What Just Happened to Global Credit?

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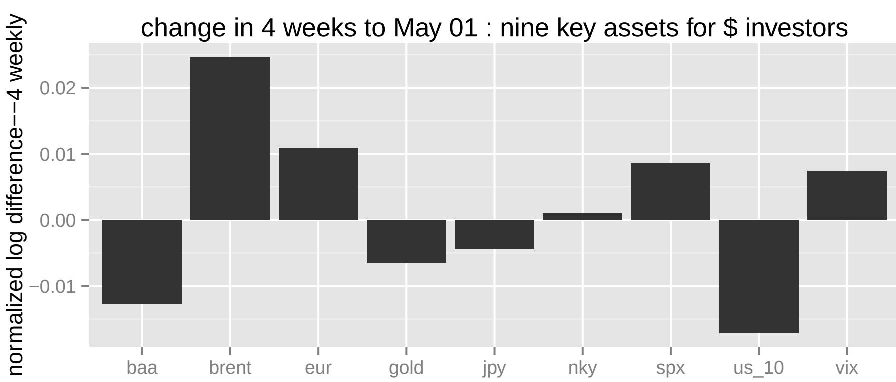
- **Adjusting to delayed rate hikes**
- **Global supply chains and the US**
- **Europe's deepening recovery**
- **China's slow credit crunch**

Investors solved their problem with how far the dollar should rise when the US slows–the answer is not so much as it had done.

Paradoxically, in a situation where the balance of new information was softer, oil prices rose quite sharply. Bond yields backed up after hitting record lows, some negative.

Despite the higher oil prices, the risk of disruptive US rate hikes came down, easing potential pressures on all the spread risk in the system from junk bonds to high-flying equity and emerging market currencies.



Across my universe of assets, last month saw higher yields for the safest, government, bonds. German yields sold off the hardest as European growth is established and a negotiated solution over Greek official debt rollover seems more likely.

Other bonds closer to government ones sold off, too. But several high-risk credits, including emerging sovereigns and emerging high-yield, did better as the risk of an abrupt and disruptive US rate hike ebb.

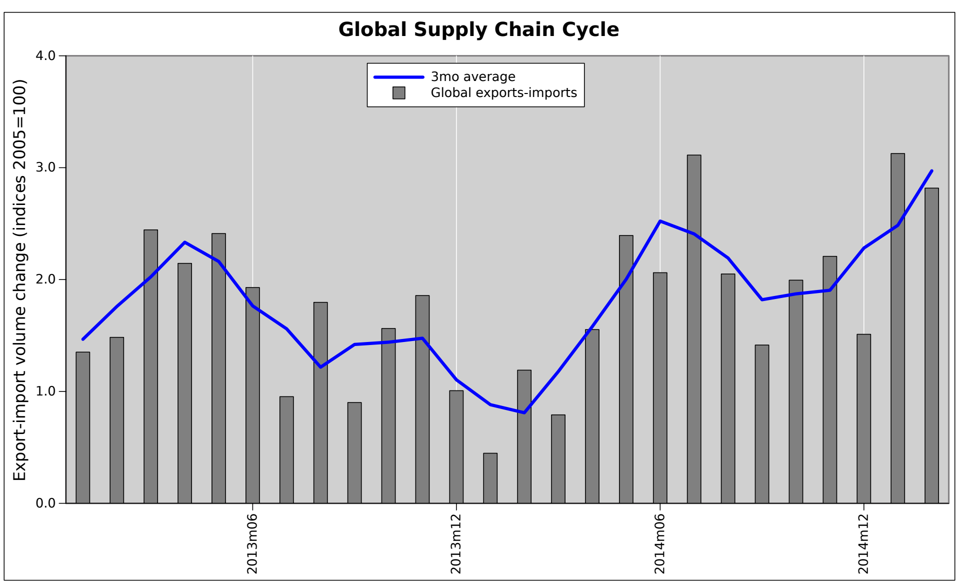
Chinese stocks continued their great surge, leading most other markets for most of the month. On a more worrisome note in emerging markets, Indonesia and Thai equity were hit hard in the final week of the month.

As upward pressure on the dollar ebbed, the pattern of sharp currency sell-offs in individual countries kept rotating. Deeply depressed currencies of Russia and Brazil recovered but new sell-offs began for Mexico, Turkey, and Indonesia. The rallies were stronger, for the moment, than the sell-offs.

Global supply chains and the US. We knew IQ GDP would be weak, but the details were weaker than I expected. A collapse in the diffuse shale oil drilling sector now seems to have done broader harm than I imagined. Falls in structural engineering and in machinery orders were joined by a sudden stop in consumer spending on goods as employees reacted to the shock. Meanwhile, net exports are falling, through the ups and downs of the trade and inventory cycle, by about $20b/ quarter or 0.5% of GDP. A trade deterioration at this pace matters over time, even for a relatively closed economy like the US. On balance, and pending an end to the collapse in shale drilling or the high value of the dollar, I have to move down my underlying growth estimate from 3.5% to 2.5% in 2015. A recovery is still intact, because income growth is solid, but may only become clear toward year-end.

One striking feature of both US and Chinese news is our link through trade. A striking inventory-trade cycle is underway in both countries, at the same time as world exports at sea hit a high in Jan-Feb. That is to say, recorded export *volumes* exceed imports by a wide margin, implying greater cargoes at sea. Some cargoes may have backed up off Los Angeles/Long Beach, but in any case they belonged to someone who will be aware he owns more inventory than expected. First quarter US GDP also showed higher landed inventories, implying a big overall inventory build on land and sea, similar to what we saw in early 2014. Long trans-Pacific shipping patterns have introduced an important new inventory element into the global supply chain that is becoming important for business conditions. In this case, we can know that inventories only build at this high rate in the US and at sea for a quarter or two before they are adjusted: this now implies an additional drag into the second quarter GDP, in China and the US, that I had not expected. (See chart below.)

Ben Bernanke's new blog offers a special window into policy by someone who knows. He and Larry Summers bandied ideas about why we might have more global savings than investment, implying the need for negative rates to clear markets or public borrowing to deploy those savings productively. Bernanke tends to think we are recovering, only slowly, from the deep crisis that originated in excess Chinese savings during 2000-2008. Summers implies the US itself has been over-saving over time and continues to do so, so he recommends higher government investment. If he is right, but government investment is precluded for political not logical reasons, that suggests the option of negative interest rates. For now, no one wants to explore that option seriously, although it was clearly reflected, briefly, in some European rate markets.



Europe's deep recovery. A sharp snap-back in Europe's growth outlook continues to develop, particularly in Italy and other peripherals where a deep gloom has lifted for business and lenders. A new stress test, new European level bank supervision, and the amplified impact of oncoming QE on effective lending rates in the periphery will all have a powerful effect easing once-constrained credit. European business sentiment indices are up, as is the Eurocoin proxy for current GDP.

While the background changed in basic ways for Europe, we listened all month to Greek negotiators cry wolf over their inability to meet each and every upcoming IMF payment. A deal has always been possible in this intra-government discussion over the terms on which official debt rollover is met with new official loans. It will look like: the new Greek government commits to a primary balance between 0.5%-2.5% of GDP and European officials resume rollover lending. For this to work, Greece must achieve a reasonable primary surplus by offset big spending promises with revenues. So far, Greek officials are suggesting they can do so with increased tax enforcement and settlement of outstanding taxes at deep discounts–both of which are only one-time measures.

That would be half the compromise because it will be unsustainable. The other half has to do with respecting the idea that low productivity in Greece can only support a low standard of living. So far the Syriza government hangs on to the idea that they can legislate a more "European" standard of living through higher pensions, public jobs, and minimum wage increases. None of this corresponds to the internal deflation model held by other Europeans, that it will take decades of wage cuts under market pressure to offset a grossly overvalued currency in Greece, as it did in the German Eastern lander.

Between negotiating rounds, the Greek government concentrated local and state owned deposits into accounts it could use. This effectively squeezed deposits out of the banking system and into state accounts. Bank deposits were replaced with new ELA loans, implying a degree of political forbearance for Greece that continues and implies eventual compromise.

United States

ACTIVITY	CREDIT	POLITICS
	NASDAQ new high	
ECI seems to show labor market turn	Corp cash pay outs surge, led by GE	
McDonald's raises wages 10%	Surge in corporate mergers in health	US interim agreement with Iran
Weak construction, orders	Leveraged buy outs limited by Fed limits	IMF: risk of global stagnation
GDP slows sharply in IQ	GE exits highly regulated finance & RE	IMF: risk of credit reaction to US rate hikes

Europe

IP rises: trade surplus rises	Credit begins to expand	
Core CPI rising	EU accepts clearing in the UK	
Stronger sentiment	Private sector lending up	EU challenges Google and Gazprom
German new orders dip	Deferred tax capital in S. Eur questioned	GR threatens IMF default if no EU funds by May
	QE may create bond shortage in DE	EU threatens no ELA for Greece if IMF default
		UK election nearing

China

	"New Deal" for real estate recovery	
	Surge in retail and spec equity accounts	
	RRR cut by a high 1%	
Slight gains in coal and copper prices	Hanergy shares surge despite doubts	Big investment package for Pakistan
Sharp fall in trade	IPO pipeline increased to quell bubble	Corruption inquiry in the military, oil companies
Weaker PMI	Equity short contracts permitted	
Falling inflation	Tianwei record domestic bond default	
	Kaisa first dollar bond default	

China's slow credit crunch. Output in China is clearly slowing, in summary PMI survey terms and in a lowish reported growth for the first quarter. A drop in apartment construction and in exports were reported after the new year holiday. Construction fell as sales (often ahead of delivery) have been sluggish for some time and construction company finances come under stess. China's trade balance worsened sharply, and surprisingly, despite the ongoing relief from cheap commodity imports and a surge in cheap steel exports that may yet evoke countermeasures. All this *might* be offset by rising service activity, only job growth is also slowing, so the slow-down is broadening and may soon turn into a self-reinforcing downturn. Faint signs of an improvement in second quarter activity may be emerging in some PMI indicators and early signs of a bounce in home sales in Beijing. But it is hardly a done deal yet, amid concerns about a consistent trend toward deflation.

Financial pressures, including a swelling domestic bankruptcy list, permeate the old industrial sectors. Coal mining companies are under particular stress because of the flood of cheap Australian coal, and mining district local government finances are particularly shaky. Bank financing has been cut off for highly polluting and overinvested heavy industry, for construction, and for local government funding vehicles, pushing these unfavored sectors into shadow and offshore financing. There bankruptcy finally reached Kaisa Construction's offshore dollar bonds, a possible signal of more to come.

Policy makers are well aware of what they have done to cut credit to unfavored sectos, and they promise replacement investment opportunities in public transport, new free trade zones, pollution control projects, and infrastructure projects abroad. Unfortunately they have not stabilized free-flowing regulations to the point where a reasonable profit opportunity if clearly visible in any of these areas, and any public sector innovation is hampered by the fear of spreading corruption investigations.

Partly buying into "reform bullishness" about the new investment opportunities, and partly to avoid investment losses in a falling home market, Chinese investors have piled into equities. Again, regulators have promptly reacted to this surge by ratcheting up permitted new equity issuance, lifting equity marging requirements and granting permission for new equity shorting instruments. Clearly the idea is to absorb and limit credit flows into equity before a crash becomes inevitable. Meanwhile, bank credit flows will be channelled back into stressed debt and bank markets. Here the PBOC cut reserve requirements, boosting bank lending room, and has reportedly considered a program of refinancing banks that buy local government debt. Bank lending terms and regulatory permissions for mortgage lending were also eased.

China looks like a country wrestling with powerfull swings in its enlarged financial markets. Using available regulatory powers, while encouraging deregulated activity at every turn, a wise policy mix might guide the nation through its slow-going credit crunch with limited harm. But its by no means a clear thing, and it will be further tested if global demand for Chinese exports is indeed due for an adjustment to clear inventories, including those delivered to the US and at sea.

Last month may have been one of my better efforts. Investors were indeed ready to adjust to a weaker US expansion. And Greece indeed turnedo out to be a tempest in a teapot, not a system-risk at all.

So where is the next surprise? I think it may be in the trade cycle and the long shipping lines on which it depends. This links the US and Chinese slow-downs in early 2015, as ships from China to the US have been filled up with goods.

When orders adjust, the surprise could be how weak Chinese growth remains, shaking the fragile equity bubble there.