What Just Happened to Global Credit?

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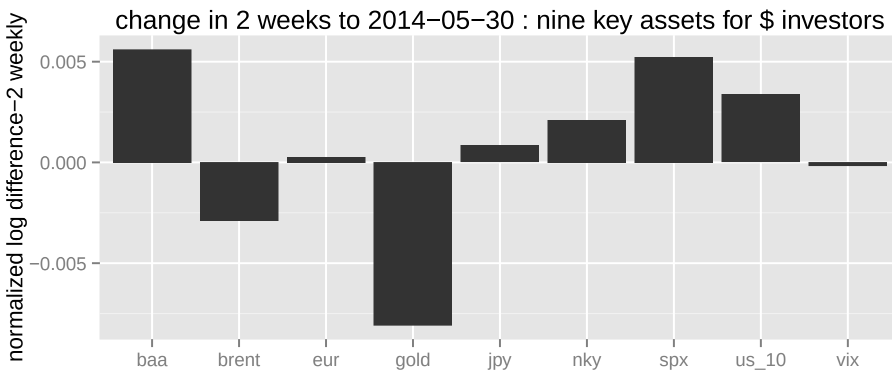
- **Secular stagnation boosts credit**
- **After US inventory adjustment, inflation creeps back**
- **Europe wrestles with democracy, Russia, and QE**
- **Lively Chinese policy to stop the housing slump**

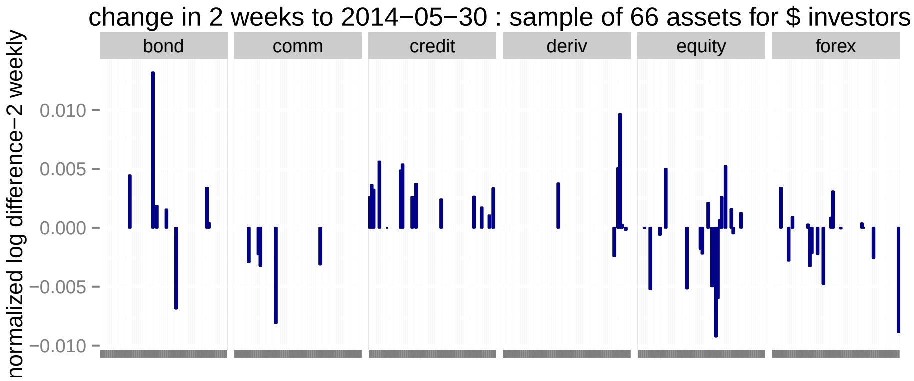
"Secular stagnation" talk kept reverberating in these markets, leading to continued advances in US bonds, and from there into corporate bonds and stocks. Ms. Yellen's promise to hold rates down longer has given us a carry world again, at least for now. Gold fell hard, partly because Russian moves against the Ukraine seemed persistent but more contained than before.



Secular stagnation boosts credit. Credit spreads raced down, as did government bond yields. If we are in for a long period of very low rates to boost asset values to indirectly rescue the world from secular stagnation, that makes sense. The biggest winner was Italian government bonds, as the electorate's embrace of Renzi as a reformer improved Italy's future outlook. Other winners included Ukraine dollar bonds, as we expected.

Equity markets, however, started splitting up into big losers and winners. Developed markets did better and emerging ones fell. Meanwhile expected US break-even inflation over five years in five years from now moved up, a warning for the "secular stagnation" view.

A new cycle of EM weakness beyond equities was hinted at in weaker currency values. Particularly striking was South Africa, where soft growth led to a collapse in all assets: stocks, government bonds, and the currency.



After US inventory adjustment, inflation creeps back. GDP in the US was revised lower in IQ, but it is a transient dip. A big reduction in the pace of US inventory build now means a big obstacle to future growth is lifted. The sooner the better, and the less disruptive. Its not all weather, by the way. How can we otherwise explain the global lift in trade in late 2013 followed by a dip in the first quarter? No, the simple explanation is a bigger global inventory cycle running through our longer global supply chains. The real question is whether this inventory adjustment can derails a broadening recovery. Probably not. Core inflation is moving up, jobs are up, consumer confidence is up, and mortgage rates just dropped half way back from their recent hike, from 4.5% toward 4.0%.

The Fed knows all about inventory cycles. So, seeing the underlying recovery, US policy doves are being forced into retreat and now resort to macro-prudential suggestions to delay rate hikes. They dare not say that rising growth increases the risks and diminished the advantages from financial excess due to easy money, but they need to show an alternative to rate hikes to deal with the excess. They may suggest varying reserve requirements, or capital ratios, or borrower qualifications.

Even if macro-prudential policy is deployed to allow a delay in rate hikes, the hikes will still require new methods. Rates used to be set through reserve availability compared to bank demand, so the old rate setting methods would require a big sale of the Fed's massive portfolio before banks start to bid for reserves at any positive rate. Alternatively, the Fed can pay banks on reverse repurchases or term deposits, replacing bank excess reserves with these interest bearing instruments, the yield on which can become a floor for market rates. Rate hikes are coming, it is only a question of ways and means.

Europe wrestles with democracy, Russia, and QE. Elections came and went with a slap in the face for defenders of the status quo and its cost-adjustment plans via ever-deeper recession. Europe's recovery remains patchy, with big differences in growth, inflation and financing that belie the decline in government bond yields. These differences could point to underlying correction of earlier excess inflation in the periphery, as the Bundesbank claims, but it could also fuel divisive populist dissent on the advantages of Europe.

Meanwhile, Ukraine's struggle to remain intact as a nation seem to have shrinking market impact. Russia seems to have brought in Chechen killers to bolster the local rabble in the Eastern Ukraine that it had armed earlier. But direct intervention seems out.

Amid these political, strategic and economic difficulties, the ECB is considering how to pump up monetary policy. ECB President Draghi sees two risks: a transient dip in inflation due to a high euro, and a deeper problem in which deflation in highly indebted countries amplifies local debt management struggles. We, and most investors, see the second risk looming, so we should see negative deposit rates from the ECB. That will run down bank deposits in a gentle and politically viable fashion. It will also give banks the profits to keep writing off bad loans while enabling them to lend for recovery rather than quietly run down their loan books as they are now doing.

United States

ACTIVITY	CREDIT	POLITICS
ISM manf & services rising	4.0% 30-year mortgage rate	
Higher core PCE inflation	Home foreclosure rates keep dropping	
Inventory adjustment partly over	Fed focus on means of rate hike	Minor military aid to Syrian rebels
GDP -1% in IQ	Home price gains slow--Zillow	
April consumer spending slows		

Europe

ACTIVITY	CREDIT	POLITICS
	Securitization preparations	EU considers elected EU commissioner
Consumer confidence still rising	ECB prepares new forms of ease	Russia moves troops away from Ukraine
Business confidence, construction hesitate	M3 and credit slowing	Russia inserts Chechen allies in Ukraine
e-coin dips		
Zew keeps falling on Russia risk		

China

ACTIVITY	CREDIT	POLITICS
	Home buying restrictions lifted	
	Local governments allowed to issue bonds	
Stronger HSBC survey	Banks directed to make 1st time mtgs.	Russian gas deal signed
Record low iron ore prices	Home price drops deepening	
	New regulations on interbank lending	
	State-backed shipping co defaults	

Lively Chinese policy to stop the housing slump. Timely action was taken to stop a housing construction collapse, almost as soon as it became visible. Officials say they want housing price variations, but limited in degree both up and down. They now pressure banks into easier lending for mortgages, up to zero downpayment financing for first time home-buyers. That can work to promote a bubble, but can it stop a full bust once it starts? A surge of new supply is coming into the Beijing market in June, so we shall see how prices hold up.

Commodity prices point to a sharper decline than does the economic data. Iron ore, in particular, has dropped deeply, as have rebar prices in Shanghai. Some reports point to foreign financing of iron ore inventory in November-December, followed by immediate ore sales locally. These foreign credits come due in six months, around now, and without easy rollover they may lead to forced sales that may exaggerate the downside economic risk. Cheap iron ore may be pushing up iron and steel production, forcing these product prices down in turn. A recovery in the HSBC ISM suggests this activity could become part of widening circle of rising industrial activity.

If China gets through its compounding credit challenges, it will be by the aggressive use of administrative tools including: recommended mortgage lending, pushing rail construction, and assorted liberalization measures. But its not going to be easy. Now we learn that aspiring Chinese have sent their few children to university, with 7.2 million graduating this year. While minimum wages are rising 10%-15% a year, pay for college graduates, often with indifferent qualifications, is down 34% from 2011. Social and political pressures will be rising directly from the clash of expectations with reality for these kids.

"Secular stagnation" and endlessly low interest rates could be getting ready to give way to another view. Recent European and Chinese credit measures are positive, while US inflation, and the logic of a passing inventory adjustment event both argue for a stronger growth phase coming.

Investors moving from cash to risk, and then to leveraged risk have driven up asset values. But the further this goes the more badly it can end, and central banks know it. That is why it is an inconsistent and tricky market to play, for them and for investors. I put the next panicky sell-off in the second half, when we see a healthy US recovery confirmed in GDP reports, forcing forward the timing of rate hikes.