What Just Happened to Global Credit?

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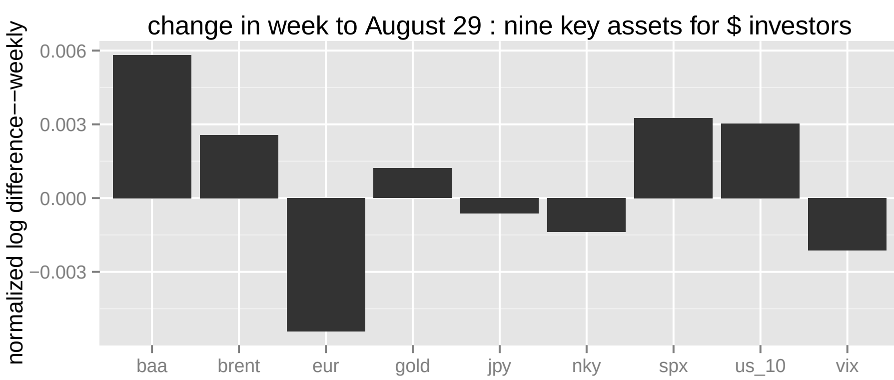
- **A Mini High-Yield Crash**
- **No US inventory push in the second half**
- **Will Europe be pulled together by Putin?**
- **Credit concerns are rising again in China**

Last month saw a mini-crash and then recovery, both led by credit bonds. First it looked like higher government rates were finally threatening higher yields in credit, as well. A sprinkle of default news and political risk helped. Then a panic about forced ETF selling emerged, as these baskets were forced to sell assets into illiquid markets. Equity and emerging markets caught the panic.

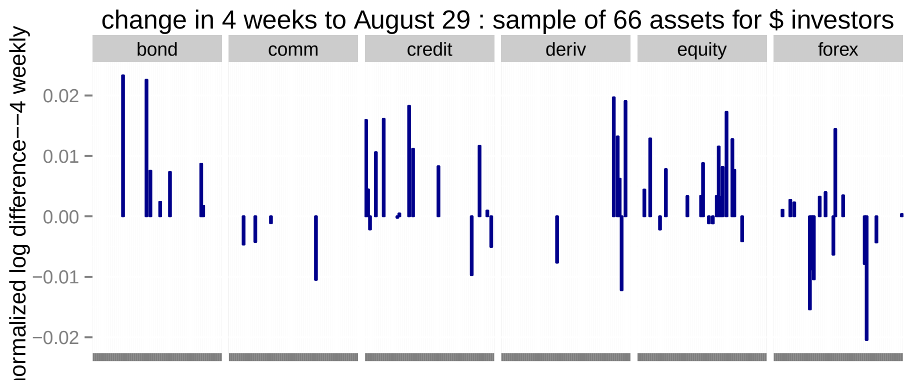
But not for long. Spotty global conditions amid possible credit disruption suggested renewed recession and, in fact, no need for higher bond yields. US bond yields fell, eventually followed by credit yields as investors went back to expecting asset value inflation to promote the shaky recovery. It was all over in a flash, but we may yet have a chance to revisit the disruptive ideas so quickly brushed away.



A Mini High-Yield Crash. After the flash-crash in high-yield debt, global equities, and emerging market currencies was reversed, that left a picture of delayed US policy normalization and a need for substantial new European financial ease. These views were expressed in a continually lower euro and in a broad rise in value for most credit bonds.

Investors had positive returns in government bonds as yields came down, and as bonds seemed refuge from the the flash-crash. At the height of the crash, a technical default by Argentina, a sudden intervention at Banco Espirito Santo, and at a South African bank all fueled credit fears. When broad credit indices recovered, however, sustained losses lingered for Ukrainian, Argentine, and Venezuelan bonds, possibly reflecting forced sales by ETF platforms into these highly illiquid markets.

Equity markets had a hiccup but quick recovery, too. Most strikingly, Chinese equities have broken out on the upside, probably reflecting the upcoming link of Hong Kong equities to the mainland that will create an arbitrage bid for mainland shares. Also the upcoming equity issue of Alibaba in New York promises to pull in high levels of cash to bid up values for a poster-child of China's deregulatory growth program.



No US inventory push in the second half. Estimates for the second quarter were firmed up, still leaving us with what looks like an increasingly lack-luster expansion overall. For me, a hoped-for inventory rebuilding cycle that could have pushed activity forward in the second half may be small to non-existent now, after inventories are estimated up substantially in the second quarter. Since underlying demand is running at a 2-3% pace, that is all we can hope for in the third quarter. All the short-term indicators confirm this view: Treasury taxes are weaker, gasoline consumption is up but less so than earlier, and initial unemployment claims are no longer declining. Key cyclical drivers of consumer spending may be faltering, too, as light vehicle sales seem to be topping out at 16.5 million units (annual rate), and home construction picks up reluctantly. Most importantly, the home value upswing of the last few years seems to be sputtering out amid a pick-up in much-delayed foreclosures in states that require judges to review these cases. Partly for that reason home price gains seem to have slowed.

Also depressing is the way average wage gains are trifling compared to the pace of falling unemployment. Ms. Yellen remarked on this phenomenon in some detail at Jackson Hole, and it is also quite visible in the UK. Employers may have been reluctant to cut wages and then deal with resentful employees even in a severe recession, but may be willing to push harder for lower wages for new employees, hence the unexpectedly weak wage gains we see. Eventually, one would expect the crowd of qualified workers eager for employment will ease and wages will pick up more normally, possibly quickly. That is one reason for hurrying up with the process of getting back to normal interest rates, but it is not helpful for immediate demand.

In credit markets, a sharp sell-off in high yield bonds was bothersome and a warning. Super-easy credit conditions will certainly trigger a new process of extending credit to increasingly marginal borrowers, prompting some to take on more than is prudent. Its only a question of time before the weak borrowers are discovered and a flight from risk follows. Ms. Yellen takes the line that if this happens it cannot turn critical because of much-reinforced bank capital levels. Unfortunately, risk finds its way into every balance sheet in the system, not only banks. Forced liquidation last month, if only briefly, of Exchange Traded Fund high-yield bond portfolios are an example. In general, risk is tied to the mass of new corporate credit issued to: US high-yield companies, emerging market companies, and US mainstream companies that appear to be using the funds to evade taxes and bid up their equity values, with a very minor share of the new money going to new investment. It is the last class of surging credit which is the most perilous for me, partly because all involved seem to have little idea of the risks they are taking.

Will Europe be pulled together by Putin? Business conditions are now clearly faltering in Europe. Euro-zone GDP was flat, partly reflecting some payback for earlier good weather in Germany, but also reflecting a deeper malaise in the over-prices and under-competitive French and Italian economies. Retail sales held up through June, but construction surveys weakened, ISM indicators are turning down and the €-coin monthly GDP is clearly slowing into August. Surveys in Germany show growing fear of economic harm from sanctions against Russia, while nations closer to Ukraine, like Poland, show a free-fall in confidence. Adding to the unease is a sense of economic drift. Inflation fell to only 0.3% in the year to August. Underling inflation is falling less slowly, to around 0.8%, but the mix of falling prices in uncompetitive countries without any sign of higher prices in Germany makes economic adjustment an increasingly a long term and politically risky project.

Credit growth remains sluggish, but not noticeably more so after the fiasco at Banco Espirito Santo. Presumably the €4.9b used to recapitalize a new good bank will be replaced with private capital or a call on the banking system, not public funds. There was brief surge in use of the ELA emergency credit facility, but the pressure passed in a few weeks, which is progress. But, still, bank credit growth is only very slowly coming back. Mostly banks are stuck lending abroad or paying back old debts to balance their growth in deposits, as they have for years now. What may be new is the ECB's reaction to slowing growth with Targeted Long Term Repo Operations and, possibly, purchases of asset backed securities and sovereign bonds. This should help but cannot solve Europe's adjustment problems.

Political action is the key to European economic recovery. Thanks to increasingly overt Russian military action in the Ukraine, Europe is slipping into a slow-down or worse. Russian actions to dismember Ukraine obviously benefit from a strong central command that can pick opportunities and concentrate forces. Europe's ability to support Ukrainians who desperately wanting to join is limited by a weak political union that barely pull itself away from fighting over national priorities to focus on the new threat. But, once again, the solution for Europe may be more Europe. In this way, oddly enough, Russian bullying may actually unify Europeans to find their way to a joint European defense force, including non-conventional capabilities, and a joint European investment program to escape its lingering recession. Failure, which is not impossible, however, could look like a unilateral move to ignore existing fiscal deals by France and Italy.

United States

ACTIVITY	CREDIT	POLITICS
	"Gone Concern" bonds readied for Nov G-20	
209th jobs in July	US regulators reject bank living wills	Proposal to regulate tax advantages of inversion
4.2% GDP recovery in 2Q--1% 1H	Yellen suggests delayed wage weakness	
Inventory rebound seems off	ETF outflows from junk bonds	US mid-term may yield move divisive deadlock in government
	Bank costs for mortgage lending reach $50b	
	$122b treasury repo fails on July 28	

Europe

ACTIVITY	CREDIT	POLITICS
	Balckrock to examine ABS for ECB purchases	
	Overnight rates dip ahead of TLTRO and negative ECB deposit rates	FR,IT call for automatic ease of fiscal targets
FR, IT GDP decline in 2Q	BES split and recapitalized for e4.9b	US-EU sectoral and bank sanctions on Russia
Quickening deflation in Portugal, Italy, Cyprus?		Hollande replaces austerity rebels in cabinet
UK wages fall as unemployment falls		Russian troops invade Eastern Ukraine

China

ACTIVITY	CREDIT	POLITICS
	Alibaba equity issue in NY coming	
	Sinopec outside investors allowed	
	New push to sell partial control in SOE	
Trade surplus surges	HK equities trading into China approved	
Iron ore prices new low	China anti-trust for Microsoft, car suppliers	Zhou Yongkang charged with corruption
ISM indicators down, sharply	Home prices rebates emerge	
	Central government tax take falls	

Credit concerns are rising again in China. Business conditions are slowing again in China. ISM indicators turned down, as did residential construction. Iron ore prices, that can reflect basic industrial demand, hit a multiyear low nearly 35% lower than a year ago. Basic indicators of activity, electricity consumption, freight movements, and government tax revenues have all slowed. Even a sudden surge in exports, not matched with rising imports, could be more a sign of companies scrambling to gain cash than a sign of health. Through July retail sales and industrial production were slightly weaker. Most analysts assume a minor speed bump is unfolding like several before that will be offset, as in many earlier cases, just in time by new policy initiatives.

One reason for more concern this time is the slowing of social credit growth in July to its lowest pace in since 2011. Several disruptive factors seem to be coming together: foreign lending is hurt by mafeasance in commodity-linked loans, trust loans are hurt by a new inspection of the trust companies and higher required risk reserves, and undiscounted banker's acceptances fell sharply with overall risk. Policy immediately turned to ways to get low-cost credit to smaller companies and farms, reinforcing the assessment of emerging problems. Financial risks are rising with losses, newly imposed on lenders, in the depressed coal mining sector and among real estate companies carrying fast-growing inventories of unsold homes. Most worrisome as a vector for real trouble is the possible breakdown of the cycle of land buying for development, local land sales, and record local revenues paying for the provision of local services for a rapidly urbanizing China.

Reflation through deregulatory policies continue. New ideas including a push for mixed ownership of the big and badly underperfoming state owned companies. Related efforts to break up the state energy company are starting, led by an intensive anti-corruption investigation. Breaking up the fuel distribution company and allowing some independent petroleum exports are under discussion. In another move to create new opportunities, Alibaba's equity offering in New York is a reminder of tech possibilities in China. But not everyone seemingly is on board with the concept of reflation through deregulation, as the NDRC imposed a wave of "anti-monopoly" penalties on foreign and particularly Japanese companies. Foreign direct investment will certainly be cut back, at a bad time for Chinese growth. I still assume deregulation can create enough new opportunities to offset credit losses, but its going to be a close thing.

I was expecting stronger and instead weaker economic, credit, and political news developed last month. I was wrong and safe government bonds yields fell sharply. Sadly, I must report that the incoming news is indeed softer so any counter-trade may have to wait.

The process of adapting to recovery and to higher policy rates is going to have to wait another quarter at least, but when it comes these markets that are most overextended will have losses. You can see what that will look like in the brief but ugly flash-crash in high yield bonds. The sooner we absorb the adjustment to higher rates the better.

Getting to that point of healthy adjustment will require fixing three problems: US wages need to start to edge up, Europe needs to show some political organization, and China needs to absorb a deepening credit and economic slow-down as it has several earlier ones.