What Just Happened to Global Credit?

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- **Changing rate-hike plans**
- **Another volatile US quarter**
- **Europe responded to promised QE**
- **A real slow-down in China**
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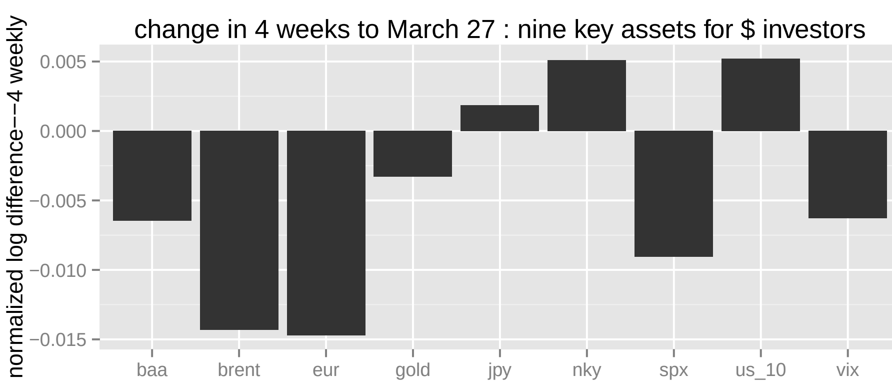
Changing rate-hike plans. *Investors spent most of the month reacting to nearing US rate hikes after the Fed dropped "patient" from its statement. A much stronger dollar resulted, enough so to suggest risk to the US recovery, and to equity returns.*

While the Fed may be tightening, the ECB went the other way, beginning a massive bond buying program. German bond yields fell particularly sharply to more negative yields over the month. Defensive negative policy rates in Switzerland, Sweden, and Denmark continued to explore the scope for sustained negative rates. So far no problems.

Ahead of the Fed's implied hike, the dollar rose against almost every currency in my universe, but most against the Brazilian real. Other emerging currencies did poorly, including Mexico and Turkey toward month-end.

Several emerging market equities were down sharply and US equities were down a little over the month. Meanwhile Shanghai and Shenzen stocks were up sharply, and so were European markets.



Another volatile US quarter. Discordant with the expected rate hike, weak US news keeps accumulating. International trade and capital goods orders were particularly worrisome. Stumbling into a 1% IQ, which now looks more likely, will necessarily give pause to rate hike enthusiasts on the Fed Board. I have long held that prudence calls for an early hike in June, but this combination of deteriorating information paints a worrisome picture of weaker corporate earnings, and a widening circle of declining equipment orders not only in the oil sector.

Besides oil sector weakness, which we expected, adjustments may have spread more broadly. Company earnings were weak in late 2014, amid a sense that large and unpredictable currency movements are likely, creating revaluation risks for increasingly integrated global operations. Still, for now, sustained onshore hiring gains continue, despite the new hurdles to investment. Weekly readings on gasoline consumption, tax withholding and initial unemployment claims all support a profile of solid income and spending that should support a quick recovery by mid-year.

Prospects for higher US rates have been pulling funds into US money markets from across the globe. Emerging market central banks, particularly, have been loosing reserves to residents shifting into dollar balances ahead of expected positive US returns. Rounds of reserve losses on balances held with the New York Fed in its custody account are becoming larger and the downswings in reserve level more sustained over time. (See below.) Credit difficulties add to the emerging market stress. An effective default announcement for the Ukraine does not help, and neither does debt service problems for oil companies from Venezuela to Russia and Brazil. Weak currencies expose, once again, the risk for oil and other companies that have borrowed in dollars.

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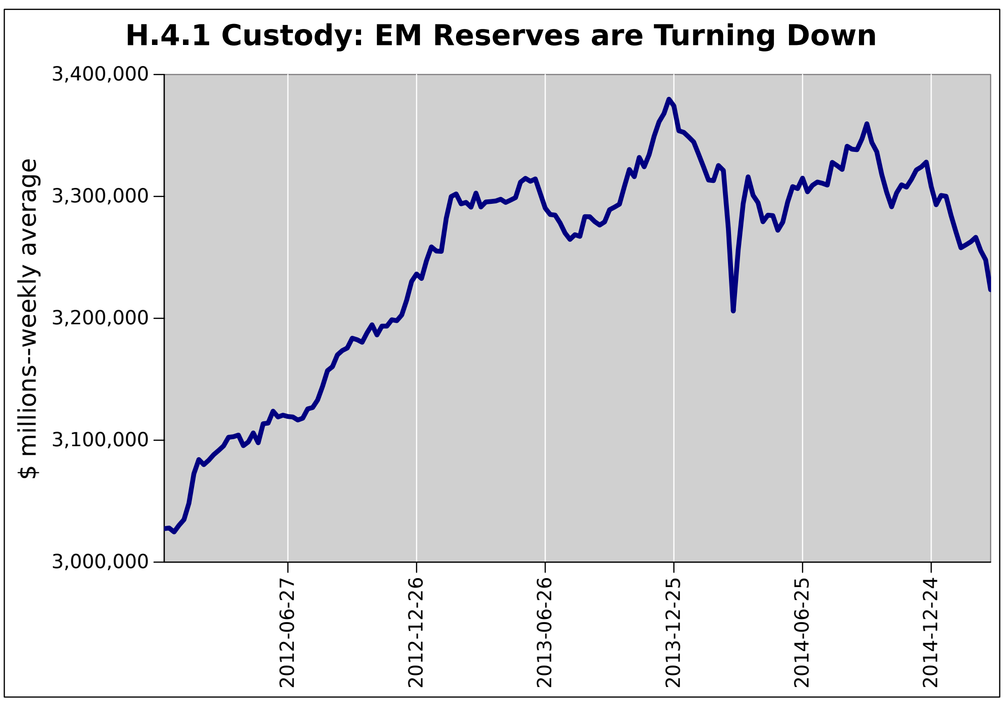

Europe responded to promised QE. Surveys and real-time growth estimates have been turning up in Europe, even before QE could start. Europe seems to have overcome confidence shocks tied to Russian trade and Greek confidence as attention turns to the good things to come from a massive QE program. For Europe, finding institutional scope for strong reflationary action is highly comforting because it reduces the risk of systematic failure.

Asset finally buying began this month after long anticipation. Europe has been confronted with a banking system that is systematically running down credit to companies, many of which suffer from overvaluation and company default risk. Banks have instead bought government bonds and offshore bank deposits with their funds. A shortage of bonds could force them into new lending, again. Within Greece, there will be no relief. Depositors took out at least €24 billion from October to February. Banks met the withdrawal with €51 billion in funding from the Eurosystem.

A more buoyant growth outlook has stiffened the resolve of European leaders dealing with Greece. Right now the state of play seems to be that Greece is committed to staying in the Eurozone, probably on the hope of eventual future transfers. And Europe is committed to helping Greece **if** it takes actions to adjust down its future borrowing needs. For the moment the argument is about a possible failure by Greece to honor official claims if the adjustment path demanded is too harsh, but this is entirely an intra-official matter not likely to cause any market contagion as long as Greece stays in the Euro.

At the same time, the Russian military threat to Europe seems to be less. A key Russian dissident was killed just outside the Kremlin in a way that suggested murderous and disorganized rivalries between factions supporting President Putin. And the President himself disappeared, possibly to attend to the birth of a child to his girlfriend in an expensive Italian resort. He looks more and more like a new Berlusconi heading an unmanageable state that cannot be a sustained risk to Europe.

A real slow-down in China. Activity turned down decisively in China in January and February. Lunar new year irregularities prevented a clear assessment until now, but know we know the answer: a slow motion credit crunch is indeed taking down activity, at an accelerating rate. Old industry steel and cement and shipbuilding companies are slowly shrinking as their earnings dwindle. Housing, too, is in the midst of a correction. Prices fell in the first two months of the new year and government tax revenue from land sales is down sharply. Reflecting the poor news, China announced a 7.0% target for GDP growth, down 0.5

But its going to be a close thing. A muted, slow motion, but clearly identifiable credit crunch is underway. Easy access to credit always creates room for ponzi schemes, where money is borrowed and repaid with new borrowings. Such schemes have held up shipping, home builders, and possibly a big solar cell makers, but these are all under pressure as lenders become suspicious. One typical escape from a growing cash crunch is raise cash with surging exports and a drop-off in imports, as we see in China. A sudden surge in bank renminbi lending in the new year may also have been directed by regulators to relieve tightening credit. PBOC Governor Zhou played down the risks, saying moderate rate and reserve requirement cuts were all that is needed. No massive ease was necessary because China was in a troubled but desirable transition to a "new normal' of slower, lighter, greener growth.

Meanwhile, the pace of corruption inquiries in the military is picking up. Targets are primarily political rivals of Premier Xi, in an attempt to cripple factions tied to prior presidents in such a way as to assure a friendly replacement is lined up for Xi next year. While enforcing party discipline, the administration also allows some outlets for public feelings. One such area seems to be resentment at uncontrolled pollution. Control efforts are increasingly likely after the release of a video "Under the Dome" about China's industrial poisoning of the environment became a viral hit.

United States

ACTIVITY	CREDIT	POLITICS
Payrolls continue rising: ECI wages up	Yellen suggests early end to "patience"	
Walmart raises its minimum wage	JPMorgan to charge large depositors	
Jan car sales 16.7m rate	Wave of long US corporate bond issues	
Drillers cut back	Companies cut oil investment plans	Obama suggests tax on offshore corporate cash
LA/Long Beach disruptions continue	S&P downgrades Puerto Rico	Weapons for Ukraine suggested
Slow 4q investment and high imports	Student and car loan delinquencies rise	

Europe

E-coin up		France avoids EU fine with its reform plan
Stong Italian car sales	Some bank outflows return to Greek banks	Modest French reforms at great political cost
Strong German IQ GDP	Swedish, Danish negative rates	Greeks agree to adjustment and loan
Solid IGMetall wage contract in Germany	Italian mutual bank structure to change	Greek collateral no longer good at ECB
		ELA credit replaces regular loans. E60b=>68b
		Greek default risk rises

China

	Surge in trust lending	
	First housing junk bond sold since Kaisa failed	
	Reserve requirement cut	New Year Holiday
Stabilizing manuf survey	FT questions Hanergy Solar's funding	Widening corruption inquiry in the military
Tech protectionism steps taken	Capital outflows continue	
No sign of a bottom in steel prices		

Greek novices discover Europe. Some of the increasingly acerbic and personalized dispute between Greek and European officials may arise from misinformation on the Greek side. None of its people have been in power before, and many spent a lifetime in academia. Certainly, as they say, an oversized debi is latex normally best reduced by default. But Greece is long past that stage, by having agreed to let official lenders take over its debt as it came due. Now the debt burden is not commercial, but mostly official, which means it can be reduced at the stroke of a pen, certainly in terms of interest and principal due in any one year. The burden of this debt **should** be a non-issue.

A second discovery for the incoming Greeks is that new lending to roll over the offical debt has ceased. Payments are now demanded on each of the loan instruments of the program that would otherwise have been offset with new lending as long as Greece was on a long-term adjustment path. Instead of liberating itself from a debt burden by default and handing out the proceeds freely, Greek officials find themselves facing an unexpectedly severe cash-drain. And, again, these payments are to international official agencies and hard to dishonor, as the lenders repeatedly insist.

Official lenders can always patch up their relations with official borrowers. New money can be found at the last minute in ways you will hardly see in a commercial negotiation with many suspicious creditors. So I assume a non-default outcome for Greece. But even so, the incoming novices in Greece may find one more surprise in the way they have lost control over their banks. Allowing ELA credit to Greek banks, while sweeping out every penny of emergency funds for banks from the hands of the Greek state, Europe has taken an important degree of control over these banks. Its control is apparent in the ECB refusal to allow Greek banks to buy any additional government debt.

The net of these surprise is that Greece's new leaders may be astonished to learn that they must now choose between an unprecedented failure to repay official lenders or a failure to make payroll and pension payments. They refer to "trivial cash flow problems", but it is anything but that. Their problem grows out of electoral promises not consistent with Greece's gross overvaluation and necessary adjustment to local productivity levels. Aspiration for a Northern European standard of living and demands for credit to support it were always going to run into credit and then budget constraints at some point, just much sooner than anyone expected.

Exacerbating the problem is a probably growing underling primary deficit. Because the outgoing conservative government increased spending already last year, the Greek public sector was not anywhere near agreed primary surplus targets. A 1.5% primary balance for 2014, which once seemed likely, dwindled into a 0.3% surplus. I must assume that new spending measures taken by the Syriza government will take this into a primary deficit, hinted at by a determined effort not to reveal the figures to visiting European officials. But official lenders will not resume new lending for more than the amount of interest and principal due, particularly when they do not clearly understand future credit needs. So, even after some form of new lending averts an official-to-official default, the emerging primary deficit will leave the Greek government stumbling from payroll date to payroll date under any conditions.

Slowing growth in the US and China could more than offset the better news from Europe. Unless we are very mistakened, US rate hikes are going to have to wait, despite every prudential argument for a hike in June. This is the new idea investors should be working with in April.

Distracting from this basic news is the ongoing drama of Greek public payments difficulties. I think the Greek government has been demoted to a backwater of the Euro economy, and that a last minute deal will be patched up anyway. But that is no longer the big story. The big story is weakness everywhere but Europe.

Because so severe a downdraft has hit emerging market currencies from the prospect of growth and US hikes, the possibility of a delay in those hikes could lead to relief. One good idea for the next few months could be to own a basket of emerging market currencies weighted by the degree to which they have been oversold. Russia would have a heavy weight, India an interediate one and Brazil a light one, since I find it still substantially overvalued.