What Just Happened to Global Credit?

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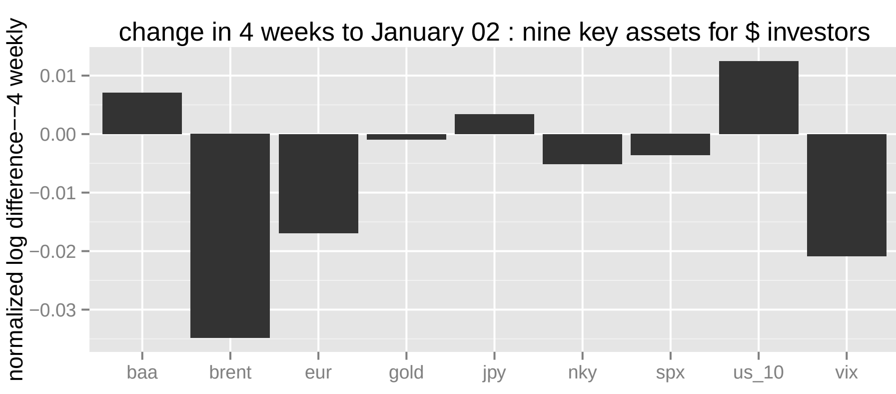
Falling oil prices did indeed trigger a credit shock in December. Oil exporter currency, equity and dollar bonds all followed the price of oil down. By mid-month, some parts of the credit market were in disarray and pricing was choppy. Short positions in targeted credit made huge returns.

In the new year, the real question is whether the credit shock is contained or spreads. One feature of over-sized global balance sheets in a time of quantitative ease is the tendency for long swings of investor sentiment to develop that go far beyond reason. So, will a long swing out of credit products develop now, in which investors fear losses, cut allocations, and leave managers with a variety of illiquid paper and tough choices?

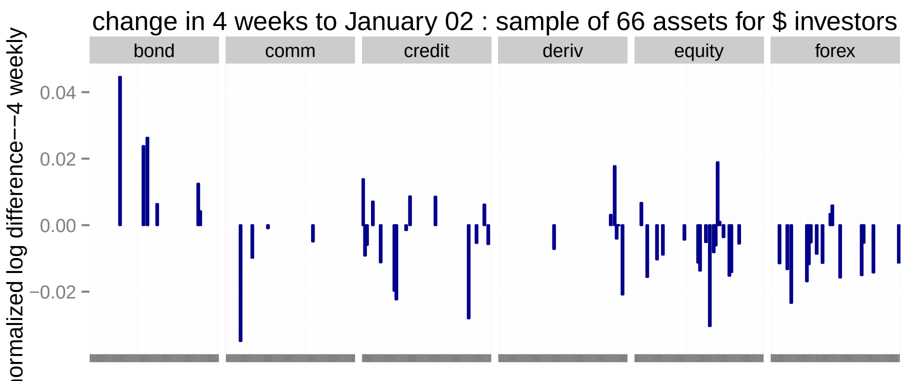
Credit excess, including to oil-linked sectors, has been deliberately fostered by policies of quantitative ease for their side effect in bolstering demand. But by driving up asset prices, quantitative ease would inevitably create a situation where outsized losses are possible as well as continued gains. If this is the time for a round of generalized losses, it will happen through renewed portfolio allocations out of credit and, possibly, equity risk in the new year.



Oil Shocks Turned Into Credit Shocks. Oil kept falling at a headlong pace, followed by copper, iron ore and coal. Whatever ails the Chinese motor of the world manufacturing, it is not using raw materials the way it used to. Immediate losses for investors were concentrated in Russian equity, Ukrainian credit, the Canadian dollar because of high-cost oil-sands production now at risk.

All emerging markets began to seem at risk. Currencies, corporate and sovereign dollar bonds, and equities all fell. Corporate and sovereign bond indices, particularly, fell sharply as default risks began to emerge in Russia. Venezuela and, to a lesser extent, Ukraine.

Everywhere but in China, rising risks have created caution among equity investors, too. That leaves the safest government bonds, and possibly cash, as the safest investment alternatives; indeed US, German and Japanese bonds all went up in price. Among credit instruments only those linked to the highest quality credits and to mortgages which track government rates most closely did better.



US Data Problems. An increasingly solid underlying US growth trajectory seems to be developing, based securely on a slowly but certainly improving labor market. With the reduction in unemployment comes income growth and willingness to borrow and to buy. Further along, the fall in unemployment should eventually create wage pressure. In the meantime, lower gasoline costs will boosting real incomes. Available short-term indicators of demand all confirm the trend: Treasury taxes withheld and gasoline usage are both up. But output measures are more uncertain in the short-run. Car assemblies may need to adjust to stabilizing sales, capital goods orders are softening because of lower energy spending, and home sales are stable. Add to that a pause in global trade after a strong period, high US inventories, and a temporary slowdown in production is possible.

In this mixed situation, reported GDP growth came in at 5.0% for the third quarter. The report reflects both the deep underlying strength of a labor market recovery and a worrisome instability of US GDP estimates. In trying to measure the services sector directly, particularly health care, US statisticians have developed a new Quarterly Services Spending estimate. Not only is the new measure rough, but it has a short history, creating possible spurious seasonals. The new estimation appears particularly vulnerable to error when coping with recent sharp changes in underlying medical spending by Americans as a campaign of fear-mongering led many to hold off on medical treatment in 2013, only to rush to catch up in 2014. Working together, these real and statistical problems raise the real possibility of a much lower GDP report, particularly in the final revision of 4Q, due in late March, 2015.

Without visible inflation pressure, this complex data situation leaves the Fed on course to begin a long series of small rate hikes in mid-2015. But wisdom dictates that the Fed will wait at least for the final 4Q GDP print to be sure about the degree of slow-down developing. I see a good chance of statistical and inventory downdrafts to GDP through IQ 2015 and the Fed wisely chose to wait until mid-2015 to be sure the weaker reports are transient and not basic. All signs point this way: removal of the "considerable period " language about timing, focus on "patience" in regard to the small size of hikes when they begin, and the Fed Board's expected rate path.

Credit and Politics Heat Up in Europe. Initial fear about lost Russian orders seems to have faded somewhat, and European growth indications have become mixed. But the collapse in oil prices, amplified by a weaker euro now poses a real problem for price stability. Yearly headline inflation will almost certainly fall negative for Europe overall in early 2015, and may do so even in Germany, increasing the alarm and calls for reflationary policy.

One reason for sluggish growth is that European banks are not offering credit for recovering businesses. Bank credit to business fell sharply again in November, as ongoing regulatory pressure on banks cuts into their appetite for loans. One response to boost credit flow could be to hurry official sector lending through the EIB, as is now planned. Another could be for the ECB to buy sovereign or other bonds. Whatever happens, however, counterproductive additional austerity measures are both unlikely and unnecessary.

Politically, Europe is still feeling its way toward its multi-year objective of economic union, but ever so slowly. For the moment that best that can be done seems to be quid-pro-quo in which labor market reforms are taken as a substitute for fiscal tightening. Italy and France both intend to avail themselves of this new option that should theoretically ease the way to an "internal devaluation" alternative to actual devaluation. But as ECB President Draghi pointed out in a thoughtful editorial, these are all at best partial measures ahead of a true economic union and deeper institutional integration.

Meanwhile, politics and dismal economics are coming together for Greece, Portugal and Cyprus. In each, political leaders have promised debt relief to voters, something they can only deliver through imposing losses on the rest of Europe. But, now that bond markets seem less contagion-prone, the core of Europe could well say "No". It did not seem possible earlier, but it is a growing risk now. And it might be a small market event, surprisingly.

United States

ACTIVITY	CREDIT	POLITICS
Payrolls solid, QCEW revises up PCE		Cuban trade prohibition lifted
5.0% 3QGDP: solid final demand	P2P Lending Club IPO	New Congress may increase military spending
Disruptions at LA ports	BIS fears $-credit stress in EM	
Softer Home Sales	JPM hefty capital increase needed: Fed	

Europe

ACTIVITY	CREDIT	POLITICS
	EU HG bonds up on EU buying plan	
	EE bids for EU e315b investment funds	No further Russian provocations in Ukraine
BBK cuts 2015 GDP fcst from 2% to 1%	Greek default risk rising with Syriza	Possible Syriza win in Feb Greek general election
BBK sees neagative inflation ahead	ECB TLTRO goes mostly to peripheral banks	French budget is still pending March EU approval
Airbus order difficulties		German anti-immigrant demonstrations

China

ACTIVITY	CREDIT	POLITICS
Surge in oil imports and tanker rates	Equity boom on reform promises and IPOs	
Weak imports, weak ip	Extreme equity volatility around possible top	
Nov IP halted to clear air for Beijing		

China's IPO-linked Credit Crunch. Activity keeps limping along, supported by the drip-feed of official construction. Official construction was mainly rail and airports earlier, but will increasingly include affordable urban housing going forward. It is all barely enough to keep activity humming along at the lower "new normal" rate to which officials now aspire. Private home building is still slowing as big inventories hang over the market, and an adjustment down in car assemblies is underway to trim a build-up in car inventories. Export growth slowed, too, after a surge in 3Q, and industrial company profits are down. GDP tracking still shows GDP in 4Q growing about 6.5% from a year ago.

Financial markets experienced another micro-squeeze in mid-December. Repo rates rose sharply as funds flowed into blocked accounts held against upcoming IPO bids, but could also reflect the continued broader need for funds to rollover high rate date elsewhere in the system. The tightness is a littel perplexing, however, because lower oil import costs delivered a massive trade surplus that should have increased bank reserves, unless capital outflows are developing. In response to tight market rates, the PBOC relaxed bank deposit to loan ratios (by including interbank deposits as deposits), giving investors the sense this would ease financial risks–with an immediate kick to stock prices and a rumored boost to home sales.

Fearing of contageon from Russian-led losses, China's authorities have been taking steps. The easiest way to stop emerging market contageon is to offer CNY currency swaps or short term credits to Russia and others. Swaps encourage the use of CNY in trade and, if necessary, can also be sold for dollars effectively sharing China's vast reserves with other nations at greater risk of investor withdrawals. So far, China's credit bubble seems to be only slightly at risk from a growing scepticism among global bond investors.

Russia Shows the Way. Russia's unfolding financial failure looms over all emerging markets. All have similarly taken advantage of low dollar funding rates, particularly bond rates. As long as the dollar was falling, these bonds looked like they bore a *negative* cost. It was all good as long as the flows continued, further driving up local currencies. When the cycle stopped, of course, these currencies can fall a long way, amplifying the risk on a surprising large amount of debt. Oil prices falls are an important trigger, but they gain power from this deeper swing from a positive to a negative self-reinforcing credit cycle.

Russia is the poster-child of this process with a predominance of bonds in its external debt, up to $252b counting bonds issued abroad by Russian entities. By the same broad measure, China owed $390b and Brazil $327b in September 2014. Some of this can be against dollar export earnings, but sadly it always turns out not all is so hedged. So losses will follow, and not slowly either. Venezuelan bonds (which are an extreme case of the same phenomenon) are already trading at default values.

For Russia, the paradox is that Putin's cronies used cheap dollar finance and threats to take over big swathes of the local economy. They, like most other Russians do not trust local long-term financial instruments so they borrow in dollars and deposit abroad in dollars, too. Theoretically this use of offshore markets is two-sided; Russian investors abroad might be forced back home to refinance companies cut off by fear and sanctions from rolling over their foreign debts. Countries from Venezuela to Argentina have tried this and it never works in distress. Those who do not trust their system in good times are unlikely to risk all in a crisis.

Very deep losses have, in fact, been sustained in several oil-related bonds in mid-December. Credit funds of various kinds have begun to react to these losses, including sales by retail investors in US mutual funds. Central banks have been dabbling in this asset class, perhaps in a big way, and will react late but forcefully once they recognize what has happened. More importantly, short-credit investors will have rediscovered the profits in targeted sales of one weak credit after another.

The first response to stress has been to pile into safer bonds,including US Treasuries. This happened even in the face of impending US rate hikes, and will, in fact, increase the odds of an early start to rate hikes. So the safe bond alternative is unlikely to hold up for long.

Bond yields offer little room for lower rates, and equity prices have gone to levels that suggest at least two way risk. So we are in a basic trap of the long application of quantitative ease: expansive public balance sheets chase asset prices to high levels, from which disorderly retreat is increasingly possible. It has not happened yet, but it could.