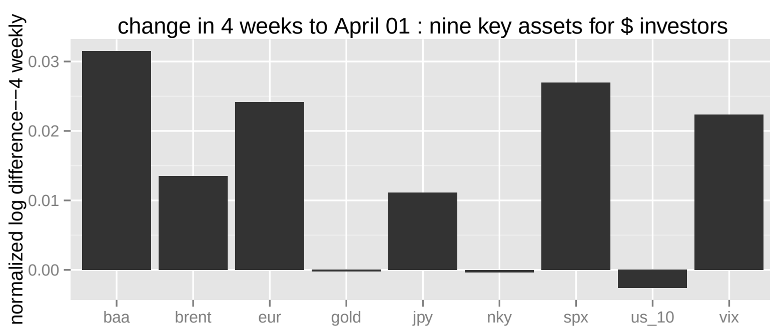
Asset Values Keep Rising

Lars J. Pedersen
lars23jacob@gmail.com

- **G-20 coordination cuts out more risk**
- **Yellen comes out Dovish...**
- **...while Draghi backs off from deep negative rates**
- **China's corrective recession**

Markets continued rebounding all month, exceeding my expectations. A reduction in policy divergences and possible accidents, under G-20 guidance, was the main sources of good news this month.

One reason for stronger market movements up and down recently may be the amplifying effect of enormous corporate bond rollovers that remain constantly in the background. These have built up over years of quantitative ease to create sudden credit squeezes in the face of any adverse news.



Asset price recoveries continued for a second month. Along the way, inflation break-evens, which are the difference between nominal and indexed yields, shot up. If accurate, these now imply G-20 policy over-stimulation is emerging on a global scale.

Among markets, particularly large gains were seen in some of the markets that were hit hardest back in January-February. Now the Korean won, US investment grade credit, and Brazilian equities all surged in a global rush for risk.

But by the end of the month, investors seemed to started to show more caution. Business indicators are still mixed, and oil and several commodities dropped, as did several US high yield indices. But emerging market equities and credits were still holding up.

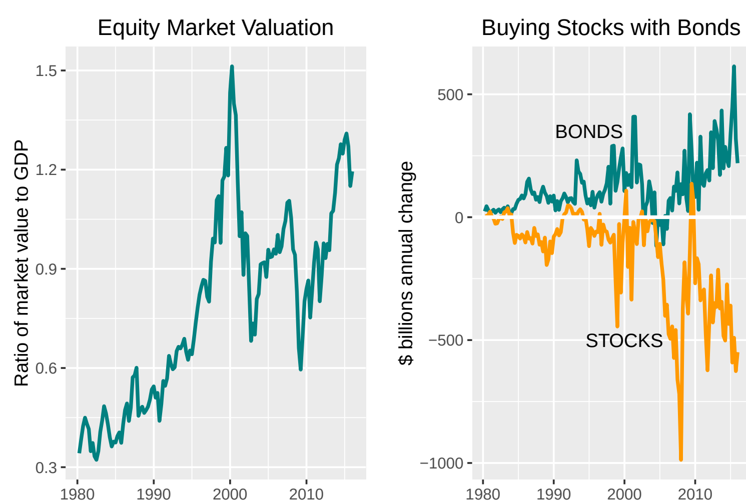
Yellen comes out dovish... US activity has been choppy during this complex transition period. Cross currents include a long-depressed manufacturing sector and a services side that has held up well. Our interpretation that we are in a temporary period of inventory and trade adjustment accords well with these observations, and the latest strong employment and ISM purchasing managers surveys point to recovery from a low point reached in IQ2016.

That cyclical low point due to the inventory adjustment may be deepened by a brief pause in consumption, investment and construction. But as long as employers keep hiring increasingly scarce and cheap labor, the jobs and future consumption keep piling up. On balance, this remains a young US recovery, which relies on rebounds in deferred spending for cars, for health care, and for new homes. Of these, the last–new home building–is likely to develop in importance this year.

Ms Yellen at the Fed looked this situation and claims the trajectory of gradual tightening should be deferred. In saying so she asserted that the real neutral rate of interest could be zero, implying nominal rates will only approach 2% (the inflation target) slowly and if all goes well. That is a far cry from the earlier planned approach 3% rates. A more gloomy long-term view justifies current market interest rates, but did long term trends really change from quarter to quarter? More likely the G-20 prevailed on policy makers in the US, Europe and China to work for a joint global recovery. For the US, the contribution was to take one step back from otherwise needed rate hikes, justified with this troubled real rate explanation.

Ms Yellen could be making the mistake of her career by falling in line with the G-20. A real central banker would be conscious that the big game is about normalize interest rates without financial disruption, not about finding excuses for delay. Years of super-low rates have fostered a full cycle of corporate balance sheet re-leveraging that now needs to be brought under control. One way to see this re-leveraging is through the 4Q Flow of Funds. As government bonds became scarce, corporate bonds became attractive and easy to sell. Net bonds sold by US corporations spiked in 3Q, and reportedly again in 1Q. Net, the funds have mostly gone to stock buy-backs from the public. We ended up with a transmission from government bond shortages to equity shortages.

Periodic corporate releveraging this way in 1999, 2007, and now again has always brought a peak in the value of US equities compared to GDP. And then a fall. (See charts below.) Allowing a fresh re-leveraging cycle to continue building is a high price for global unified policy. And that unified policy may not even achieve growth if it sets up disruptive financial turmoil.



Source:Federal Reserve Flow of Funds

...while Draghi backs off from deep negative rates. Short run indicators are still weakening in Europe but a real downturn is inplausible. Because of the deeply damaging relapse into recession of 2011, Europeans including at the ECB may overreact to hints of renewed recession. Substantial export gains may no longer we as easily forthcoming, but sustained job gains, higher real wages, a recovery in construction, and a growing tendency to ease fiscal austerity all argue for a sustained recovery. The one real risk is another political breakdown, as in 2011, in the project of ever-closer union.

That political risk is most apparent in three places: one is the UK referendum on leaving the EU on 23 June, the other is an apparent failure of France to adopt a thorough-going labor reform converging to the German one of years ago, and the third is continued debt accumulation in Southern Europe: as seen in Spain's bulging public deficit and in bank non-performing loans in Italy, and Portugal and in renewed stress in Greece's debt negotiations. If you were an uneasy European, the arrival of disorderly refugees and the latest atrocity in Brussels might put you over the edge of precautionary cuts in spending, briefly.

Sensitive to the rising risks for Europe, the ECB came up with a minor cut in already negative deposit rates, a big increase in corporate bond buying, and a novel Targeted Long Term Repo Operation. The long-term funding operation is a quantity auction at the deposit rate if banks increase targeted lending. In effect, the new facility is layered onto QE so that banks can offset the charges from negative rates on their QE-expanded deposits. This is apparently not fully understood and is widely rejected by harassed bankers who have suffered years of regulatory tightening. But it is certainly true that this cheap funding auction is a direct subsidy for a very substantial share of banks' increased costs from negative rates on deposits. The ECB will effectively hand over the amounts it charges for deposits back to banks through these auctions. Weak European bank equity prices have for this reason been a surprise to us.

We think that the ECB and the Fed both took a step back from unilateral rate moves after the last G-20 meeting in Shanghai. I had assumed the G-20 was an empty talking shop, but maybe not. A bigger establishment of senior working groups seems to have emerged that has the weight to push unified policies. They must have asked: how can we get through this pause in global growth without triggering a cycle of competitive devaluations or other errors? The prescription seems to be to moderate both US rate hikes and European rate cuts, so reducing the exchange rate risk there. Stepping up into the inner circle of global policy-making, the Chinese seem to have taken this all very seriously by decisively stopping the slide in their CNY rate since the Shanghai meeting.

United States

ACTIVITY	CREDIT	POLITICS
Service spending solid, in 4Q	Fed dot plots at 50bps of hikes per year	
Solid payrolls, mostly service sector	Yellen considers zero real rates neutral	Trump-Cruz weaken Rep chances
Construction pauses in 1Q	Valeant bond default possible	
Weak retail and car spending	Credit default rates rise; recoveries fall	
New low on shipping rates	Oil collateral revaluation in March	

Europe

German IP surges		
Retail sales, construction all up	5.2% Spanish deficit/GDP	
Continued solid real wage gains	Draghi cuts rates to more negative, buys corp bonds, funds banks cheaply	
Unemployment continues falling		Refugee deal is struck with Turkey
A pause in Ifo, Zew, EU confidence	EU banks complain about deposit tax at negative rates	ISIS bomb in Brussels
German exports slow		UK Brexit vote set for 23 June
UK sentiment most hurt by Brexit risk		France waters down labor reform

China

First tier city RE prices are rising again		
Real estate investment turned up	New P2P mortgage lending	
Inflation turns up on food	CB's Xhou says forex devaluation off	
Manf+Services ISM indices up	Propose subprime debt sales to fgners	
2million coal and steel workers to go	Moody's cuts China rating	Letter calls for Xi's resignation
Dispute on funding retraining projects	Zombie companies emerge in steel-coal	
Exports drop sharply	Anbang drops Starwood merger	
Retail sales slow	Credit slowed after Jan surge	

China's Corrective Recession. Chinese data has not fully cleared up from the Lunar New Year distortions, but could have begun to recover. Certainly a move up in the Caixin manufacturers survey seems to point that way. Key iron ore and coal prices have been stabilizing, and car sales have held up after a drop in incentives. Industrial profits rose, partly it seems by cost cutting in heavy industry. And first tier cities now even seem to be facing a problem of renewed real estate bubbles, fuelled partly with new and unregulated Peer-to-Peer lending for downpayments. A budding recovery may have made room for long-delayed adjustment in China's rust belt. If so, the first quarter could be the low point for China in this cycle.

Shutting down heavy industry in the North East, where many districts are dependent on coal and steel, will be difficult. As we have argued, dumping this steel internationally at a loss, at a time of weak world growth, risked triggering dangerous defensive tariffs. Now, with steel mills closing, we have seen a sharp drop in Chinese exports, as fewer products are dumped. This kind of a fall in exports is, paradoxically, actually a positive for the rest of the world, expanding its available market. As Chinese companies are directed to close, credit losses must be recognized, but a political decision on how let these fall is not yet clear.

Meanwhile, the People's Bank of China is still riding the tiger of excess domestic finance. PBOC head Zhou's problem is how to manage a mixed market and administered system to get needed financial adjustment but no panic. It did not work very well when China tried to slip in a devaluation earlier in the year, and trouble is bound to come up as credit losses emerge in the closing industries. How will he engineer enough losses to teach lenders credit discipline, but not so much as to panic them into abandoning ongoing businesses? Meanwhile the world is by no means free of Chinese capital flight, which keeps taking new forms, only the latest of which is the explosion in high-prices acquisitions of foreign companies by Chinese ones, funded with easy money at home.

China's long-delayed industrial adjustment will create political costs. A public letter was published this month that shows more unease with the situation than appears on the surface. Sounding very much like senior party functionaries, the writers of the anonymous letter complained about centralized power under Xi and an elite anti-corruption network that is effectively replacing the communist party. Since then, release of the Panama Papers shows Xi's relatives involved in Caribbean offshore shell companies, which will not help his credibility in fighting corruption. The letter ends ominously with a warning about the personal risks to Chairman Xi and his family.

Low oil and high credit risk have certainly been removed as weights on this market. And the addition of G-20 coordination increases the odds of a recovery. But credit risks remain at this stage of the cycle, always ready to erupt if massive new issuance pauses at all because of uncertainty.

One area of disruptive uncertainty is falling global trade. China's overdue adjustment of its heavy industry is probably putting in the low on global growth sometime during Q1. It is still a little unnerving to see the drops in Chinese, Japanese, Korean and Taiwanese exports that have followed. Closing loss-making industries in China and moving on can only be good in the long run, so my main case remains a nice recovery in global trade and the global economy by mid-year.

That could mark the point where G-20 inspired monetary policy in the US and Europe may look to have overstoked recovery. That gives the second potential area for disruptive uncertainty. I still expect the next big move in market values to involve a revisit of the risks of recovery, higher rates, and a reduction in the bond-funded equity buy-back process.