlier than expected in reported 2Q GDP. Apparently, the shut-down of private apartment construction has been offset by the public sector laying more rail and pushing up the pace of affordable home construction. We know this because central govenment spending has surged, largely for affordable housing. Easier credit and relaxed home buying limits should help to turn the housing market around eventually. Meanwhile, big builders are offering five year home puts to buyers (they can sell the home back at the price they paid). While we wait for these measures to hasten the end of the housing cyle, a private sector credit crunch is emerging in private construction, where most builders will strain to carry unsold houses while maintaining their building programs.

Overall credit began to pick up through June after a series of disruptions engineered by the central bank. Higher rates and episodic funding stresses have created adjustments in trust credit, and entrusted loans earlier, as company defaults were permitted and wealth management products were allowed to fail. More recently we see a dip in foreign credit as banks retract dollar-based commodity financing against unverified local collateral. But we also know that central government spending on affordable housing and rail company bond issuance surged to keep the economy turning over at a sustained rates. On balance, credit grew considerably faster in June than recent trends.

Meanwhile, the policy objective of a credit crunch in heavy industry is only slowly working out. Here state owned companies in collusion with local governments resist any reduction in excess and very dirty industrial capacity. Companies struggle to remain open while some other locality's steel mills close, relying on local government credit guarantees and lborrowing from shadow banks when the state banks were instructed to cut them off. Now, suspicion is rising that some portion of the oversized iron ore stocks at Chinese ports has also been used to finance this political and economic struggle of entrenched local interests against the center. Reformers' main idea seems to be to shift provincial financing to bonds, where they will be subject to full reporting, so that financing abuses will can cut off by informed investors. It could work.

Several accidents that have depressed key commodity markets could easily reverse, and US data revisions could well give us a more intelligible and positive picture of an economy coming out of an inventory adjustment. Global growth news is set to look stronger.

Over the past year, we can see a pattern of markets slowly adapting to eventual higher yields that must come with growth. First it was falling gold prices, because gold has no yield. Then it was higher US mortgage rates, until a home buying boom slowed down. Now it may be higher corporate bond yields, until the corporate financing boom slows down. But to have such deep effect, unexpected defaults are probably needed to deepen and continue a credit sell off.

If an early credit cut-off and default wave does not develop, a stronger global recovery may force earlier rate hikes that push up risk-free government bond yields. So, its either meaningfull and disruptive credit events or higher government yields. One or the other. I favor the second case.