What Just Happened in Global Credit?

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- **Taper fear brings rate fear after all**
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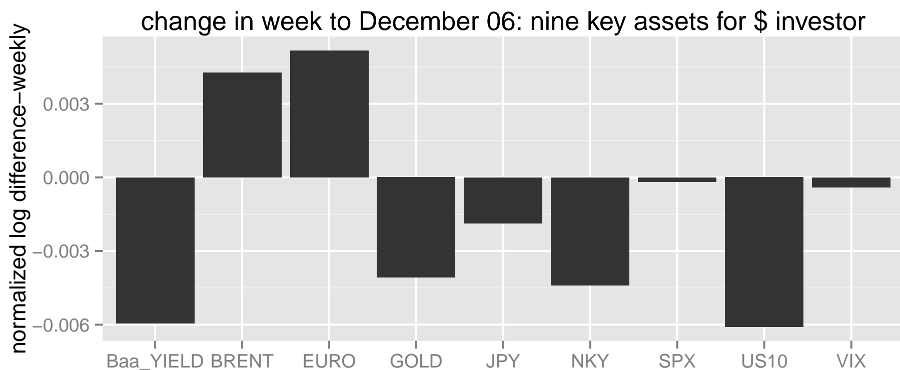
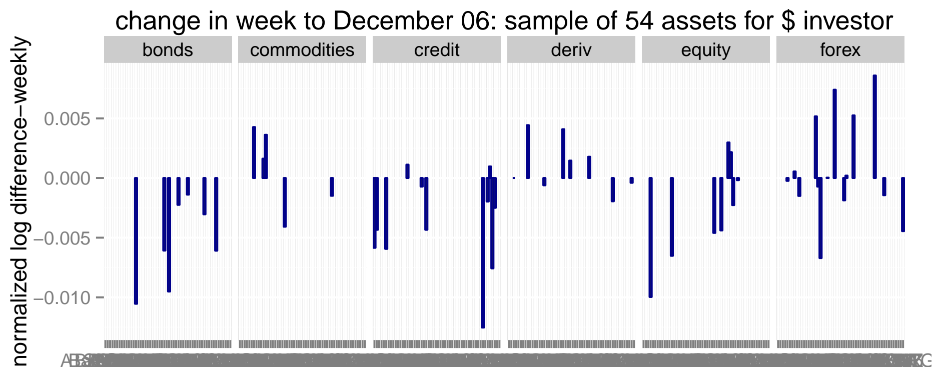
As tapering got one step closer on strong data, investors dropped their certainty that it would be followed by a long wait for rate hikes. US bonds and US corporate credits priced off bonds both fell sharply. Less obviously, the Euro rose against the dollar, a paradox if the big news is stronger US growth.



US and global bonds were hard hit. Bonds sold off solidly, not only the US but also in Europe and Japan, which surprised me–particularly the sharp German bond sell-off. Perhaps we have a more global duration market than you might think. Among sovereign credits that did particularly badly, Ukraine bonds stand out as the political struggle there intensifies.

Equity markets, too, took a less benign view of the coming tapering, falling broadly across our sample except in Shanghai and Shenzen. Last week's emerging market currency weakness, which seemed excessive, gave way to big rebounds in India and Mexico. Lastly, the euro keeps grinding upward, partly because of Japanese and other global portfolio reallocations back into the big and rich Italian and Spanish government debt markets.



There you have it: a solid US recovery. A needless budget deadlock could have been a threat, but it turns out to have been only a bump in the road. Evidence of US growth is widespread, but most importantly in the jobs reports. Here, the strong payroll report probably trumps weak household data. One reason is that the payroll report samples ten times as many workplaces as the household report samples households. And the payroll survey is initiated by employers as a matter of course: the household survey is a largely phone survey initiated by US government employees many of whom where told to stop working in October and were only catching up in November. So, for me, steady job gains mean a solid underpinning for fourth quarter GDP, and we have every reason to see the Fed taper down its bond buying.

The other main risk to a US expansion besides the budget deadlock is higher mortgage rates. But low mortgage rates have in a sense already worked too well, threatening new bubbles, as we see in several regional housing markets. For this reason the rise in mortgage rates we have see, to 4.5% for 30 years, could be more desirable than dangerous, if it can help to taper down any home price bubbles before they start. It is time to taper.

Europe's deflation and bank lending risks. A grudging, slow, and painful recovery slowed by balance sheet adjustments seems to be in place, as shown by a mere 0.1% 3Q GDP growth. A slow recovery like this has two problems: one is it can falter through absence of lending and the other is that zero or negative average inflation makes reducing relative prices in the overpriced periphery that much harder. For this reason a brush with deflation is urgently unacceptable in Europe and will call for immediate financial measures, although Mr. Draghi would not say which ones. A higher euro is going very much the wrong way here and could provoke a response.

On the credit side, Draghi mentioned that banks are unloading the big government bond positions they had accumulated with funds from the ECB's long term reserve operations. Taking their capital gains, and shedding potential risk for the upcoming asset quality inspection, they are selling out to global investors who have finally concluded that Europe is not spinning apart. But banks will not replace the bonds with local credit risk in many places, preferring, I notice, to pay down international interbank loans instead.

United States

ACTIVITY	CREDIT	POLITICS
Strong ISM manufacturing		
Record new car sales		
Solid employment report		
3.6% 3Q GDP surprise	EM reserves in NY rise again	Small but rational budget deal possible
Initial Thanksgiving sales are weak	Fed speakers consider fixed QE ending	
Capital goods orders flatten out		

Europe

ACTIVITY	CREDIT	POLITICS
	Banks sell bonds to foreign investors	
	Drop in November Target2 balances	
Markit indices positive but flat	e7b drop in ELA credit	Demos in Kiev show Europe is attractive
Marginal 3Q GDP growth	ECB prepares further measures	SL, PT, IE: all private funding soon
Retail sales tick down	Bank credit to private sector falls	

China

ACTIVITY	CREDIT	POLITICS
Logistics ISM positive	IPOs to be permitted	
Services ISMs remain positive	Beijing land price frenzy continues	Jade Rabitt launched
High inventories in corporate reporting	"Financial risk notice" on land lending	Zhou Yongkang arrested

Financial and political risks in China. Speculative fever could be good if it channels savings into the the possibilities opened up by G4 licenses, in a reopened new issue equity market, and in refinements of the Shanghai free trade zone. Symbolic of the new opportunities, China just launched its "Jade Rabbit" rover to the moon. But not all speculation is good. Apparently, bitcoin trading has exploded in China, a vast lottery system has emerged over the internet, and actual sales prices transacted in Beijing were up over 30% in the year to October, as financial credit for raw land purchases exploded, to fuel bidding wars for land. The CBRC sent a "financial risk notice" to banks on the unreasonable growth and probable rising risk in commercial lending for land purchases.

It is a volatile situation, both financially and politically. I particularly did not like hearing that Zhou Yongkang had twice tried to kill the President. (After earlier murdering his own wife.) An unstable process of political change within one party puts China's abrupt declaration of an air security zone over the South China Sea in a more threatening light. Unstable power at home can mean foster aggression abroad, as we see in North Korea. Both financial and political event risk in China remains a source of system-wide tail risk.

Aussie and Canada show the uses of a falling currency. In both Australia and Canada, central banks are talking down their currencies as inflation and growth disappoint. In Australia, currency intervention is possible and a rate cut not inconceivable as a lower currency is needed to balances off the collapse in mining investment. In Canada the central bank, under a new governor, has reversed its bias to hike rates and is now content to keep rates where they are to fight low inflation. In both cases a weaker currency is hardly destabilizing to long-term inflation expectations.

While emerging markets are yet in a position to wield the floating currency instrument so effectively, these are important examples of what can be done. So, they have every reason to hold the line against falling currencies that lead to excess inflation now, in order to earn the right to effectively use floating rates in the future. It should be worth the trouble.

Strong US reports mean the tapering is on. So far, the market damage from the stronger news fell more heavily on bonds in general than on equity, perhaps because the big retail portfolio shift from bonds to stocks remains underway.

Hopefully tapering risks will be manageable in quiet year-end markets, after full discussion for nearly six months. One reason is the limping recovery in Europe that should dampen any global recovery. Another is that China's growth seems fine for now, but is clearly vulnerable to financial or political surprises.