What Just Happened to Global Credit?

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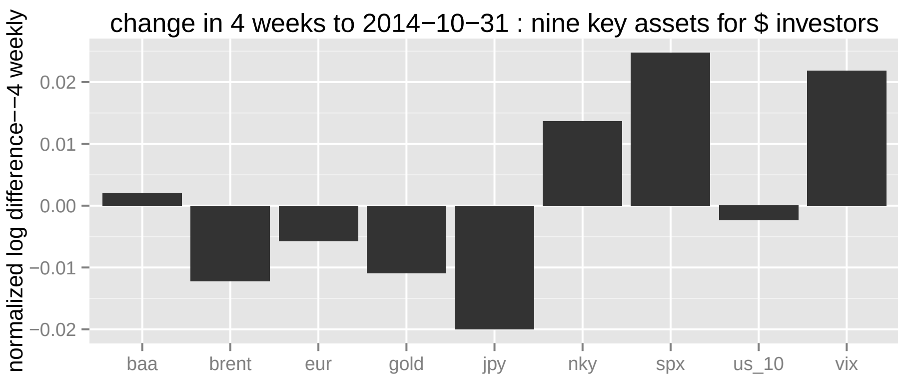
Markets certainly got more complicated in the last month. What had been a cycle of retreat from investment risk starting in bond yields, spreading into corporate bonds and then, finally, into equities. Eventually values were pushed to lows that implied the global recovery would fail if extreme monetary ease were ever withdrawn and so bond values rose. At that point, equity, and to a lesser extent corporate bond losses, came decisively to an end.

This rushed search for a plausible path of financial prices leaves us in a volatile situation which depends, above all, on a view about how global policy will support a recovery. Investors found comfort in the unrolling European bank stress test and possible other measures, and, at the end of the month, in the Bank of Japan's move to up its pace of quantitative ease. Both policies could offset the pending loss of US quantitative ease. Japan's policy, in particular, contributed to the two biggest market moves of the month (adjusting for asset value volatility): a higher Nikkei Average and a lower Yen.

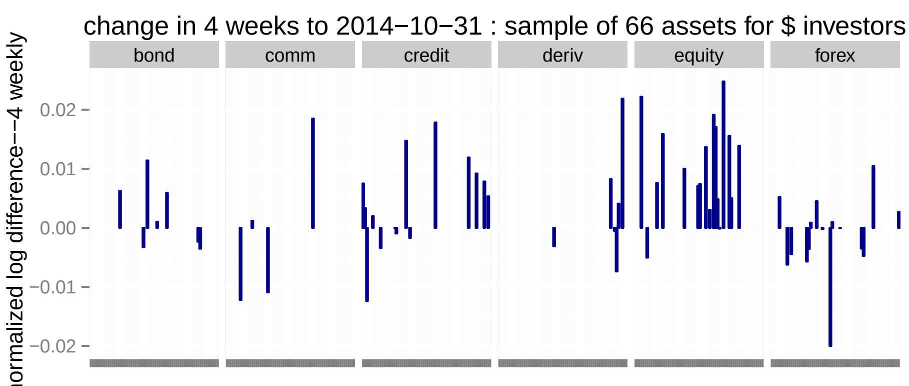
At least as important, lower oil prices developing over several months will bolster consumer spending for all non-oil producers. Losses for Saudi Arabia, Iraq, Russia and Venezuela will deliver a defuse but important gain for others, which comes at a useful time to buttress a global recovery. Taken together, these pieces of an unfolding and complex macro-economic picture have fueled continued high levels of volatility around elevated asset market valuations.



Oversized Positions And Volatile Markets. Lower oil and the certainty of Japanese quantitative ease were felt in a strikingly broad rise in global equity values. Scarce but striking exceptions were falls in Brazil and Shenzen markets in the month and in Indonesia in the week. Corporate bonds recovered, too, in a pale reflection of equity gains.

Riskless government bonds were understandably a two-way street. An end of US quantitative easing was confirmed without great fanfare, while the possibility of more quantitative ease in Europe and Japan drove down yields there. Differentials in the upcoming stance of quantitative ease, or prospective scarcity of risk-free assets, was felt in sharply lower European and Japanese yields and a modest increase in US ones.

Among currencies, the sharply differential outlook for quantitative ease tended to drive up the dollar against both the Euro and the Yen. Specific problem cases in emerging markets, Brazil and Russia particularly, also saw sharply lower currencies. But several carry stalwarts of emerging market came back sharply amid the prevailing, if possibly transient, improvement of investor confidence.



Ending US Quantitative Ease, Finally. After an unusually unstable first half, estimates of GDP should settle down around 3% growth, with the third quarter a little lower and the fourth a little higher. All short-term indicators point to a self-reinforcing expansion that will not be thrown off easily. What bad news there is should be more than offset by continued job gains, amplified by the equivalent of a tax cut in the form of lower gasoline prices now coming up on $3.00 per gallon. GDP growth at 3.5% was supported largely by inventories, exports, and government spending, which are non-repeating items that suggest we have at best a shot at a 3.0% underlying trend of domestic demand, up from 2.0% in recent years.

One important reason for supposing this expansion will continue unbroken is the recovery in housing from its adjustment from 3.5% 30-year mortgage rates to 4.5%. There was a pause in construction, a hiccup in price advances, and even a twitch up in foreclosures and late payments, but generally the system seem to have absorbed a much-feared adjustment toward normal interest rates. Another reason for optimism is signs of a rising commitment of corporate funds to real investment and away from speculative carry trades. This is a deeply positive development for productivity and a continued expansion.

If we are in for a continued and long-lived expansion, markets will continue to turn on the expected timing of US rate hikes. This will depend partly on an eventual return of inflation. Rates must also go up, perhaps more urgently, to dampen financial leverage that is clearly building up in dollar-based credit markets, including in corporate balance sheets. If further evidence were needed, a recent report from the Financial Stability Board showed that in 2013 non-bank credit expansion in the global system grew at the fastest pace since 2008, as measured in dollars.

Political Impediments to European QE. A sharp reduction in German official growth estimates, fully justified by increasingly sickly-looking confidence, industrial production, and exports has changed the terms of the political discussion in Europe. No longer can German politicians blandly increase political pressure on others by suggesting national credit risk: the impact on their own economy and electorate of a renewed downturn would now be too costly. Today's vulnerability on growth is the cost of taking a tough stance on Russian sanctions, felt most directly in falling German exports.

Almost certainly key leaders met behind closed doors at the last IMF meetings in Washington to consider joint measures to stop a renewed global recession. Coming back from Washington, German leaders will have to give up some ground on their national austerity demands, and the push to shift fiscal policy to a trans-European governance. One way could be to encourage a big European Investment Bank borrowing program for investment in Europe; another will be to seek public-private investment in German and other infrastructure projects. In each case they get credit-backed spending booked off national balance sheets. Meanwhile, it is a sign of how much economic pressure Germany now faces that its leaders will have to permit the substantial anti-austerity push by France and Italy to go by unchallenged. Look for accommodation for Greece, Cyprus, and Portugal to follow.

Weakening news puts pressure on the ECB, too, to buy time for recovery. But here the possibility of action is limited. An asset-backed securities buying program has started up in small size on a small base of securities. Eventually a bigger program including purchases of government bonds may seem needed. The only trouble, of course, is that it will run squarely into the insistence of German leaders that national sovereign debts cannot be commingled: only a shared political unit can take on shared obligations. Co-mingling national debt on the ECB balance sheet means diluting the principle of national credit risk, a bridge that cannot be crossed now, they feel. So scope for a big ECB balance sheet expansion seems deadlocked for now, increasing the urgency of fiscal action in some form.

United States

ACTIVITY	CREDIT	POLITICS
IEA sees lower oil demand	US, UK policy may react to stock crash	
Stronger to mixed jobs report	Banks cede derivative termination rights	Mid-term elections
Final demand in GDP weaker	PIMCO position unwinds in eurodollar contracts	First US Ebola case
	JPMorgan-Fidelity hacked by Russians	
	FSB requires higher repo haircuts	
	Fed ends QE	

Europe

ACTIVITY	CREDIT	POLITICS
	Stress test--25 banks failed, most in Italy	
	ECB starts ABS purchses including Cypriot	
IMF sees EU recession possible	FR-IT budget review: minor revisions made	Ireland phases out special tax treatments
	Greek bond yields spike up	Apple and others subject to EU tax review
	Sweden goes to zero rates	

China

ACTIVITY	CREDIT	POLITICS
Exports surge--but questioned	Gov. Bank guarantees defaulted corp bond	
New lows for iron ore prices	Rail companies merge for export markets	

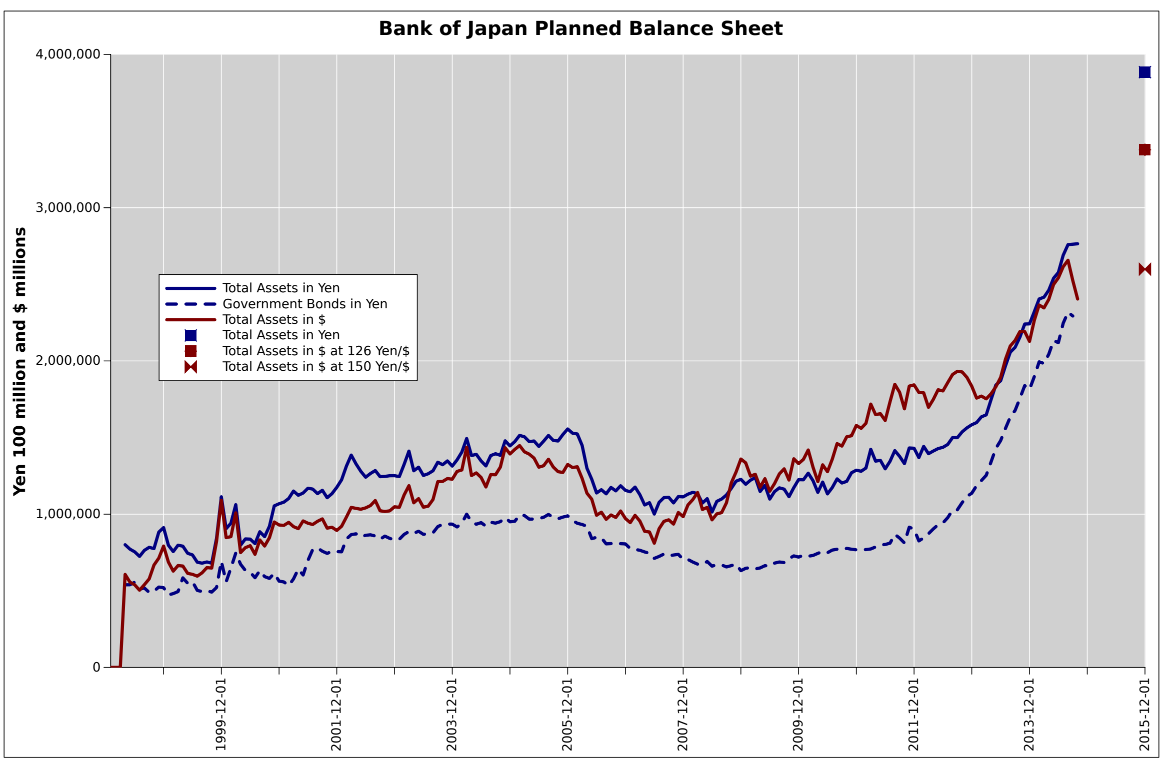
Other

ACTIVITY	CREDIT	POLITICS
	Kazakh uses ICMA contract text	
	Russian rate defense of ruble	Brazil election--narrowly Rousseff
	Brazil rate defense of real	

Direct QE for Japan, Devalued for Others. At the recent IMF meetings in Washington, Japan may feel it was given cover to take a step toward additional quantitative ease, even if it spells another move down in the yen. In its public statements, the Bank of Japan said that recent sales tax hikes had hurt demand more than expected, while the defensive expansion of Japanese firms abroad to beat decades of high currency valuation have limited the beneficial impacts of a weaker yen. Lower oil prices, welcome elsewhere, could undercut the positive inflation expectations upon which Japanese policy depends to exit from what could otherwise become a public debt trap. The bank was insistent, and we agree, that great risks face Japan if historical public debt is not eventually diminished by inflation.

Unlike the European Central Bank, the Bank of Japan faces no political obstacles to buying massive amounts of government bonds and other assets, including real estate and equity-based securities. It will increase its buying, mostly of government bonds, to a ¥80 billion annual rate. We assume that a shortage of risk-free assets will force large Japanese investment portfolios to move abroad and into local equity. They will necessarily have to take this additional risk simply because there will be less risk-free investments available. And they will eventually find rising US short-rates preclude hedging away the currency risk that they also will have to take. All this will push down the yen.

On balance, the impact of Japan's measures outside of Japan may be less than expected. Once the central bank balance sheet is large, the dollar effect on its existing position will be large, too, tending to cancel the dollar effect of any new flows. About ¥100 trillion in balance sheet expansion over the 14 months to end-2015 could work out to $970 billion at today's exchange rate of around 115 per dollar. But the diminished value of the Bank's yen holdings if the yen were to reach 125 yen per dollar would take the net impact, including revaluation of the old balance sheet in dollars, to $700b. A drop in the yen all the way to 150 yen to the dollar, which is not impossible, would take that impact down to a relatively minor $190 billion.



Measuring the Credit Squeeze in Emerging Markets. The key developed countries are right to take no chances with the global recovery, as China and emerging markets stumble. In China a drawn-out credit crunch is clearly underway with signs of slowing growth that could exacerbate the problem. And countries that pumped out commodities to meet China's needs now have a problem with export prices. Emerging markets also have a problem with the potential withdrawal of funding flows, which seem to have become acute recently.

Russia is losing reserves again. A reasonable estimate would be a $20b loss in October, after a drop of $22b following the February take over of Crimea. These are withdrawals from the Russian financial system by nuveau-riche oligarchs who no longer think their funds are secure. Brazilian business people, too, worry that Dilma Rousseff's newly re-elected populist administration could easily take a turn further to the left, in the direction of Argentina and Venezuela and to the detriment of their assets. But these two cases cannot explain the full size of recent emerging market reserve losses.

Looking back, emerging markets seem subject to a cycle of increasingly acute reserve losses every six months or so, of which the $68b loss in the five weeks to 29 October is the sharpest to date. (Excluding the week when Russia removed the bulk of its dollar reserves from US safe-keeping in March.) Such big declines may be a sign of specific problems and of a broader unwinding of carry trades, including by global corporate treasurers who have had lucrative access to a one-way carry trade in emerging market currencies for many years now. A disorderly unwinding of these carry positions remains a big risk for the global system.

We are indeed in a world of excessive of market volatility, on both the upside and the downside. One reason is the hesitant and seemingly inflation-free global recovery. Another is the changing character of untried policies of quantitative ease, with untried exit strategies.

But something new became apparent last week: a glimmer of a coherent allocation of policy tools among the US, Europe, and Japan. The US is to end QE and move to tighten rates, stemming global financial leverage which is mostly in dollars. Europe is to move, with German leaders kicking and screaming, to a mixture of national and trans-national fiscal and pseudo-fiscal expansion. Japan is to step up its quantitative ease because all agree its public debt is in a danger zone. Taken together these policies, if I read them right, will tend to support a global recovery. But they are not going to evade the problem for markets of adjusting valuations to higher US rates.

Its going to be an adjustment with an increasingly secure global recovery and less financial support in dollar markets. Because I think of global markets in dollar terms, I discount the impact in dollars of QE in a falling currency. That means more currency weakness for Japan and less indirect impact on US yields than might be supposed. More dollar strength and less dollar liquidity may be a challenge to the well-established US recovery, hopefully compensated by lower oil prices.

I remain of the view that inflated balance sheets were always going to make the exit from US quantitative ease a difficult time for investors. Indirect quantitative outside the US could cushion the shock of adjustment, but its going to be a roller-coaster anyway. It could not be anything else after investors had five years to move into all the different cracks and crevasses of the global carry and speculative system. So, the earlier the normalization of these positions often taken with non-bank credit, the better.