What Just Happened in Global Credit?

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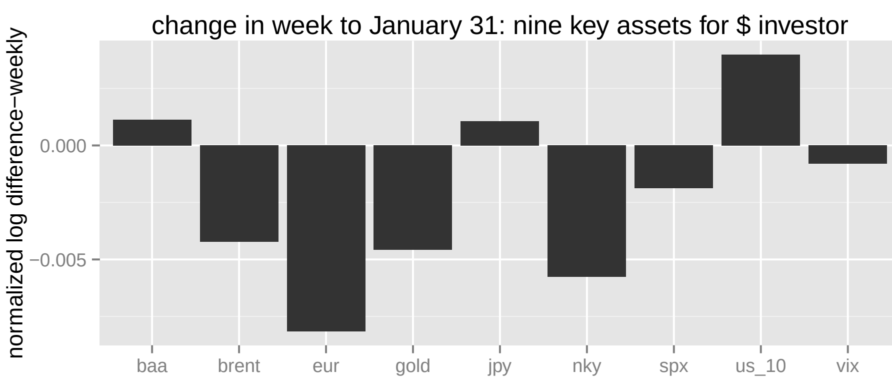
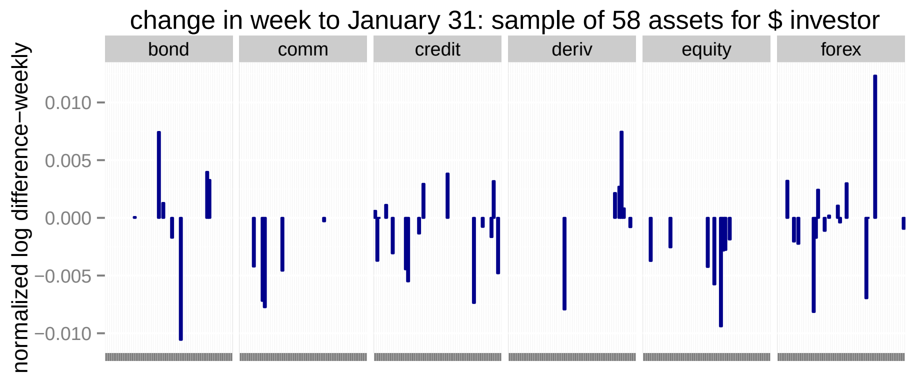
- **The trouble spreads to equities**
- **US retail investors panic**
- **Constitutional choices in Europe**
- **No fail, no growth in China**
- **Broadening into an EM-asset panic**

The story continues: emerging market risk has begun to trigger global risk reduction. This explains both a big drop in the euro that may be due to reserve sales by emerging market central banks facing outflows, and also the sudden drop in the Nikkei equity index. Global equity values besides the Nikkei started to look fragile, and the safest assets anywhere, US bonds, rose in value. We are in an incipient global risk-reduction cycle and run for cash.



The trouble spreads to equities. Emerging market currencies are indeed highly tradable, with rebounds for Turkey and Mexico once interest rates become attractive. But it seems the damage is already done: falling currencies have tripped a broader flight from emerging market assets, including equities and local bonds. One of the biggest movers was the jump in South African local bond yields, followed by a jump in Ukrainian dollar bond yields.

Strikingly, every equity market we follow was down, led by India. Foreign retail investors, hurt by currency declines (typically institutional investors hedge currency, retail does not) demanded their money back from mutual and exchange traded funds. Under pressure, in illiquid markets, some funds may have sold whatever they held that was salable, creating sudden, seemingly random, drops across these markets.



US retail investors panic. Late 2013 growth reports contained the seeds of the pause in growth we have been looking for. Big inventory build-ups at the pace recorded in the second half are never sustained: its just a question of how sharp the rebalancing will be. At a time of slow growth, global inventory cycles seem to have an oversized impact, and this is what seems to be building. Still, it should only be a pause in the expansion, not a new downturn, and so it should not be enough to stop Fed tapering that increasingly looks to have been delayed only to compensate for a one-time fiscal tightening.

Slower growth, even briefly, is going to be a problem for retail investment flows that have been increasingly erratic. Using mutual and exchange traded funds, retail investors have been aggressively chasing headlines about emerging market equity risk, and potentially, US market risk. Exchange traded instruments are particularly destructive amplifiers of panic because intraday liquidity for investors can be hard to achieve in illiquid emerging markets. Managers can be forced into generalized selling to raise cash.

The reciprocal of those headlong sales is local currency intervention, as registered in the dropping US custody account for foreign central banks, now down $45b over six weeks. Intervention sales dollars can force central banks to sell euro reserves, to retain balance in their falling overall reserve levels. Indeed this may explain part of the euro's unusual weakness last week.

Constitutional choices in Europe. Business and consumer sentiment reports were up, commercial vehicle sales leaped up, and the Eurocoin monthly GDP indicator is rising. Even unemployment has stopped rising. So a recovery seems to be slowly emerging, although it may face a test from a world-wide inventory adjustment in early 2014, if one develops. A particularly fragile financial position, with rapidly declining bank credit, anemic M3 growth does little to support investment and growth.

Meanwhile, the debate about Europe's constitution is warming up beyond the helpful convergence of German and French policy to a Social Democratic middle ground. That could be a minimum for European stability. But the debate is also warming up about the degree to which national policy adjustment, forced on countries in crisis in return for finance, is to be achieved under normal conditions for many countries.

A series of non-compulsory but strongly worded adjustment triggers have been adopted during the crisis. But without compulsion in good times, the German argument goes, we cannot have loss sharing in bad times. Along this line, the Bundesbank just proposed local wealth taxes to pay down excessive debt in troubled countries. You want national economic independence? You may not know what the full cost can be.

	ACTIVITY	CREDIT	POLITICS
United States	GDP solid 3.2% Home sales slow because of weather Inventory build will correct	No disruptive change in Fed logic Slower home price gains OCC fears weak leveraged loan terms	Small scale State of the Nation
Europe	Inflation not rising	Barnier bank trading rules announced EU stress test partial details announced Eonia pressures come down Falling bank credit	Merkel talks European convergence Italy proposes new electoral law Greece proposes market financing BBK propose wealth taxes
China	Drop in private ISM indicator Weaker business survey	Wealth management made whole	

No fail, no growth in China. China's risk of an immediate financial accident was blocked, which reduces global risk for the moment. Under an emergency package, investors will be paid back principle and even get 2.9% interest on the ICBC loan packaged and sold to wealthy investors by China Credit Trust. Foreigners cannot figure out how this contributes to rewarding due diligence by retail investors, however, and it remains unclear who even paid the money and who took any responsibility for loss. The trouble is that a credit boom will crash somehow: bailouts can only buy a little time.

China is involved in a great seasonal migration from the cities to the country and back this week so other news will be scant. When business resumes the following week, it may be sluggish, judging by the first signs for January in ISM-style indicators from HSBC. Growth is begining to slow, and official statistics also show flagging business profits in principal businesses. Our sense is that a trans-pacific inventory build-up in late 2013 is about to be replaced with a brief period of slower activity, a view this is not disproven by the Chinese data so far.

Broadening into an EM-asset panic. Evidence of retail investor rejection of emerging market assets is visible in mutual fund flows. As these trend-following investors exercise their right to demand cash, in some cases (exchange traded funds) within the day, they can put pressure on fund managers to sell into increasingly illiquid markets. Eventually, managers may be forced to sell higher quality assets they would otherwise choose to keep. That is how specific weaknesses turn into an asset-class panic characterized by large and sudden drops in seemingly random asset values.

As foreign retail portfolios amplify the panic, the amounts that are moving have become big enough to register on the central balance of the system. Emerging market central banks seeking to buffer declines in their currencies through intervention spend dollar reserves. US Federal Reserve custody holdings for foreign central banks were down $45 billion in the six weeks to January 25, a sharp reversal after rising $50 billion in the period to December 25. Partial information indicates that investor outflows have been getting much worse since January 25 in some markets like South Africa.

Markets really are not digesting the end of exceptional bond buying by the Fed very well. Some investors, mainly retail investors in emerging markets, seem to be reacting vigorously in ways that are amplifying their losses. One possible risk here is the spread of sudden retail-oriented sales to US and core markets.

One difficulty I am having with this panic-induced path is that bond yields in the US are falling, not rising as originally feared under tapering. So where is the supposed harmful impact of tapering on long rates? Instead, the economic harm from potentially higher rates is supposed to be so great that rates actually can never go up. It is a contradiction that cannot last.