What Just Happened in Global Credit?

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- **Emerging Markets crack up further**
- **US financial policy blindness**
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- **Forex volatility in China can tighten credit**
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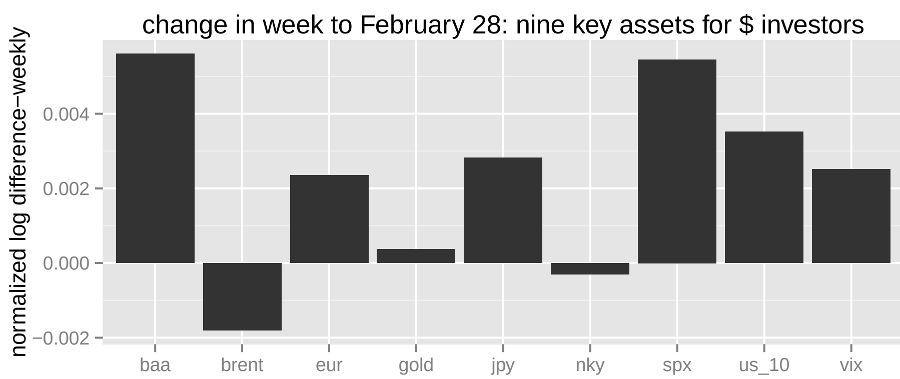
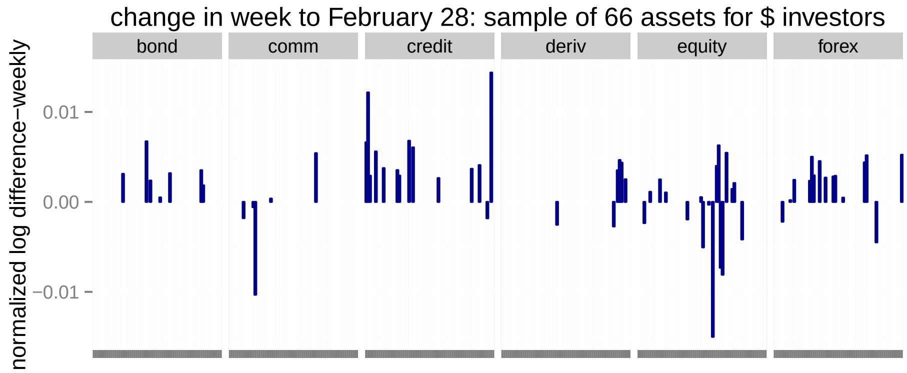
Weakness in the US became clearer as the sustainability of China's financing boom also came under increased doubts. So US assets, including riskier credit paper, and both government bonds and stocks all went up together on the clarifying picture of a slow first half, and the implication of lower rates for longer. Perceived weakness in the US also fostered a weaker dollar against most major counterparts.



Emerging Markets crack up further. Weaker US and global news meant every sovereign bond in our sample rose. Despite Italian plans to throw off some parts of the Euro-straight jacket, Italian bonds surged again. With broadly lower sovereign yields, credit yields fell, too. All dollar credit surged as money also went for higher risk bonds including Venezuela, Argentina, and even the Ukraine, even in the teeth of possible military action there.

The dollar was broadly down against most currencies, with the exception of the Ukraine hryvna and its closest neighbors, Turkish lira and Russian ruble. In the Ukraine the currency free-fall has come to a danger point where it may trigger hyperinflation.

Equity performance was also sharply divergent, with sharp falls in Shanghai and Shenzen where bank, real estate, and currency troubles proliferate. In Russia, equities fell sharply on rising political risks. But, global investors seemed to react, for now, by rotating into Indian and US stocks rather than cash.



US financial policy blindness. National Accountants have now clarified the bigger drag on spending from the government shut down, partly offset by continued high inventory build, although less than we thought. In 2014, curtailed government work should snap back, but inventories may very well come down. So we should get a smoother profile now around a low 1-2% growth path for a time. A contained slowdown is consistent with visibly slow progress in initial unemployment claims, gasoline deliveries, and tax receipts. Bad weather, the volatility of public spending, and an inventory adjustment should pass and be followed in the second half by resumed growth driven by the ongoing and powerful healing underway in our housing market.

Detailed transcripts from the Federal Reserve Meetings in 2008 make worrisome reading because participants had so little idea of the scale of financial crash that was coming. How can this group now hope to scale down its experiment in massive bond buying with a fine-tuned approach? Far better to get on a fixed tapering path. For markets the conclusion from this display of financial blindness may be: expect tapering to go forward with a very high threshold for delay. But interest rates can still be kept at near-zero for an extended period of time. If necessary, and growth remains sub-normal, various promises about that extended period can still be made that will bolster demand by boosting asset values.

A surprising amount financial stress in Europe, still. Activity seems to be picking up, although no longer accelerating. Germany leads the way, with a strong IFO survey and falling unemployment. The gains are general, however, with the Euro-wide Eurocoin index up, reflecting stronger sentiment and equity prices, while average unemployment is no longer rising and inflation is no longer falling. It could be the beginning of a healthy recovery. It has to be, because politics and finances may not hold up to a relapse in growth.

The most obvious political flash point is Italy, where the Renzi administration is getting set to take emergency job-creation measures to fight unemployment that rose to 12.9% in total and 42.4% for young people. One key measure will be employment tax cuts, like those in France and Greece, in an effort to subsidize employment, presumably out of taxes coming with recovery. Its a hope and it might work.

In Italy, Portugal and Greece, bank deposits started dropping again, although the overall Euro area money stock is rising. Some depositors in high debt-economies may fear a round of bank deposit haircuts, as in Cyprus. Amid these doubts, one of the national banks is back at the ELA account again, financing local banks. Possibly it was some smaller Italian banks financing at the Banca d'Italia after the EU asked for an explanation of how a scheme to increase the capital of the Banca d'Italia (held by banks) was not a paper re-capitalization designed to ease the impact of the bank stress tests now underway.

United States

ACTIVITY	CREDIT	POLITICS
Chicago ISM is strong	Seriously delinquent mtgs down	US may head off Russian moves
US GDP revised down	Detailed Fed record of 2008 meetings	Ukraine war risk
Capital goods orders down	Home price gains slow	
Markit services ISM drops		

Europe

Eurocoin up		
Markit ISM positive but loses momentum		
German unemployment drops		Renzo plans employment tax cut
Italy: falling prices, rising unemployment	EU asks for explanation of BdI equity	Ukraine war risk
	Bank deposits fall in S.Europe	Discuss bank caps on local govt. Debt

China

	Rates still falling	
Commodity inventories rise	Currency drops	
	Regional housing market drops	

Forex volatility in China can tighten credit. Whatever ails China's financial markets, officials are reacting. Both interest rates and the currency came down sharply. Regardless of money market rates, however, credit spreads will widen as long as wealth management products, and other unconventional debts come due. Not only legacy heavy industry credits are at risk. A credit mini-panic erupted briefly on news that one bank had stopped extending credit to some real estate borrowers. Stories of a price-cutting war in one city added to the sense of risk for real estate investors.

A weaker currency, which also developed, could make life slightly easier for exporting businesses. But it also disrupts the positive carry postion in CNY that has crept into global balance sheets, partly through derivative products. In all cases, the basic operation is to borrow at near-zero rates in dollars that have grown cheaper with time, and put the funds to work in China for 5% risk-free and up to 20% with risk. If the CNY now falls, or even just becomes more volatile, the logic of these positions is disrupted and dollar credit fuelling the last leg of the China credit boom may be cut off. If these inflows dry up, that could intensify the ongoing credit crunch, so the weak currency policy could wind up intensifying rather than easing a financial problem.

Emerging market citizens demand more. Emerging market stresses are popping up through surprising new channels. Starting in Thailand and Turkey and now including the Ukraine and Venezuela, aspiring middle classes are no longer willing to see their lives wasted in futile and unnecessary poverty. Effective dictatorships behind a thin veneer of pseudo-democracy have systematically handed out crippling monopoly powers to friends and families in all these places. The ultimate example is Venezuela, which is effectively remote from the US, but stark cross-border comparison with Poland is easy from the Ukraine. Demands for change and political violence follows.

Financial stress in merging markets is rising in other ways. Fear of an end to cheap credit originating in the US has hit nations with floating exchange rates anchored to local inflation targets first. That cycle seems to have stabilized, but stresses have moved on to the late-cycle credit boom in China, that controls its currency tightly. Lastly, and only in the last few weeks, the stress has moved on to the exchange-rate peggers of the remote periphery: Argentina, Ukraine, and Venezuela. Also, you could add, Russia. All now face delayed but sharp currency drops.

Its looking like the emerging markets shock from the end to US quantitative ease has morphed into both political and financial crises. Russian military moves in the Crimea and possibly the rest of the Ukraine are the biggest surprise. But the tottering financial boom in China has highly disruptive potential, too.

Sharply weaker emerging markets point to a long wait before policy interest rates rise in the US or Europe. So far, that is all. But rising uncertainty has led to sharp drops in Russian and Chinese equity and currencies, although it has not spread much further yet. New risks are multiplying, however, and could easily spread to global equities.