What Just Happened to Global Credit?

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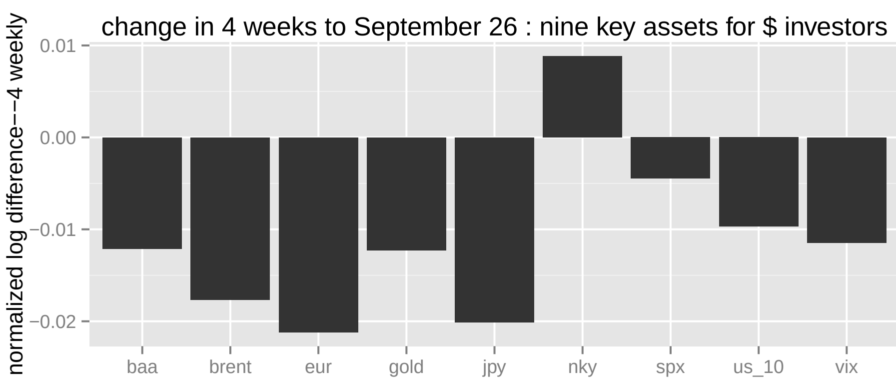
- **Spreading risk**
- **Reviving US investment, finally**
- **Strains are building again in Europe**
- **Will Alibaba's promise save China?**

Investors have been selling bonds and buying dollars for several weeks in response to a stronger US amid a weaker global economy. Last month, the dollar rose sharply, again, against the yen and the euro in the biggest normalized move in my sample. A stronger dollar should spread some of our recovery to foreign exporters, at least up to the point where it begins to undermine the US recovery.

The dollar's rise has been linked to higher expected US interest rates. Again, higher rates are reaction to a stronger economy, but rates cannot rise so far that they interrupt the process of corporate borrowing and expansion.

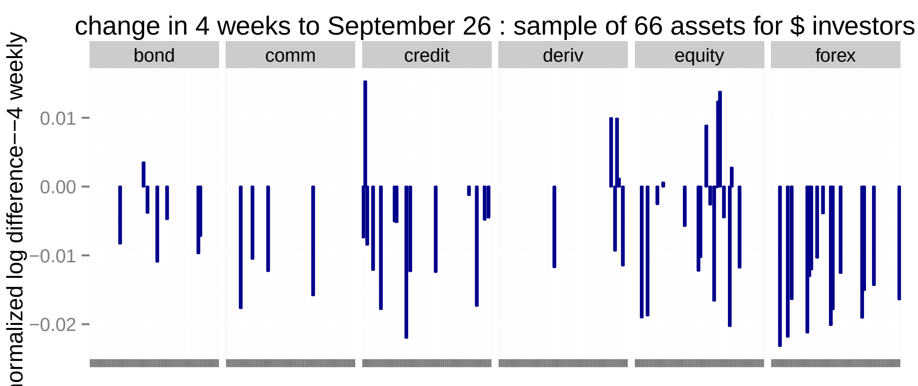
Investor losses in global equity markets just emerged this month as the sudden forex and bond market moves continued. We know forex and bond losses cannot mount endlessly, but the complexity of the adjustment underway, together with continued one-way declines in some markets may push investors to cut all risk and into a generalized sale of asset for cash. We are getting close to an ugly place with good investment opportunities.



Spreading risk. In my sample of equity markets only China, buoyed by the positive reception of Alibaba shares in New York, was up. Elsewhere equity declines were uniform and large. Concentrated losses in the most liquid segments of any market often indicates sudden hedging of risk by large investors.

The dollar picked up sharply against the Euro, continuing a multi-month trend. ECB policy is seemingly set to produce new policies until the euro weakens: whatever else easy money policies may deliver they almost certainly yield a weaker currency. Liquid emerging market currencies fell hard as well, including Mexico and Brazil, and those two honorary members of the EM club, Australia and Canada.

As higher-return investments are liquidated, the obvious investment alternatives are cash (dollars) and bonds. Government bonds indeed stabilized in the past week, and values were up in Japan, Germany and the US. Restructuring the large PIMCO portfolios to reduce risk and potentially liquidate positions could be an additional force behind some of these investor flows.



Reviving US investment. Job gains were a little softer in August, but not by enough to change the overall impression of expansion. GDP was revised up for the second quarter, and real-time values for gasoline, taxes, and unemployment were all consistent with steady if slightly weaker growth into 3Q. Surveys of manufacturing were up, and capital goods orders remained strong in a particularly welcome development, because business capital spending is one area where demand can expand freely by using massive cash balances. Elsewhere, housing activity is choppy, foreclosures ticked up, and consumer spending gains may ease up after a splurge. But, lower gasoline prices should help incomes and prevent any sudden drop in spending. Underlying final demand may be growing at a 2-3

A sustained recovery depends on balanced financing. Second quarter flow of funds data show a corporate sector that continued to build up cash balances, largely with the proceeds of record bond issuance at low yields. Some of the funds also went to stock buy-backs that continued at a record pace, supporting high valuations. At least as worrisome may be the all-time record consumer credit extended in the second quarter, with additional hefty gains into August. We know that a deeply unequal recovery has left many families with reduced real incomes; financing their spending with credit extended at very high real cost is not a sustainable path to recovery.

President Obama's navigation of the Ukraine and Mideast challenges may help to rebuild his credibility with the American public as a war leader. If the Affordable Health Plan also seems to be working unobtrusively, the mid-term elections could go better for the Democrats than expected. That may reduce the risks of destructive confrontations in Congress during the last two years of this administration, reducing one source of market instability.

Strains are building again in Europe. The €-coin monthly GDP was down again, ISM-style surveys are turning over, and Germany's Ifo survey has dipped sharply. GDP growth was zero for the Eurozone in 2Q, but this was partly due to irregular weather that the Bundesbank says will soon be reversed, at least in Germany. So far, momentum is fading but not yet to the point of a double-dip, as in 2012. But fears of war in the Ukraine, and of a failing economic governance of Europe are clearly eroding public confidence and business investment plans.

Europe's recovery can be helped but not assured with ECB credit policies. Plans to accept high-quality asset backed securities as collateral are one way to expand credit, another is the Targeted Long Term Repo Operation (linked to credit extension). The trouble of course, is that credit risk is exactly the stick that forces down wages and costs in countries that have let costs run away from them over twenty years of monetary union. As the Bundesbank's Weidmann says, cutting these high costs releases an economy from recession. It worked for Ireland and Spain: it can work for Italy and France, he says. Credit measures that boost the ECB's balance sheet cannot hasten this "internal devaluation" within the monetary union.

A bigger ECB balance sheet may have more effect on the value of the euro than anything else. Traders often expect currencies to go down when the supply or reserve money in a country expands. And US reserve increases are coming to an end next month. In this view, excess reserve money will flow out of a country as locals bid for alternative, more scarce, money abroad. The euro is indeed falling hard, which could yield some gains in demand and some more time for the "internal devaluations" to emerge in Europe.

Meanwhile, a lagging recovery may be setting up a fresh round of financial and economic stress in Europe, although hopefully nothing like what we suffered during 2010-2012. In his comments, Weidmann also outlined why zero unified debt, including any ECB purchases of sovereign bonds, is acceptable under current political arrangements. He, like other theoreticians of European Union may feel that this is the time to dig in to deny union level credit that could ease the cost of adjustment coming in France and Italy. Politicians from those places are urgently seeking union-level credit or room for expanded local deficits immediately. If they do not get what they want, into a threatening recession, frightened publics may demand their politicians do something, even sign up for a new European constitution with debt sharing. That would be the plan, anyway.

United States

ACTIVITY	CREDIT	POLITICS
Strong car sales	Corp bond issuance surge in September	Obama promises long, low-key war on ISIS
Softer jobs report	High yield issuance jumps Sep/Aug	Even fight on mid-term control of Senate
Lower core inflation	Global funding rules hamper equity short sales	New sanctions on Russian state companies
	Growing private-equity syndicated loan levg.	
	Fed stress test cost for high leveraged loans	
	Falling inflation break-evens	

Europe

ACTIVITY	CREDIT	POLITICS
		Renzi labor reforms heavy going
	France will miss 2015 deficit target	Greek tax cuts may limit new EU credit
	Draghi looks to ABS but not QE, cuts depo rate	Scotland stays in the Union after a scare
	Negative ST bond rates	Cease-fire in Ukraine
Falling Ifo, Markit and other surveys	German rejects many EU-level spending plans	Le Pen ahead of Hollande in French polls
	Low TLTRO take up	Google's EU anti-monopoly review
	EBRD: fears loss of EU "peace dividend"	Air France loses to pilots strike

China

ACTIVITY	CREDIT	POLITICS
	Record Chinese corporate foreign bond sales	
	Record Alibaba IPO in NY	
Stronger ISM readings	Ban low-grade coal use in Eastern Provinces	
Iron ore prices new low	Falling FDI	Begin to investigate corrupt nationals abroad
Low industrial production, electricity use	Sinosteel rumored debt difficulties	

Will Alibaba's promise save China? Direct readings of Chinese business activity show a slowing domestic economy, including a drop in electricity use by large industry, and a slower expansion of industrial production. Production surveys have been up for three months, however, implying a modest set-back at most. Meanwhile, rumors have emerged of a long-delayed withdrawal of credit from the overbuilt steel sector, including for one big state company. Those rumors can interfere with new credit and may force the pace of much-neeed closures of excess steel capacity. Hopefully, a renewal of global trade after a first half pause may come just in time to cushion China's much needed adjustments in steel, and several other areas that have been the backbone of this recovery.

An enthusiastic market welcome for Alibaba shares in New York draws attention to China's new-economy potential. Fast-growing new-economy sectors could, in time, compensate for falling activity in older steel, coal, and construction. It would be a neat trick, but it looks possible, and emergency government spending measures may be less than many expect in view of official optimism on this transition. Indeed Li Keqiang, at Davos in Tianjin reiterated his view that strong reforms were of greater worth than strong stimulous measures. Meanwhile, however, total credit data seems to show a credit contraction developing, particularly in shadow banking. With credit losses pending, including newly discovered problems in dollar trade finance, this should not be surprising.

A tolerance for more economic weakness and an appetite for more economic reform than earlier seems to be emerging. One possibility is that the Xi administration has negotiated with the party for the arrest of its most import enemies over recent months and so faces reduced threats to its hold on power. It is still early in the government period and a good time to get as much reform done as possible, to reap the rewards over the next ten years. With key opponents isolated, now is the time to do it.

Investors have been moving positions with increased speed to adapt to what looks like a US-led global recovery and early policy tightening. These moves have accelerated in recent weeks.

Can these escalating moves derail the US expansion, through a suddenly stronger dollar or a halt in new bond sales? And can that risk, whether it materializes or not, cause a precautionary repricing in equity markets that have until now seemed relatively safe? Of course, if we go there, it would spell somewhat lower interest rates and the financial cycle goes on.

Considering the great difficulties investors have in judging exactly how market values will evolve, it is almost certainly better to get these disruptions over with now rather than later. Sooner or later, US rate normalization is inevitable, and the later that happens the bigger the absolute risk on larger positions at more extreme prices. It is for this reason that only a full stop to global growth will delay normalization by much, in my view.

Ultimately, it is all about the huge balance sheets that remained after the crisis of 2008. Since a thorough-going write-down of these claims was never undertaken, as would have happened in earlier cycles, they remain the source of excessive speculation and then sudden panic. Its going to be a great time for traders who can stay one step ahead of the game.