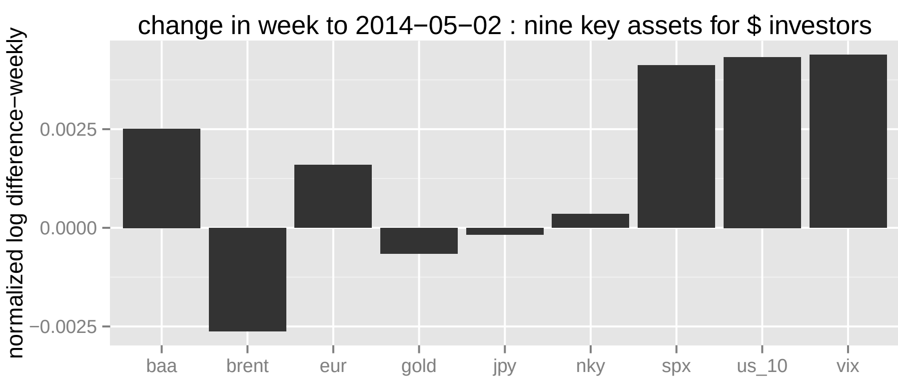
What Just Happened to Global Credit?

Lars J. Pedersen
lars23jacob@gmail.com

- **US assets and global equities snap back**
- **A US recovery is building**
- **France's internal devaluation**
- **Slow motion real estate slide in China**
- **Taking risk in the Ukraine**

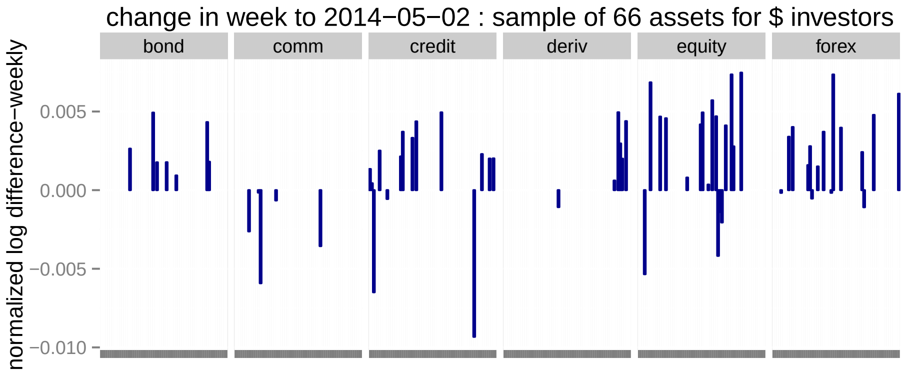
All US assets came back strongly, despite the low GDP print, with the economy's strong underlying momentum. This comes, oddly, with a lower US bond yield that seems to imply a long hold on the US return to normal interest rates. Just enough disruption in China and the Ukraine is implied to keep global inflation down while not disrupting the US growth take-off. A narrow path for the global economy, and certainly one that is easy to fall off.



US assets and global equities snap back. Equities came back strongly from last week's dip. Turkey and Russia led the way, suggesting that whatever ails either's power-crazed leadership will not do major global damage. Mexican and Taiwanese markets rose, too. But again, and with ominous regularity, Chinese markets were down.

The dollar fell back from last weeks rally, to the benefit of US investors in foreign currencies and foreign equities. Gains were concentrated in Korean, South Africa, Turkey and Mexico. Ominously, again, every commodity I track was down. This is at least partly due to a sudden stop in Chinese use of commodity financing facilities as its credit crunch spreads.

Ukraine's sovereign bonds fell hard on that country's crumbling hold on its Eastern districts. This could be a buy because the IMF's funding for what might become a rump of the old Ukraine is a political gesture that may work to the accidental benefit of investors. (More below.)



A US recovery is building. Much was reported and great confusion created about the health of the US recovery. GDP came in at a low and hard to credit 0.1%, pulled down by a deep drop in investment spending and fall in exports. This was roughly offset by a surge in consumer spending throughout the quarter on medical care, and at quarter-end for cars. Beside these very large and partly offsetting surprises, a reduction in the pace of inventory building was hardly noticed but will probably show up in the final revision as the real story. Roughly speaking, GDP is growing at about 2%, with a 4% quarter last year on the back of an unsustainable ramping up of the pace of inventory build and a dip to 0% as it was at least partly wound back.

Whatever held back growth in the first quarter was a transient event. All the basic indicators are advancing strongly, including jobs and underlying consumption trends that have been building for some time, ever since the attempt to destroy public credit to force back the Affordable Health Care plan failed last year. Health spending picked up as insurance seemed secure for marginal households. Household jobs have been on a steadily rising trend as employers realized that a European-style debt crisis was not coming to the US. Investment spending, too, was depressed for similar reasons but is coming back now in the second quarter.

For investors the hard problem is how to handle the 4-5% growth we could see by year-end, once we have shaken off the impact of any further inventory adjustments. Understanding this sequence of events will be the key to profitable trades in the rest of the year.

France's internal devaluation. European activity is still picking up, but at a slowing pace. Procyclical government spending, most recently showing up in Italy's request for a delay in its fiscal adjustment, is likely to keep the recovery going. Markit manufacturer's sentiment was up in several countries ahead of the pace reported by Germany, an important change. But the recovery is still fragile. Unemployment stopped improving and was up in Italy, the Netherlands and Finland.

French spending cuts to pay for a reduction in labor employment costs works out to be an internal devaluation. These can succeed, as we see in Ireland and Spain, to cut out some of the cost gap with Germany due to earlier labor reforms and strategic opening to Russian business by Germany. Internal devaluation is a deliberate and massively positive event for the long-term future of Europe monetary union because it cuts out the long-term risk from divergent costs. By pushing the adjustment through public taxes and spending, France effectively cheapens labor and cutting public living standards exactly as a devaluation would do.

Finally, pending stress tests should persuade investors that European banks will be sound even in a severe global downturn. Together these measures: pro-cyclical fiscal policy in Southern Europe, internal devaluation in France, and completion of the stress tests should be big contributions to a deeper European recovery.

United States

ACTIVITY	CREDIT	POLITICS
Strong consumer spending	Highway Trust comes up for increase	
Very strong payrolls	Apple issues bond to pay for buybacks	Merkel-Obama meet on Ukraine
GDP 0.1% growth!	Record low mortgage origination	Sanctions on Russian inner circle
Record US crude inventory	EFH high yield default	
	Puerto Rico "not thinking of rescheduling"	

Europe

ACTIVITY	CREDIT	POLITICS
Jump in Greek consumer confidence	Financial Integration report: good	
UK PMI up sharply	Tax cuts promised in Ireland	France details e50b spending cuts
Peak in final Euro-Markit PMI	Greece plans another e3-6b in bond issue	Party leaders debate Euro policy
German PMI dips	6-9 mos for AQR and stress bank recap	Schroder goes to Putin's birthday
Unemployment and Investmet weak	Portugal and Italy lag in LTRO repayment	Rising death-toll in the Ukraine
	Bank credit to business is falling faster	

China

ACTIVITY	CREDIT	POLITICS
Narrow gain in HSBC ISM index	Stress test for banks	
Drop in logistics index	More reported home price reductions	
	Yangtze River development zone announced	

Slow motion real estate slide in China. Activity still shows weak gains. HSBC's index of manufacturer's sentiment and an index of logistics activity were up slightly. But export orders were down, in line with weak exports reported in recent weeks. In line with the policy of providing indirect support for activity through deregulation and administrative simplification, we saw renewed discussion of the proposed Beijing-Hebei-Tanjin development region that includes shifting some administrative offices out of Beijing and some polluting activities further inland. And discussion of a new Yangtze River industrial zone inland from Shanghai surfaced this week, as well.

Managing a shift from old industries to new opportunities depends on the balance between deregulation and the slow-motion credit crunch now underway. The credit crunch could get worse in real estate, particularly. Here, supply has not yet been reined in and unsold properties have been backing up, more in small cities than in big ones, but there too. Low sales must mean sharp cuts in new building and and end to spiralling bids for new land. This is almost certainly going to put great pressure on local government finances by the second half, in the face of their rising repayment profiles. Skillfull steering through this complex situation may be expected, but big risks remain if the ongoing credit crunch gets out of hand.

Taking risk in the Ukraine. Ukraine got an IMF and EU credit program that sets up the official community up to assume the country's debts to private creditors as they come due. The amounts will be in the order of $10b a year. In return, the official sector reasonably asks that net new borrowing be rapidly eliminated. Not severely overvalued by my measures, Ukraine's a big fiscal deficit of 6%-8% of GDP flowed out into a comparable current account deficit, linked to high consumption of deeply subsidized natural gas. A devaluation was not as necessary as a gas price hike, but a disorganized fall in the currency when the central bank ran out of reserves came to the same thing: increasing all import costs, not only for gas.

The country is at real risk of dismemberment by locals given arms by Russian special forces with concealed insignias. That deliberately fomented slide into communal warfare increases risks of a catastrophic outcome for investors in the currency or the hard currency bonds. On the other hand, once a political decision has been made in the West to commit funds to support the Ukraine in opposition to thug-based Russia hegemony in the region, the Ukraine's failure to make payments on a relatively small debt becomes easily avoidable. Both the currency and the sovereign bonds look attractive to me in small amounts.

It was a good week for underlying US growth, balanced by ongoing disruption risk in the China and the Ukraine.

For the moment, US growth does not equal global inflation risk, so we are stuck teeter-tottering back and forth between brief panics and longer periods of rising asset prices.