What Just Happened to Global Credit?

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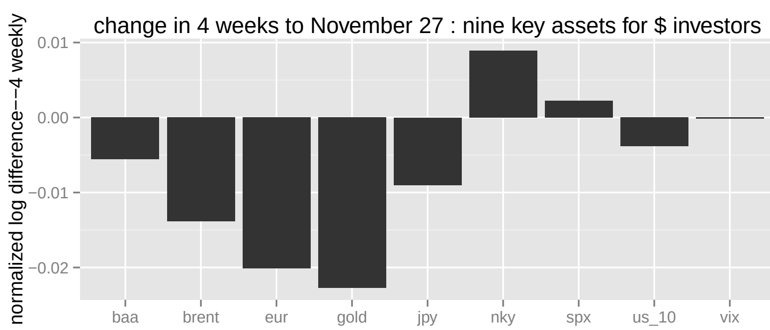
- **US rate hikes are coming, if only to ease market tension**
- **Europe considers rate cuts below zero**
- **Policing China's high-pressure financial system**

Leading up to this month's big rate decisions by the Fed and the ECB, core equity markets have mainly gone quiet. S&P volatility has continued to come down.

The euro fell in response to the ECB's bias to ease and the Fed's divergent bias to raise rates. Investors have also been shunning gold, in line with the coming higher US rates that will penalize the sterile metal.



Uncertainty about how the upcoming rotation of rates can work out will be hanging over market through December. Faced with the uncertainty, investors have just begun to sell equities. By last week, sales were becoming widespread, with striking exceptions of the German and Indian markets.

The approach of higher US rates also led investors to buy dollars against every other currency. The effect was felt in China and in emerging markets, most strikingly in Turkey, Brazil and South Africa.

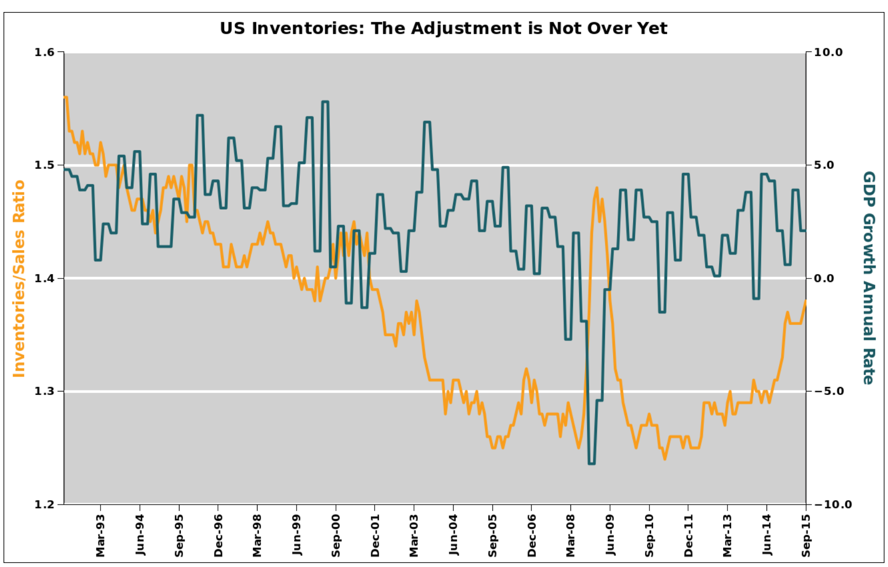
US rates hikes are coming, but they may not rise as quickly as we once thought. Accordingly, dollar government and high-rated bonds rose in value. At the same time, riskier bonds fell in value implying risk aversion in certain pockets, including oil producers.

US rate hikes are coming, if only to ease market tension. We made a great deal of the seemingly early and healthy end to the US inventory correction last month. That observation also pushed the Fed to signal its intention to start raising interest rates on December 16th. Since then, revisions and new data now show the case was not quite so clear. Only a part of the needed cuts in inventory accumulation seems to have been completed in 3Q, and more waits to be done–pushing up the 3Q GDP revision but holding down the 4Q and later GDP forecast. The risk of slowing US growth that spreads into a real recession is one that will probably be with us into the new year.

A cyclical inventory build can be a key indicator of a business downturn. But it can also give almost twice as many false as correct signals, as shown in the chart below. Admittedly the ratio of total business inventories to sales in the US is now high. One reason is the tidal wave of oil shipped to the US by desperate countries struggling for income when oil prices fall. This process is actually running into storage limits and is already spilling over into oil held in ships moored off major ports. We also know that long supply chains mean global suppliers under stress can try to ship as much as possible of their material to the US for early payment. If so, high inventories may not imply so much a US adjustment as one abroad.

While I am comfortable that inventory adjustment is rarely the *cause* of recession, a pause in underlying US final demand growth has also emerged since US equities sold off in September. That selloff had an almost immediate impact on consumption and even on capital goods orders. After working through those impacts, I assume underlying demand will rebound if we have no further equity shocks. Employment is rising steadily, as it gets harder to find good unemployed workers. Wages are starting to tick up, as you would expect under these conditions. With wages growing, real-time income taxes paid are moving up, although a little more slowly than last year. A slight rise in initial unemployment claims is consistent with the brief adjustment in US production we expect to absorb an inventory adjustment. Lastly, a year-long dip in capital goods orders seems contained to the oil drilling and aircraft segments. In particular, sharply lower fuel costs have apparently removed an incentive to buy new fuel-efficient aircraft.

But US equity valuations may indeed be vulnerable to the beginning of rate hikes. Extremely supportive financial conditions have led to surge in bond-financed credit flows. Some of these funds have almost certainly ended up being used to buy back shares and support market valuations. So if actual rate hikes destabilize US equity markets as much as their anticipation has already done, and if spending is as sensitive to equity valuations as it was during September-October, then US final spending growth may be slower that we expect for a month or two more. If things fall out that way, the pace of rate hikes can be slowed to a crawl. But the hikes should start now, if only to get past the disruptive uncertainty of waiting for when the hikes will begin.



Europe considers rate cuts below zero. Activity seems to be holding up despite shocks, most recently the terrorist atrocity in Paris. Before then, monthly GDP tracking and most confidence measures were showing steady improvement. The one exception was a hint of fear in German confidence surveys that a tidal wave of immigration could eventually depress wages. So far, feared falls in exports to China and the rest of the emerging markets seems to have been offset by higher exports to an expanding US.

In this situation of potential risk to a very early recovery, the ECB is understandably super-vigilant against deflation. It may even innovate by pushing overnight rates more deeply into negative territory, something the US and Japan never did during their experiments with quantitative ease. Negative rates were long seen to be impossible because depositors could merely opt for cash rather than accept a negative rate on deposits.

This remains true, but wholesale money rates and bond yields, have gone negative in much of core Europe. And Switzerland has been running -75bps overnight rates for some time. Perhaps the real lower bound on wholesale risk-free rates is at the point where *bank lending rates* turn negative, because then an arbitrage to borrow and accumulate industrial size stocks of cash could emerge. Given bank lending spreads of 200-300 basis points over funding costs, that point is quite a long way from here. The ECB has room to innovate.

Negative interest rates on this scale will heal an over-borrowed continent struggling to get into a full recovery. Most importantly, overhanging excess debt will no longer accumulate interest due faster than nominal GDP growth. This helpful effect is already very visible in the German fiscal balance, where interest costs are dropping, making room for a bigger primary deficit. The same should begin to happen for other governments and for commercial credit, too. It is either work down excessive debt slowly in this general indirect way, or wipe it out with disruptive defaults–a prospect that remains quite open in parts of Southern Europe.

Negative interest rates can also help to hold down the euro despite the region's very large current account surplus. This surplus is almost all due to super-competitive German exporters. Since policy makers are stuck with a continent where very different levels of wage costs have developed, this could be equivalent to seeking a weaker currency appropriate for Southern Europe over one at is more appropriate for German industry. In effect, a weaker Euro will tend to overheat the German economy, working wages and costs up to the level prevailing in Southern Europe, and so correcting the deep relative cost problem ailing Europe. Again, negative rate innovation can surprisingly constructive for the European experiment.

	ACTIVITY	CREDIT	POLITICS
United States	Solid payrolls Car inventories are coming down Inventory adjustment will take longer Retail and Investment slowing Zero aircraft orders at Dubai airshow` Statoil drops Alaska oil exploration Walmart and others see weak sales	Pfizer-Allegan tax inversion prepared Yellen and Fischer talk up a Dec rate hike SNC review shows oil sector strains Glencore divests to support stock price Lonmin distressed rights issue	TDD terms disclosed ahead of Congress' vote Obama blocks Keystone Pipeline US considers blocking Pfizer tax avoidance
Europe	Moderate 3Q GDP ISM and other indicators solid BoE not raising rates soon Fears terror will stop investment plans	ECB still considering more negative rates Greek banks issue equity to match EU funds FR and ES miss deficit forecasts Calls for EC to give up deficit control	Europe to pay Turkey to hold Syrian refugees Delayed Greek bailout funds OK'd Paris terrorist atrocity Portugal tries a Socialist government
China	Housing prices recover in Beijing Car sales surge Copper and Iron ore hit new lows Weak industrial indicators Steel is being dumped world-wide	Finance rails in Indonesia, nuclear in Arg Arrest prominent speculators Default of a cement company affects CLOs	Xi announces military reorganization Intensifying corruption investigations
Other	Australia solid jobs IEA sees record DC oil inventory JP 3Q GDP falls	Saudis plan Jan bond issue	Erdogan's AKP wins majority in Turkey CNY inclusion in SDR Turkey-Russia air clash Russian civilian plane blown up over Sinai

Policing China's high-pressure financial system. Business conditions are still slipping. Freight, industrial value added, and electicity use are all consistent with the heavy industry side of the Chinese economy expanding at no more than a 2% pace. Commodity prices related to the collapsing heavy industry sector are in a slump, hitting new lows for coal and iron ore. And Chinese steel is being dumped at distress prices from Japan to Brazil. Some consumer-related areas are doing better, including car and residential home sales in first-tier cities. But these benefit from special one-time support measures.

Policy responses to the deeper than admitted weakness is broad-based. One approach is to target credit through policy banks to priority businesses outside of heavy industry. Another is to talk up a non-stop stream of reforms–including a new interest rate corridor, new financial regulations, and a new five year plan. The key is to foster a deregulated economy that can innovate beyond heavy industry. And key to broad acceptance of these innovations is the story of their success, as reflected foremost in the stock market. So a worried administration met an equity crash with massive balance sheet measures to absorb the sudden outflows.

Since then, balance sheet measures have been reduced and replaced with a program of persecuting equity short-sellers, particularly in futures markets. This includes dark references to "foreign attacks" using offshore servers and high-fequency trading methods. Whatever the police think they are doing, it must look to investors as if buying is politically correct but selling into a crash is subject to prosecution. Not a healthy package for any sober investor and very likely to be self-defeating for investor confidence.

As we have argued, bloated but isolated Chinese financial markets will have difficulty integrating into global markets. China's new participation in the IMF's currency basket is a case in point: it requires at least some elements of currency convertibility, increasing the ways for Chinese investors to move offshore. Very large amounts may start to move into previously prohibited areas, in what can look like for a time like a tidal-wave of money. A weaker CNY, as emerged at the end of last week adds to this risk once it starts amplifying offshore returns. Like so many other overvalued emerging markets, China too needs a step-by-step weakening of its currency that does not turn into a destabilizing rout.

Global conditions are, on balance, softer than we thought last month and so less able to cope with the beginning of US rate hikes. But US hikes offset by European and Chinese ease presents a picture of global policy rotation and may be less risky than US hikes alone.

Because we have no experience with exiting quantitative ease, the US part of this process is disturbing to market expectations. Can rate hikes prevail in a world prone to structural slumps? Can the US expansion survive a stronger dollar and a possible equity correction? Massive releveraging of corporate balance sheets through bond sales means the answer to these questions may lead to outsized moves in market valuations.

But it is not only US risk that needs worrying about. European debt overhangs still lurk in Southern Europe, although dismissed for the moment. And Chinese recovery from its great credit bust is only just beginning. Overall we tilt to avoiding undue risk until the dust clears in the new year.