What Just Happened to Global Credit?

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- **Oil Shocks**
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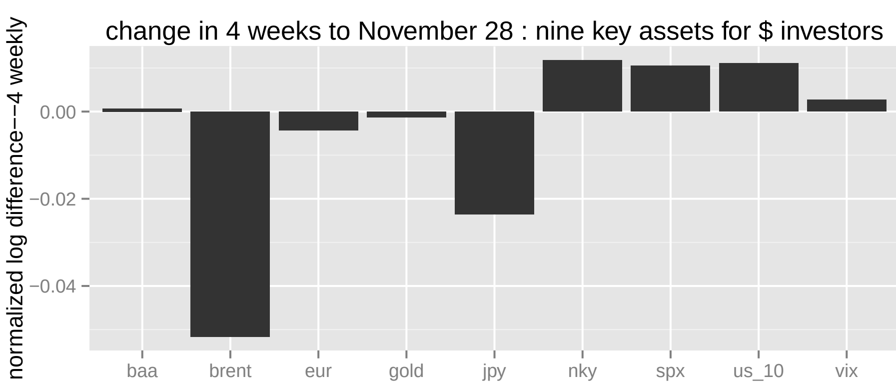
A massive oil price fall will change everything. A small number of oil producers will see incomes slashed. Some have financial buffers and can take their time about adjusting: others will have to squash spending immediately. Meanwhile every single global consumer of petroleum products will experience something like a tax cut that boosts his spending power. On balance, the shock should boost spending.

Investors and financial leaders have, however, also focused on the fall in headline inflation from lower oil prices. Indeed, lower oil does pose a new hurdle to getting out of a lurking deflation trap. If the trap is pressing, higher inflation is sorely needed to start eroding the real value of highly inflated debts around the system. In the absence of higher inflation, then, recession could follow.

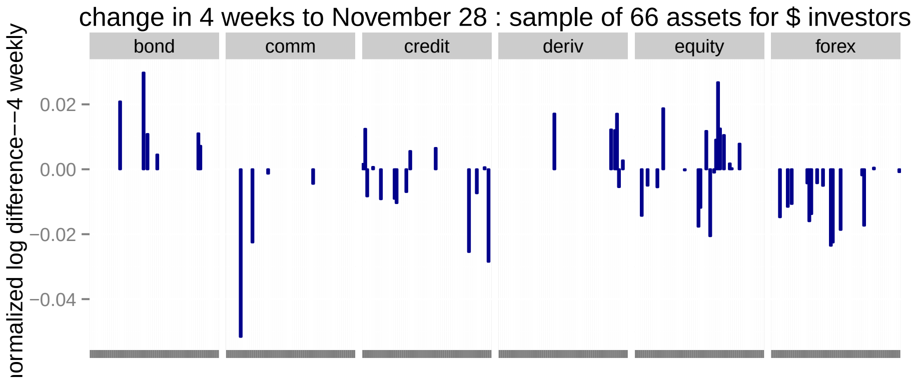
Lastly, and most important for me, falling oil could rock the bloated financial leverage in the global system created by QE. I will show below how that could work as investors suddenly face big new risks.



Oil Shocks. Initially, at least, investors saw lower oil as a mainly deflationary event and bought risk-free government bonds. If the shared global policy priority is to get higher inflation, policy rates must stay lower longer.

Meanwhile, credit bonds fell in value as some of the biggest recent borrowers in the system depend on oil. The damage was greatest for Venezuelan bonds. Ukraine, which may be close to default for other, war-related, reasons came close behind.

Investors were split on equities, buying Chinese and developed country shares while selling other emerging markets, starting with Russia. In currencies, dollar buying continued unabated, reflecting an emerging taste for safety.



US Trending Stronger. Upwardly revised 3Q GDP buttresses our case for a sustained US recovery, but one that may catch its breath in the next few quarters. Counting only consumption, investment and exports as final demand (and excluding trade and inventories that are highly variable because of long global supply chains), we have now had two quarters of 3% final growth, sharply up from the 2.0% underlying rate that has prevailed stubbornly since 2010. Underlying growth is bolstered by consumers who see lower gasoline prices, continued job gains, and the sense that their homes values are coming out from under the weight of old mortgage debt. Strong tax revenues and gasoline sales confirm these impacts.

But a tactical pause around this stronger underlying pace of growth is possible as car sales have been stable at high levels and investment goods orders seem to have paused. Weaker consumer confidence and a small rise in initial unemployment claims early in 4Q confirm a minor pause. Taking all this into consideration, and because the third quarter was so strong, we adjust down our fourth quarter estimate slightly to around 2.5% for headline GDP growth.

Several new policies to complete a new, more stable financial architecture were announced. Perhaps the regulators saw enough global recovery to warrant finishing their work of pushing up resilience in the banking system now, before public enthusiasm for reform wanes. Banks adjusting to tougher regulatory conditions will hold back credit growth, but non-banks are not so constrained.

So, we have seen a surge in non-bank credit, including highly visible new corporate bond issuance, international equity issues, and a peak in mergers and acquisitions funded with new bond sales. While fixing one set of risks in banks, offsetting exceptionally easy financing conditions have created a fresh set in the form of a bond bubble under the very noses of the busy regulators. A dawning awareness by the Fed of this trap may push it to raise rates earlier than now expected. That choice will be easier if, as we expect, a solid growth trajectory in the US has been achieved.

Domestic investor flows went into equities and out of bonds in the last few weeks according to mutual funds. Bond flows vastly outweigh equities in dollar terms, so this can create a considerable spike in equity valuations. But equity valuations depend in considerable part on corporate cash flows generated indirectly with bond sales, so I question the durability of today's valuations in a less friendly environment. For bonds, Russia is the great example of how a big bond rollover need can overwhelm all else in driving down a currency. Bond repayments can of course be offset with reserve drawdowns. In this regard, mainly emerging market reserves held at the New York Fed were up in the last month despite my fears, but this recovery may not continue as we shift to a much more risky system.

Escape From European Deflation. Activity indicators have been declining, but stabilization is still possible short of renewed recession. Markit and Eurocoin declines are slowing, and car sales are solid, but industrial production and orders have dipped, as expected with the cutting of business ties with Russia. M3 credit seems to be recovering and unemployment continues to inch downward. A weakly positive economic trajectory is not enough to stop a creeping disinflation process at the European level, at which leaders are increasingly alarmed. They worry that *relative* deflation is needed to cut high cost in some countries, which risks turning into headlong deflation there if Europe slips into overall deflation.

High costs in Italy, particularly, need to be rolled back. While this happens, high costs are crushing business, increasing credit risk and making new lending scarce, as the ECB's recent Financial Stability Report brought out. With unemployment rising and prices falling, an enormous amount rides on the Renzi reforms to break out of Italy's trap. A key part of these will be a tax-based reduction in effective labor costs covered by some spending cuts and an eventual recovery in tax revenues. Its the best that Italy can do in a difficult situation and it implies delays in meeting fixed fiscal targets.

In Italy and elsewhere political strains are rising, as popular voices are raised against the extraordinary and continued cost for underperforming economies of struggling to complete "internal devaluations" they need to keep up with years of German cost-cutting. Its a race the European periphery could lose, as President Draghi grimly reminded us in Helsinki: all countries must thrive within the union or it cannot survive for long. That implies, he says, that some form of sharing of economic adjustment is needed.

In fact, everything argues for a measured fiscal expansion in Europe although that may have to wait for constitutional change. In the meantime, a partial substitute may be in the process of construction in which Italy, Belgium and France are allowed budget flexibility in return for specific reform measures. Another substitute is the expansion of European credit for infrastructure projects, financed mainly by the private sector with a small slice of public guarantee. By keeping national debts out of it, Europe again inches toward a unified countercyclical policy. Lastly, the ECB may end up buying sovereign debt, despite the obvious risk that it may tempt nations again to fund their national needs with communal, EU-wide, obligations.

United States

ACTIVITY	CREDIT	POLITICS
Payrolls smaller gain: no wage pressure 3Q 3.9% GDP revised up: solid final demand		Obama confrontational after mid-term loss
Markit Services PMI falls Consumer confidence dips	Non-transparent ETFs rejected by SEC Higher repo haircuts proposed by FSB US leveraged lending to be reviewed again FSB final loss-absorption requirements	Obama proposes no internet "fast lane"

Europe

ACTIVITY	CREDIT	POLITICS
EU car sales up	Draghi targets e1 trillion larger ECB assets Sweden cuts rates FR calls for real money investment by EU	FR, IT budgets pass the EU test
IMF sees EU recession possible EU Commission cuts forecast for 2015 BoE says it will be a long wait for hikes	Rising non-performing loans in Cyprus	Luxembourg tax regime criticized Anti-austerity politics rising Feb possible general election in Greece

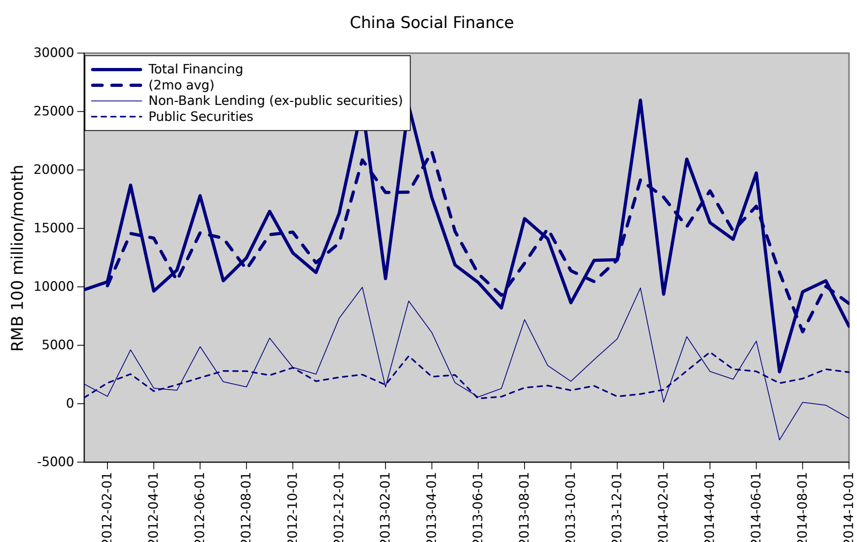
China

ACTIVITY	CREDIT	POLITICS
	Market rates spike on IPO cash demands Rate cut with relaxed deposit caps	
Weak electricity, freight, and PMI reports	Shanghai-HK limited equity trade allowed	

China's Credit Crunch Spreads. Chinese production side indicators keep slipping. Electricity, industrial value added, and freight are more consistent with 6.5% annual growth than 3Q's reported 7.3%. The shortfall is modest but persistent, and the authorities reacted by turning up the drip-feed of additional rail projects. Reasons for the slowdown include falling prices and a dip in apartment construction, as well as weak export orders at the Canton Fair. A recent surge in exports could be spurrious and at least partly dued to over-invoiced exports to Hong Kong.

Financial flows are slowing, too, in what looks like a deepening credit crunch. Funding problem seems to be exacerbated by a drain of funds into accounts held to bid for new IPO issues, often in multiples of expected allocations. Big construction company funding of projects underway may also be finding they have to fund projects longer before final sales. Meanwhile, small enterprises are reportedly finding it increasingly difficult to find finance as their default experience rises. So, total social credit growth continues to slow, as shadow banking arrangements are largely stagnant. A much-discussed effort to channel bank lending to mortgages to stop a developing home price slide is reportedly having some effect, but does not seem large so far.

The simplest explanation for a number of unusual financial developments last month is the intensifying struggle for credit in China. A newly opened link from Hong Kong to Shanghai equity markets found one-way flows into China. Similarly, construction companies and Alibaba have increased their dollar bond sales, again funding themselves abroad. Lastly, the overinvoicing of gold exports to Hong Kong can be a device to register fund flows into China. On balance, China's long struggle to cap its credit boom is slowly working out, but it is now pulling in the global capital system to cushion the adjustment. Borrowers in distress can escape imminent difficulties this way, which increases the odds of a soft credit landing.



Of all the possible effects of the oil shock, for me the most important is the harm it can do to the bond-based leverage that has exploded under QE. All leverage supposes stability of the underlying income; a shock creates leveraged losses in proportion to its magnitude and the amount of money at risk. We need a repricing in oil-linked bonds around the system, from Russia to Venezuela to US high-yield drillers, and there is no telling how much of an overshooting we will see before it is over. Credit losses loom and spreads could rise for all bonds.

Adding to the pressure on credit bond valuations, lower oil prices could also impart a positive shock to world consumers, starting in the US with its market pricing for gasoline and its car culture. Lower oil prices will be an effective tax cut here, supporting consumer demand with an exaggerated effect going into Christmas. Some oil investment cutbacks can be expected that should be relatively small.

Going into this new combination of shocks, investors had been adjusting to a fear of a very long hold at zero rates. Its not so much the extremes in these investment iterations that are notable, but how the entire structure of global asset market prices is swept up in each adjustment, creating a self-reinforcing picture that runs on further than the underlying situation really suggests. If so, the next big iteration in these markets should be more credit weakness including in emerging markets and a big surprise in the rebound of US bond yields.