What Just Happened to Global Credit?

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- **US skips a rate hike**
- **Missing inflation**
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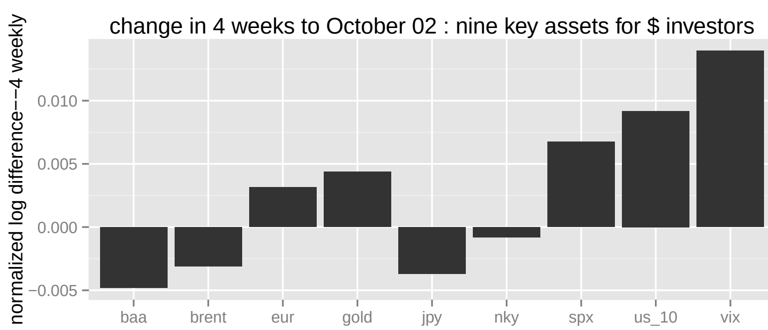
Chinese risks were enough to make the Fed hold off on a rate hike. Besides the US, stabilizing action taken in China, and considered in Europe and Japan seemed to squash a sustained panic. Sellers of equity options profited massively as the VIX index fell.

Assuming these stabilizing actions will be ongoing, investors bought US bonds and equities, after selling them the month before. Bond yields came down as it became viable to consider the absence of rate cuts for months to come.

Even emerging markets, the chronic weak point in this phase of the cycle, rallied into the last week of the month.



By month-end equity and foreign exchange was recovering across a broad range of assets outside of China, Germany and Japan. A generalized flight from high carry investments has abated, but the original core of the problem, in Chinese markets and those of these close trading partners, remains weak.

High grade credits did better all month as underlying policy rate expectations moved down, but high yield bonds importantly still kept selling off. Risks loom in the energy sector, in commodity producers, and in emerging market companies faced with far weaker currencies than they imagined after a ramp-up in dollar debt.

The dollar fell and foreign currencies rose across the board last week, in a sudden reversal of recent trends. Even the weakest cases, Brazil and Indonesia, recovered in the last week.

United States

ACTIVITY	CREDIT	POLITICS
Sharply higher job vacancies	Considering infrastructure spending plan	No legislative override of Iran deal
Unemployment hits 5.1%	IMF, WB call for no rate hike	Xi and the Pope visit Obama
IEA sees a big drop in shale oil in 2016	Yellen implies rate hike in Oct/Dec	Possible new debt ceiling fight
Global car sales revised down	Global oil cuts investment planscc	
HP, Caterpillar layoffs announced	Glencore, Petrobras, Caterpillar credit stress	
	Puerto Rico payment risk in Nov-Dec	

Europe

Solid IFO business sentiment	Solid M3 credit growth	
EU 2Q GDP revised up	Refugee support and integration action	
German exports hold up	Draghi assures that more QE is possible	Tsipras re-elected without his left-wing
E-coin slows slightly	VW diesel control evasion fiasco	Catalonia regional election: autonomy claims
Headline deflation, again		Chaotic refugee conditions

China

Drop in PMI	China criminalizes bad stock news	Weak SOE reform plan
Trade falls	Capital controls on outflows: inflows eased	
	Intervention in offshore forex	

US passes on a rate hike. Weaker jobs and manufacturers sentiment at month-end suggest slowing second half growth in GDP, possibly justifying the Fed's caution in not moving rates already. Last month, I pointed to elevated US and high global inventories at sea as a reason to suppose at least a pause in global production was needed to bring back balance. So here we are. Critical now will be every scrap of evidence that *demand* is holding up during a production adjustment. And that the adjustment falls on corporate earnings rather than on employment, averting an unnecessary temporary wave of dismissals that causes consumers to hold up spending and risks trigger a cyclical downturn.

In fact, all the partial indicators of the third quarter in the US do show demand holding up. Net exports (after a recent collapse) are up a little, and business investment including construction is also up. Car sales are toppish but running at a record pace, and the key service sector survey so far shows no sign of a precautionary retrenchment by consumers. So the odds favor a recovery, possibly a strong one, after a short pause in production.

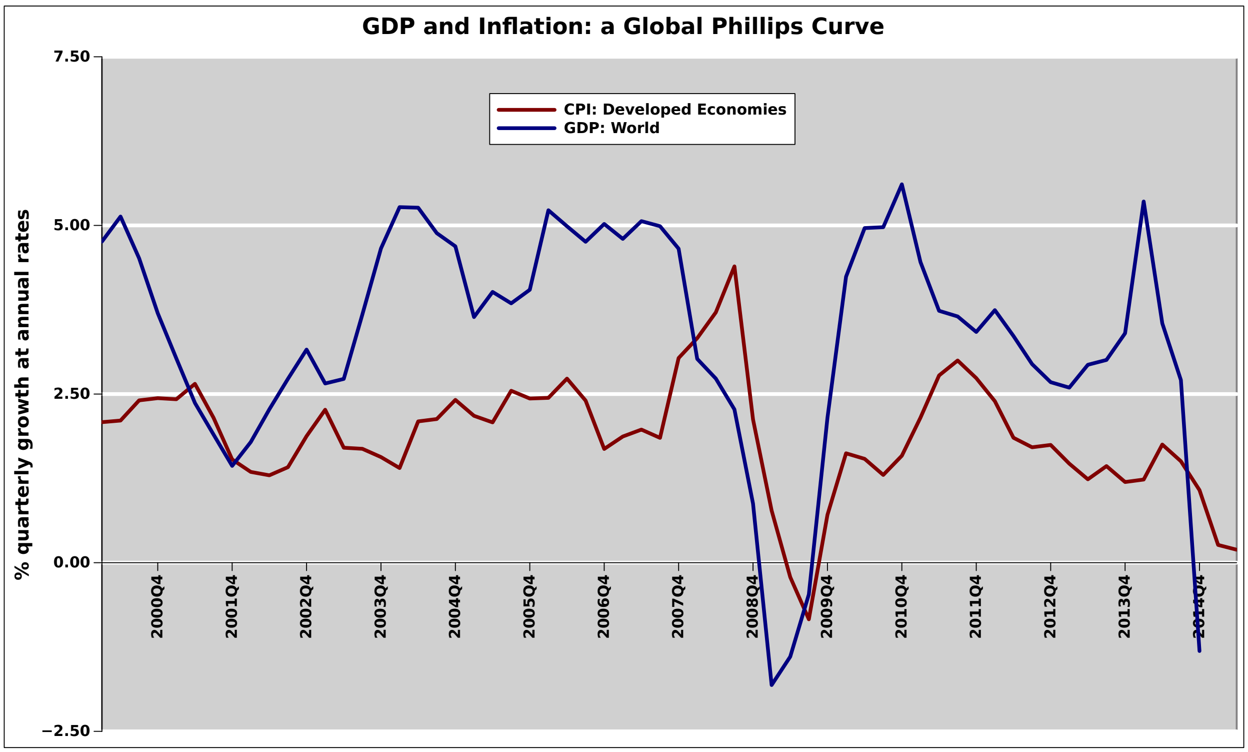
But that certainly is not the only case: amid weak global conditions, in China and other emerging markets, a renewed global recession is clearly possible. This risk will be exacerbated by a shutdown of oil and commodity investment spending. Whether these weaknesses can all derail a US recovery is what I, and others, will be watching for through year-end.

Besides the risk of a global slowdown, other late cycle credit risks are clearly mounting for investors and for the economy. Chief among these is the full but delayed impact of collapsed oil and commodity prices. Several oil companies have defaulted, big ones are considering slashing their conventional exploration work, and smaller, highly leveraged, companies in the shale oil business may be coming up on a wave of defaults soon as their existing wells start to deplete. Several global commodity producing companies are under financial stress, as well. Specific issues in pharmaceuticals and with Volkswagen blew up, too. It has been a short-sellers paradise if you can foresee the next area of sudden weakness across global markets.

Missing inflation. Transatlantic ruminations about why inflation stays stuck so low filled official conferences all month. The simple thing to say is that collapsing oil prices have biased all prices lower. But non-oil prices seem very sticky too, neither falling to fully reflect the severe developed country recession in 2008 nor rising to fully reflect the recovery, at least in the US. Since the link from aggregate demand to prices is the intellectual hinge upon which modern inflation targeting policies depend, this is worrisome. One possibility is that *global* excess demand has an effect on prices that is only indistinctly perceived in each individual country.

Evidence seems to show that the average tendency for global output to impact developed country average inflation is more regular and reliable than national links. That should not be surprising with extended global supply chains that end up influencing costs broadly and not only within one country. (See chart below.)

Seen form this point of view, the bias toward lower developed country inflation over time cannot be denied. And it is not helping that Chinese demand continues to slow to a degree that may be under-reported in these figures. One possibility is that excess private credit has long fueled spending, replaced by an aversion to loss that is holding back spending now. Possible solutions could include negative rates, or alternatively allowing for public borrowing on a scale that has been unpalatable so far.



European credit surges back Activity seems to be expanding in Europe despite a series of shocks: weaker exports to China, a flood of refugees, and the disclosure of VW software cheating on pollution control. So far the observable effect of these problems is minor. Euro-coin monthly GDP tracking was off a tiny bit but is still strong, and all the Markit indicators remain robust. But weaker exports to China, particularly of cars, and weaker diesel car sales in the US are to be expected, so a pause in European activity can be reasonably expected.

As we noted last month, a solid credit system recovery is clearly underway in Europe, documented in bouncing bank credit statistics. Once the odds of a Euro-zone break up and unpredictable exchange rate losses faded, cross border credit can open up. Effective lending rates have come down and businesses have the option again of finding financing for new operations. An enormously powerful event has been unleashed that could well overcome any modest setback in export demand.

Even the flood of refugees should be a positive factor. Obviously motivated and able, these people could provide a wave of new energy and entrepreneurship to an aging European work force. Absorbing them will trigger necessary spending at the European level and move the area along, grudgingly, toward area-wide public spending. These refugees, far from a threat, should be a positive factor immediately and in the long run for Europe.

But the debt overhang in peripheral Europe, including in Portugal, Cyprus, and Italy, has not gone away. A rush to recapitalize Greek banks on easier terms before the new year is one result. After year-end, severe losses on equity and bond investors and even large depositors at banks are required by European agreements designed to separate bank and sovereign credit risk. Before then, some part of the recapitalization required to settle the 50% NPLs at Greek banks can fall on EU funds. One can be forgiven for assuming that the Greek authorities will be working feverishly to write off as much debt as possible for their electorate, at Europe's expense.

China arrests doubters Despite officialy trumpeted signs of recovery in China, scarcely any convincing evidence is visible to me. Manufacturing sentiment is weak, car sales are falling, and exports seem unusually weak. As well, and perhaps more worrisome, government tax revenues are lagging and the big state owned enterprises face falling profits. Insistent official boosterism and claims of economic strength on thin evidence mainly suggests deeper worries about a loss of control of reality.

Clearly something is deeply the matter in retrenching heavy industry and coal mining sectors. Debt was easily incurred to keep expanding unneeded capacity and to dabble in financial speculation. But now the debt incurred is expensive, speculation is blocked, and additional output cannot be sold. In a related development, new information came to light on the scale of local government borrowing (up 40% in the year to mid-2014). Land sales, long a mainstay of revenues, has fallen sharply and borrowing obviously took its place. Borrowing on this scale will have to be reined in, dampening growth.

Facing all these hurdles, Li Keqiang made an impassioned defense of policy that, he says, has been looking through the crisis of old growth to prepare for new, innovative, service-side, businesses. Rail projects financed at the central government level are to be expanded, and financing terms for home buyers relaxed, which could eventually turn around the sluggish real estate sector. All these measures seem appropriate, but the massive intervention in equity and forex markets, followed by arrests for any who comment on the local equity markets' weakness seems to some observers to be a sign of more, of official panic. Equity values were assumed to reflect the smooth transition to Li's new model of growth, but arresting those who voice doubts is hardly comforting to investor silently watching the process.

As I said last time, we seem to be in a phase of surprisingly widespread credit disruptions to attribute to the mere possibility of a Fed rate hike. Increasingly, it is looking like that hike is not the issues. Rather, these disruptions are more linked to the slow-motion crash in Chinese and emerging market credit triggered by the slow but inevitable renewed attraction of credit flowing back into recovering European and US markets.

Of course, signs of life in US and European credit should hardly be a cause of concern. Only if outflows from emerging market credit reveals excesses and panic-inducing losses can we have any any cause to see net damage to the shifting global credit cycle. Even then, the damage would have to outweigh the gains from a prospective expansion in the US and Europe.

So we come back, again, to the perennial question of whether a credit crunch in China can run away from that country's happily intrusive managers. Its really a question of how much credit they allowed and how much control they retain over renminbi balance sheets, including those offshore. A tougher regulatory response now risks undermining the longer term promise of a deregulated market foundation for middle-income growth.

And in the US, the key question is whether the budding credit expansion has been unduly diverted into equity-supporting corporate balance sheet management. If credit continues going to financial padding and not to real investment, then indeed the global economy can have a final demand, and deflation, problem. And puffed up asset values are prime targets for sudden correction, in a process that is already visible.

For me, there is enough risk here for a renewed fall in US equity after a month of hesitant recovery. But the fall should not be enough to derail the global credit recovery. My fingers are crossed.