One Step Back From Tightening

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- **Is it inventories only? Or does more ail the US?**
- **Europe under siege, now by refugees**
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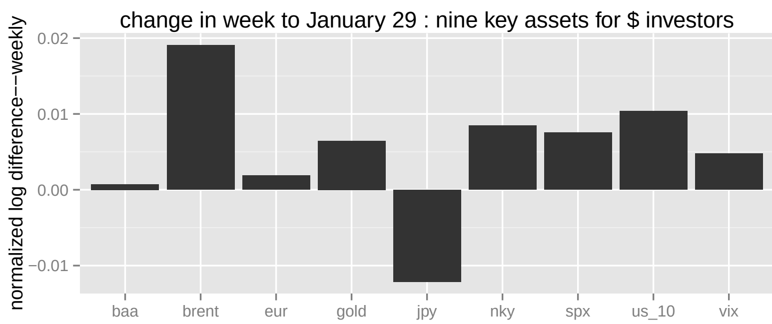
A slow patch in US growth, linked mostly to an inventory adjustment, is coming through in the data. Fearing it could be more that that, investors and policy makers started re-examining the options for extraordinary ease.

Meanwhile, the free-fall in oil prices seems to have at least slowed. Maybe an improbable Russo-Saudi agreement to cut production will offset Iranian oil coming on. Maybe not. Credit in the sector is still at risk but but at least now there is hope for relief.

In reaction to the softer news, further Fed rates seem, for the moment, postponed. Japan surprised by cutting marginal deposit rates to negative and Europe promised more deeply negative rates. The yen fell and Japanese bond yields plunged.



If global policies indeed take a big step to the accomodative side, risk-taking may come back into fashion, for a time.

The shift toward investment risk has been very visible in liquid foreign exchange markets. Every dollar value of other currencies rose sharply, except the yen with its separate weakening shock.

Credit, which has been deteriorating steadily, also settled down toward month-end. Equities mainly recovered. The only exceptions were in China, where deeper political and credit issues are involved, as I discuss below.

As global policies seemed to turn toward less tightening and more easing, bonds were up almost universally.

Is it inventories only? Or does more ail the US? We have held that the Fed's first hike will be followed by an inconveniently slowing economy. And so it seems to be. It does not help that several bits of final demand are now weaker as well. Capital goods orders are falling, car sales seem to have plateaued after a solid boost from low-price gasoline, and the big waves of health care spending after the coming of Affordable Health Care may be tapering off. Slower spending gains in early 2016, after the big snow-storm, may add further urgency to efforts to cut oversized inventory.

Despite worries, deep oil price falls need not disrupt industry to the point of triggering a general recession. Yes, a change in relative prices stops additional new investment in old projects. But, the same price change should inspire new investments. A surge in behemoth SUV sales in the US after gasoline prices fell are a case in point. Housing in the car-dependent suburbs will follow. On balance, low oil prices should be a highly disruptive *but sectoral* credit event for old, but good for new, credit sectors. It need not be a source of recession.

Fed Minutes show its Board expecting some slowing but no recession. I agree: inventory adjustments and oil price shocks are not the main story or reasons for recession. What matters is the hard process of winding down the credit bubble underway in bond markets. That credit bubble, created by easy policy, is where the deep cyclical risk lies, and the sooner it is brought under control with rate hikes the longer the recovery can last.

Europe under siege, this time by refugees. Refugee arrivals are beginning to disrupt consumer and business sentiment. Job holders fear wages undercut by desperate immigrants, and fear examples of hooliganism and violence will spread. Unease about this how this new disorder will be met is hurting retail spending, according to recent surveys. Business surveys may follow. And inflation remains stubbornly low.

Meanwhile, southern Europe is under renewed stress. Greece may soon find it impossible to manage if a horde of arriving refugees finds nowhere else to go after its European border is closed. Portugal now has a leftist coalition in power that will do everything possible to expand public spending while retaining lip-service for deficit limits. Spain has a hung parliament that is having difficulty forming a government, and may also turn to the left. Even Italy is struggling with the delayed recapitalization of its banks.

Partly to reduce these mounting strains, the ECB seeks to reflate promptly. Draghi showed particular urgency in his press conference, although clearly held back by others in the council. For now that implies a 20bp further cut in ECB wholesale deposit rates in March. As we have said, negative rates both give incentive to new borrowing and begin the process of working down oversized debts in real terms. The bigger surprise is that the Bank of Japan decided to follow this seemingly desperate model, giving it fresh credence.

United States

ACTIVITY	CREDIT	POLITICS
Strong employment gains		
Home sales recover	AB InBev high quality bonds sold easily	Iowa, NH primaries coming up
Capital goods orders dip	Puerto Rico misses debt payments	
GDP soft for 4Q	Banks report higher oil losses	
Apple sales slow	LBOs hanging on bond mkt reopening	
ISM below 50		

Europe

	Iran orders Airbus jets after sanctios lifted	
	Draghi argues for full rate review in March	Portugal adopts weaker austerity
Surveys show a tick down in confidence	Italian banks struggle to recapitalize	Apple, Google, subject to EU tax recovery
	ECB considered bigger rate cuts	Greeks resist Troika's pension cuts
		Greeks at risk of being put out of Schengen
		Spain stuck with a split parliament

China

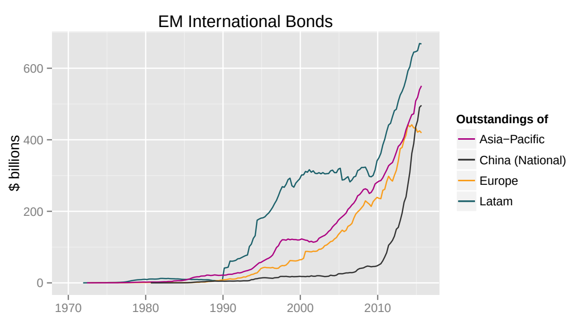
6.8% official 4Q GDP growth	Kuroda suggests capital controls	
Drop in industry profits	Equity markets closed in record time	Runs into problems with Indo rail approvals
Continued weak industrial GDP	Equities reopen with official buying	Officials declare war on Soros' speculations
	IIF estimates $700b in capital flight in 2015	

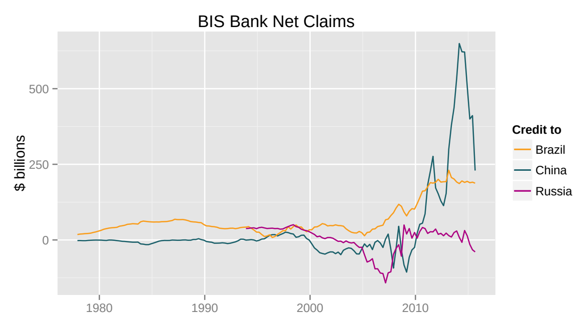
Emerging market bond strains Under quantitative ease and super-low interest rates, masses of replacement bonds have been produced by private issuers around the world This was the intention, hopefully leading to investment or at least asset value gains that would support spending. We know a mountain of US bonds were issued since 2009, creating mounting rollover risk for aggressive borrowers, particularly in the energy sector.

We now have BIS reported details showing a similar surge in emerging market bond borrowing. Companies in Latin America, Asia-Pacific, and in Europe all began a determined surge in bond borrowings in reaction to low dollar rates, exactly like American companies. As well, Chinese *national* borrowers–controlled from China–embarked on a further surge. Using offshore vehicles, mainly out of the British Caribbean, these borrowers floated bonds and brought the funds home mostly reported as foreign direct investment. Similar internationalizing flows were reported into Brazil and Russia. See chart below (left).

These bonds have a special kick to them. When the dollar rises they suddenly become much more expensive for local borrowers to service. Of all the offshore bond issuers, China saw the biggest hedging flows once a currency turn came in view, as reflected in the combined position of BIS reporting banks with Chinese residents. These positions went from a net BIS bank credit of about $600b to $200b starting in 2014. See chart below (right).

Floating exchange rates amplify dollar financial cycle offshore. Before, a rising CNY and super-low US rates came together to create negative costs of funding for Chinese companies. Suddenly those expected costs jumped as new bond rates went higher on anticipated US tightening, and the realization of bond risk, and that the CNY could weaken. The crash balance sheet adjustment to revised expectations was large and sudden, and disconcerting for a nation that is running a massive current account surplus. The lesson? At a time of bloated balance sheets, it is not all about current balances, but also about the vulnerability of bond borrowers.





Source:Bank for International Settlements

China's oversized financial system. China may soon begin closing loss-making, dirty, state firms making unneeded output. I suspect the reason for action now after long delay is that dumping of unsold products abroad by these heavy industries raises the risks of retaliation and resistance to a weaker CNY. If so, waves of unemployment are coming that make the transition to a demand-driven and service-rich economy increasingly urgent. So far, the delayed transition allowed time for limited government incentives to work. Home construction remains sluggish, but some progress is being made in selling off existing homes under relaxed lending and ownership rules. Car sales have been solid for several months now on the back of sales tax incentives. But still a deepening industrial contraction was already developing in December, judging by sharply lower industrial profits.

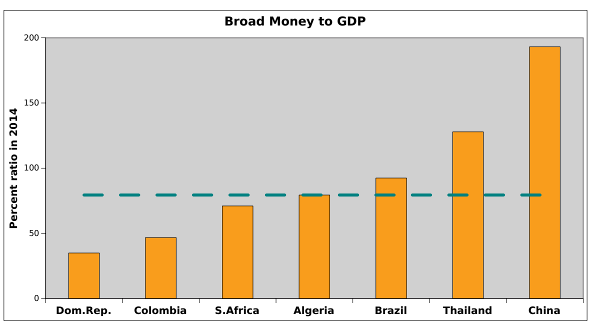
China needs functioning credit markets to make the increasingly urgent transition to market-guided investments. But authoritarian tendencies have come out under stress that could derail the effort.

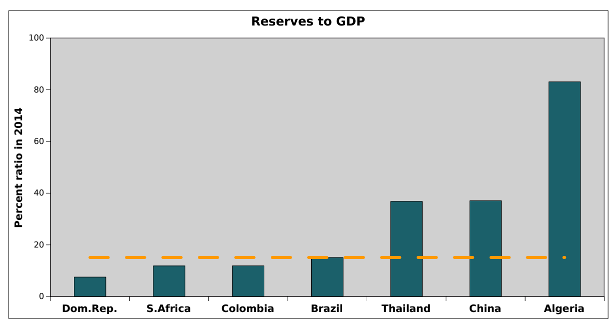
Punishment of vaguely defined "malicious sellers" of China's equities and currency will be unnerving for investors asked to invest in an increasingly unstable legal environment. Siting astride massive international trade flows, China will never be able to roll back to the Communist capital-control past, and trying to do so could be very dangerous.

China's historic economic transformation out of poverty has been supported by a surging, but bottled-up, financial system. One easy way to measure this is to compare China's broad money to GDP to the ratios that we find in other countries of a similar per-capita income. China stands out remarkably with broad money around 200% of GDP. In 6 comparably developed nations, broad money ranges widely, around a median of 80% of GDP. So China's excess money supply is as much as 120% of GDP greater than normal, the result of strict capital controls over the years of financial boom. See chart below (left.)

Seen in this light, massive Chinese reserves are not nearly as large as they seem. At nearly 40% of GDP in 2014, China's reserves were comparable to those of Thailand. China's peers carry median reserves of about 15% of GDP, leaving a surplus reserve cushion for China, but not a very big one. The excess of broad money net of reserves in China is thus fully 95

A great struggle is underway of adjustment in these figures, as the Communist party seeks financial deregulation to allocate savings better at home to foster new industries, while still trying to hold back the mass of deposits from moving offshore. But unexpectedly large waves of outflow followed the first sign in mid-year that CNY appreciation was ending. Over the year, China's authorities used $510 billion in reserves to quell a self-reinforcing slide in the CNY. Now a great cat and mouse game is on in which the authorities increasingly politicize their efforts to control the CNY's downward trajectory, squeezing various market segments where they can. It may be a battle they cannot win while sticking to their deregulatory plan.





Source:International Monetary Fund

Emerging market bonds and China's asset flight show the long reach of US financial conditions across the system. Both have reacted with unusual intensity to the possible return of normal US interest rates.

Now that a rate hike environment is finally arrived, doubts about whether the US recovery can survive normal rates are fully upon us. A vacillating Fed might be persuaded by market prices that further hikes should be put off, indefinitely if necessary. And European and Japanese policies are exploring the scope for negative rates. Maybe or maybe not.

When the recovery resumes, which I put at highly likely, we will be back to the sometimes harsh adjustments to rate normalization that we saw in Emerging Markets and in China. Next I expect the biggest shocks will hit US credit and equity, on the model we saw in early January. It is always economic recovery that is most disruptive to these overstretched markets.