Getting Through the Oil Adjustment

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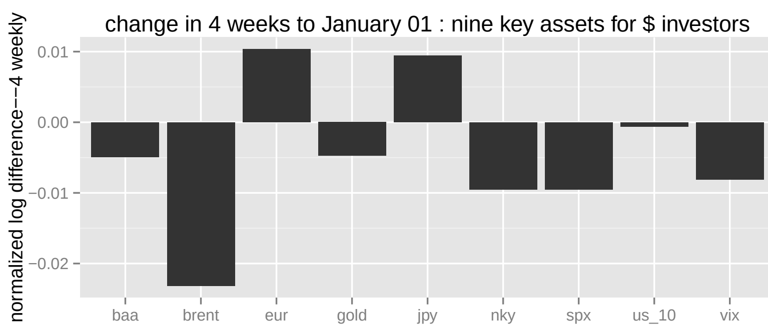
- **Oil price lows**
- **The smallest possible US hike...**
- **...meets the smallest possible EU cut**
- **China's slow motion crunch**

Oil prices fell sharply for most of December. This was only the latest in a series of commodity price busts linked to a halt in commodity-intensive infrastructure demand in China.

Collapsing oil prices, if they stick, will create important new financial risks across the financial system. Enormous credit flows, largely in bonds, went to fund commodity projects for which there was an apparently unquenchable thirst. Some of the companies, countries, and projects that borrowed heavily to keep up could now find themselves suddenly at risk.



US rate hikes and Euro cuts when they finally came were a momentary relief. But the dollar-bond centered credit market stresses that have been accumulating all year continued to disturb.

Over the month, almost every credit measure we watch deteriorated, equities were weaker, and the dollar rose. All these are signs of rising investor caution into year-end.

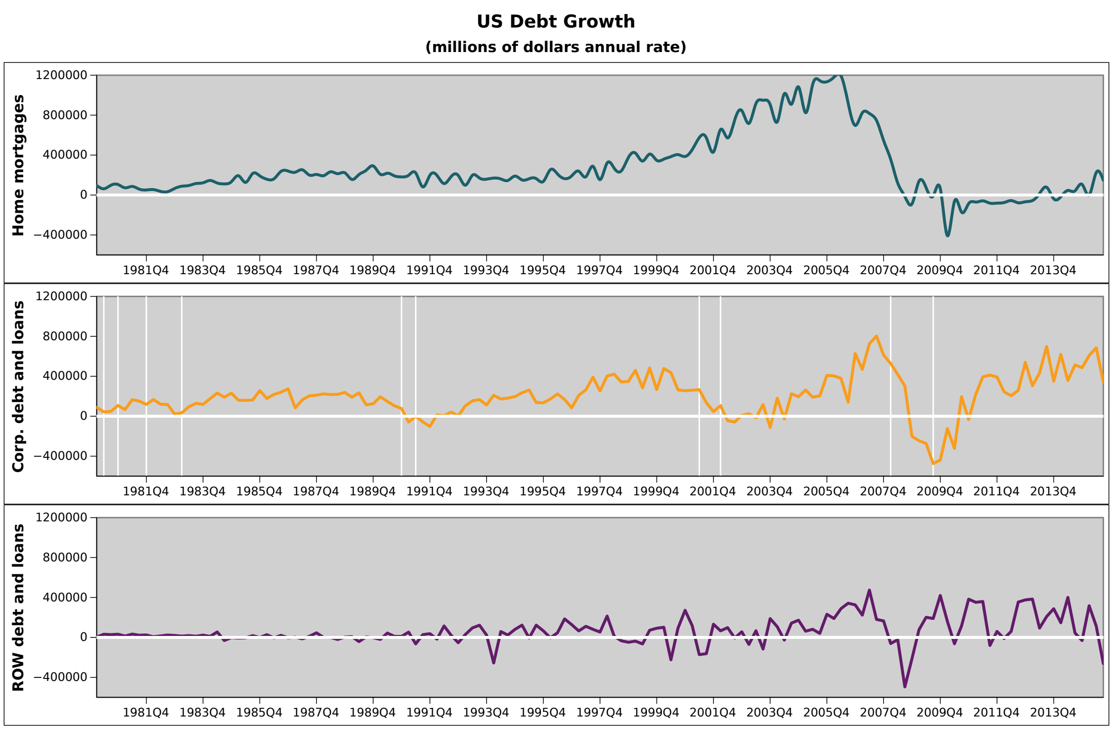
On top of a reduction in risk, aggressive shorting of individual emerging markets has emerged, too. Rotational shorting hit Malaysia, South Africa and Brazil hardest. Even Canada, as a high-cost oil producer, got caught up in the damage.

The smallest possible US hike... Inconveniently, US activity remains set for a minor slowdown after the Fed started raising rates. Soft spending seems mostly a response to the equity dip in August-September, and should, like a pending inventory adjustment, be a passing event. But passing or not, a discernible slowing in activity is plain in business surveys, industrial production, and home building.

One way to understand why rates had to start normalizing despite the inconvenient timing, is to consider US debt growth over a longer period. (See chart below.) Here we can see the scale of mortgage debt explosion that led to home price and credit excess, followed by financial failures and a long process of foreclosure and distressed sales that even now is not fully over. Still, mortgage credit is now just beginning to pick up as new lending is greater than repayments.

Offsetting that mortgage debt recovery, and often a precursor of US business downturns in the past, corporate debt has been rising. Of course, gross corporate debt can be used in many ways: to build up cash or to spend on other assets, or on real investments. Still, we know a disproportionate share of this debt, cheapened by aggressive monetary policy, was used for share buy-backs, to fund direct investment in emerging markets, and for now-dubious commodity projects, while little went to productive US investment. Even if we are not necessarily at a US cyclical turning point, this is certainly no place for super-low rates to foster even more corporate borrowing for financial engineering.

High rates of bond issuance are the direct and deliberate result of bond buying under quantitative ease. Once long rates fell and corporate bond issuance began to respond on a large scale, it led to an snow-balling roll-over requirement that is today in the order of fully $1.2 trillion a year. If investors get any ideas about risk in this market they can, by contract, demand this full amount back simply by doing nothing for a year. Of course, in the real world they cannot enforce this claim: something will change to get them to roll over. But it could be eventful getting there. Eventful for borrowers, for mutual funds, and for untried exchange traded funds that offer *intra-day* liquidity for investors in this paper.



Source:Federal Reserve Flow of Funds

...meets the smallest possible EU cut. While the US hiked rates, the ECB cut rates and extended bond buying by a little less than expected. Stronger European action may have been impossible as long as growth seemed to be holding up so well. Growth holds up with only a minor tick down so far in French services, including restaurants, after the Paris atrocity. Other indicators show an intra-European expansion gathering strength as jobs are finally being created and real wages are up due to cheap oil and low inflation. It sounds like the beginning of a long and sustained expansion.

Moving to more deeply negative rates in Europe is, as we have argued, potentially reasonable for two reasons. One is that it tends to produce a weaker euro that is to the advantage of overvalued Southern Europe. The other is that it very slowly works down accumulated public and other debts that are another problem of the South.

Excessive debt can be worked off over time by cutting down on spending. Obviously this can only work through sales abroad as domestic spending will be falling. The outcome of this approach is a large current account surplus, which Europe has indeed been running. Alternatively, negative interest rates can cut down on the value of debt, helping the adjustment process along. But, the really quick and efficient answer to excess debt is debt write-offs that allocate losses back to careless lenders. But these losses are caught in the politics of a deeper European union, where not all write-offs are politically feasible.

For the moment, the most striking version Europe's limited loss-allocation mechanism is in a new rule for bank recapitalization. In 2016, banks must seek recapitalization from equity investors, junior debt holders, and depositors. That last condition, which effectively separates bank viability from state support, will, together with some limits on bank holding of sovereign debt, move the process along of disconnecting European nation states from their banking systems. And demoting nations to what is a state or municipal status elsewhere. National abuse of the credit system will be controlled by creditor risk aversion and practical loss experience.

Some rushed bank recapitalization took place right before year end for this reason. In Greece, banks were recapitalized one more time, largely with private funds. Portugal took hasty action, too. In Italy, several small banks were intervened and recapitalized at the expense of equity and junior debt investors. The Italian maneuver led to a great outcry and a proposed welfare fund for these investors, many of whom will suffer hardship.

United States

ACTIVITY	CREDIT	POLITICS
Car sales hold up		
Solid payrolls	Fed hikes rates reluctantly by 25bps	US cautions EU on China's dumping
Home sales dip on legal changes	S&P corp bond downgrades surge	Middle class falls to less than 50%
IP weak on warm weather	Sovereign Wealth funds in rundown mode	
	Oil and mining companies keep retrenching	
	Third Avenue junk bond fund frozen	

Europe

		UK referendum on EU in summer
Moderate 3Q GDP		Renzi warns of populist reaction to austerity
ISM and other indicators solid	ECB cuts rates 10 bps, extends QE	Paris Carbon Agreement
BoE not raising rates soon	Scheuble: no to EU bank deposit guarantee	Polish populist admin attacks courts, media
Fears terror will stop investment plans	Banif rescue strains PT finances	Spain deadlocked after election
		Greek bail-out runs into pensioner resistance

China

Higher car sales		
Rising home sales in Beijing		
Exports fall: imports up	Reserves fall	Fosun chairman disappears for questioning
Coal inventories hit low	Move to Eur-$ target for CNY	

China's slow motion crunch. A slow motion credit crunch remains underway in China that will likely be offset by new public sector measures. So far these include various consumer subsidies, regulatory ease, and access to cheap credit both for car and home purchases. Car buying, particularly, surged in response during September-November. In home buying there are some signs of recovery as well, including a limited pick up in higher-end home prices and sales in Beijing. Expanded measures to come will likely include central funding for local government spending.

Even with bolstered demand measures, a sustained recovery is dicey. Local policy discussion focuses on how to encourage new, non-polluting, supply in high technology and services to complement new public sector spending support. Clearly new sources of supply are needed, since heavy industry indicators are depressed and taken alone suggest an economy growing near 2.0%, or nowhere near the 6.9% reported. But even zooming growth in internet commerce and other services may not have brought these sectors to the point where they can offset drops in the vastly bigger traditional sectors.

Leaving behind the dead-end of steel, shipbuilding, and cement production to move into new areas of supply requires some form of loan loss recognition in the old. For the moment this is covered up by state bank lending to troubled companies, and by granting access to central government bond guarantees for local government funding.

While managing a constructive credit withdrawal process *without* creating panic, officials are also trying to stabilize the stock and currency markets. They need healthy stock markets to finance the start-ups on which fresh alternative supply depends. And the CNY cannot weaken too much without leading to anti-dumping measures, for which pressure abroad is already rising.

Managing all this would be a strain for any administrator. A flustered response by China's communist party has started to include unexplained detentions of business leaders and penalties for vaguely defined "speculative" actions. This policeing of the syptoms of credit disruption will, paradoxically, risk ruining precisely the animal spirits that are needed for new investment in alternative businesses.

Immediate responses to the first US rate hike of the cycle were limited, amid relief that the uncertainty on this point was finally over. But, I still think a correction to over-inflated US credit and equity valuations will follow, as discount rates go from exceptionally low to low but closer to normal.

Unexpectedly low oil prices can intensify this asset market adjustment. Assuming the brief dip in oil prices of 2008-9 would be repeated, many company managers planned for an early rebound in oil prices. As the realization dawns that a long period of low prices is actually possible, plans will change amid big adjustments in the value of risky debt extended against oil revenues. A default wave could be coming in US oil company debt and among certain oil producing sovereign debtors.

Meanwhile, some sovereign oil producers that have piled up wealth funds may run down assets before incurring debt. These funds have spread into long-term investments in developed markets, and have already started disgorging equity and commercial real estate, to the detriment of both markets.

Sharpened by oil losses, and wealth fund retrenchment, I feel the risk to US equity and credit is rising. A correction is needed to adjust down excessive, policy driven, valuations before a healthy and balanced recovery can continue.