Next: A Growth Pause

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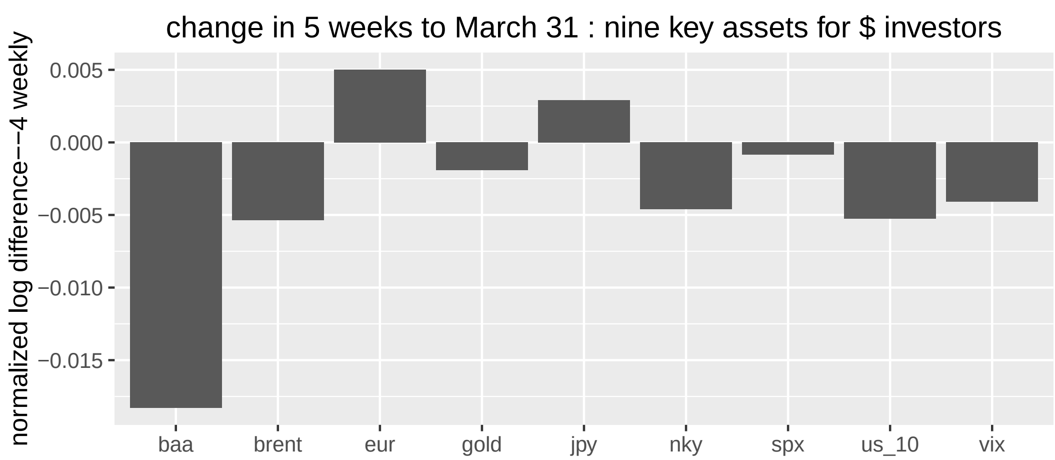
After the US raised rates investors marked down riskier corporate bond values sharply. US equity gains paused.

The euro and yen rose slightly against the dollar as investors avoided US bonds and stocks. European equities were up strongly as an alternative with less rate hike risk.



While the Fed got on with normalizing interest rates, the striking inability of the Trump-Republican combination to pass a health care bill illustrates the risk in assuming too much from this administration.

An awkward combination of populists and libertartians in US governance causes contradictions. The difficulty is amplified by the absence of room for deficit spending to paper over differences at a time of high public debt, which is completely different from when Reagan came into office. So, much less policy innovation now looks likely than a few weeks ago.

Forceful policy, overheating growth, a spike in inflation, and a sharp rise in rates centered in the US seem to be fading as possibilities. A more gradual and widening recovery looks instead more likely, with gradually widening participation in Europe and Japan.

With reduced macro risk, investors moved their funds between emerging markets. Mexico gained and South Africa lost in a big way.

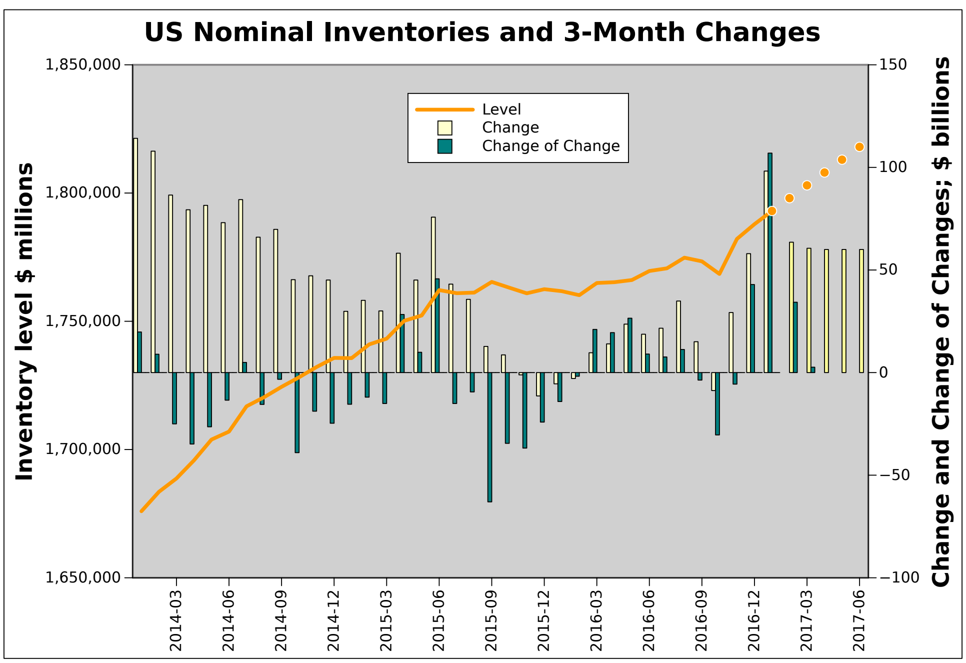
Measuring the inventory lift. After a solid couple of quarters, and probably a good first quarter as well if payrolls are any indication, US growth could slow. For the moment, a temporary inventory boost is concealing weaker underlying demand. Car sales have plateaued at a high level sustained only by riskier credit and bigger incentives. Mortgage costs may rise by nearly 30% with higher rates, impeding construction. Finally, investment spending that might be subject to radically new tax treatment is almost certainly going to wait for some clarity by year-end at best.

Inventory adjustments like we are in now can create temporary surges in business, sometimes big ones. Normally inventories rise gently as specialization steadily promotes the holding of work in progress. Since 2015, however, a long period of inventory stagnation in the US began that fortunately did not develop into a full recession. (See orange level and forecast dots in chart below.)

By mid-2016, rising inventories were needed again for a steady if sluggish economy. That extra demand for inventory in turn required extra production and we were off to the races. The change in non-commodity inventory change over three months went from zero to nearly $100 billion (measured like GDP over three months at an annual rate–green bars in chart below.) That event alone, if it is recorded in one quarter will boost GDP by 2.5%, or if it falls over two quarters by 1.25% in each. It is no small thing.

Looking ahead, an optimistic return to steady inventory building means a new *steady* demand for products. That is, for *no further change in production* going to inventory build. So we are almost certainly going to see a pause in recorded US output growth sometime in the middle of the year, falling back from rates around 3% to around 2%.

Despite the transient character of the growth jolt, the Federal Reserve still quickened its pace of raising rates. Publicly, the Fed points to full employment, inflation creeping higher, and signs of a global recovery as reasons to ease off radical monetary ease. Presumably the unstated idea is also that having taken housing values back to their previous bubble high, and equities even higher, further fuel for higher asset valuations is no longer necessary.



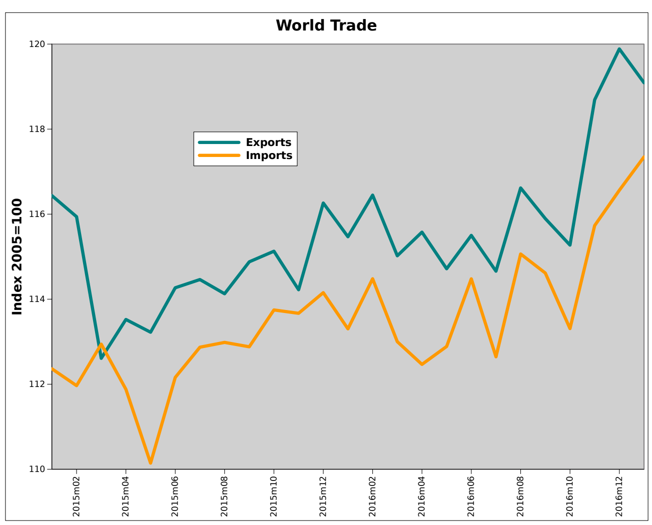
Europe does well despite Brexit. Business continues to boom in Europe, despite every political obstacle. All surveys point to a solid first quarter after a strong end of year as global export volumes, including from Europe, popped in December. In line with the US inventory cycle, a broad process of restarting world manufacturing activity got well underway at the turn of the year, with orders placed and goods placed on board ship at a quickening rate into December. Imports, as goods came off ships picked up a little later. (See chart below.) Goods in transit and works in progress are booming all over the world trading system.

In this boom, the UK finds its coming departure from the European Union has had little immediate impact. One reason might be that the customs union will remain in place until 2019, enabling current producers to do well under a pre-emptively discounted pound. But new capacity will come on reluctantly with Brexit uncertainty, to drag down growth ahead. In the meantime, the deep pre-emptive drop in sterling is causing enough inflation to begin to imperil consumer spending.

Meanwhile, the hefty bond buying program of the ECB continues. Unintended consequences keep popping up, due the great size of this buying in relatively thin markets. One consequence is remarkably low bond and negative yields as investors encounter bond shortages. Another is the way in which the ECB's bond buying is digging deeper into portfolios across the EU and abroad for each successive wave of fresh buying. The ECB argues that these bonds are held at custodians that are concentrated in certain countries, and that the sellers often concentrate sales proceeds in countries where they have historical banking links. In either case, the result tends to push up bank clearing balances in the Target2 system. So the rising Target2 imbalances we see are *not* the signal of renewed fears of currency union break-up and are not necessarily about banks losing confidence in each other as in 2011.

Meanwhile, European policy must consider how US protectionist threats could matter. Clearly, a deliberate effort to push down the euro via quantitative ease has achieved something: a huge German current account surplus only partly followed by Italy and others. Because the problem of Europe is the long drift up in peripheral wage costs, a euro weak enough to allow Italian companies to breath also serves to super-charge the trading conditions for German companies.

But this indirect avenue of policy support for Italy has now reached a political breaking point with the risk of US protectionist action, leading Draghi to used some unusually tough words about political failure to cut costs and liberalize labor markets in Southern Europe. Despite its awkward results, this ECB will be reluctant to ease off quantitative ease before 2018 or 2019 when the weaker nations of Europe get to economic lift-off.



Rising financial strains in China. Commodity prices, industrial production, and renewed waves of killing smog in Beijing all tell the same story–growth is back. China's leaders know it and have decided to get on with the deferred closures of excess heavy industry via direct orders, measuring local administrators by pollution emissions, allowing the pace of bankruptcies to quicken, and tightening mortgage credit terms in first tier cities.

As the broader world trade cycle restarted, China seems to have captured a surprisingly low share of the export gains. Higher wages and the high value of the CNY may have increased pressure on existing exporters, many of whom are complaining of high costs. Instead, China's inventory cycle was more narrowly focused on domestic construction and cars, leading to big swings in the heavy industry supply chain.

China's ultimate objective will be to bring down heavy industrial activity while fostering new higher value jobs. New opportunities for business call for new, innovative, credit backing. China's already over-banking system has certainly responded to the call. Credit default swaps were sold by local governments seeking to guarantee credit for local heavy industry a little longer. Bond repurchase deals were used to pyramid bond portfolio risk. A dairy company was revealed to have cornered its own shares by borrowing against shares already held to buy more. Lastly, negotiable bank certificates of deposit have emerged as a form of funding for highly leveraged smaller banks.

It may be time to create at least the facsimile of a credit crunch to slow down these excesses. Administrators hope they can do so without triggering a credit panic and depend on massive foreign exchange reserves held outside the system to stand as an independent guarantee of their ability do so. Seemingly, foreign reserves falling any further below $3.0 trillion threaten that guarantee, because controls on outgoing direct investment were suddenly imposed last year to stop a developing reserve drain.

All this is complicated by the arrival of the protectionist Mr. Trump. Further weakness in China's currency could tilt the US toward a protectionist position that would certainly derail China's complicated recovery. But if currency weakness is now politically off the table, then episodes of capital outflow from China's overstocked domestic credit markets can be met with only by reserve loss or higher interest rates. Between them, the balance is shifting toward higher rates.

As Chinese overnight rates start to move up, stresses are showing up in all the areas touched by financial innovation. In December, some repo lenders to bond investors panicked, creating a local bond market mini-crash. Then in January, the PBOC created a mini-crunch in the HIBOR market (Hong Kong-based CNY credit) to penalize short-sellers of CNY. In February and March, month-end in the money market saw erratic trading, as the some smaller banks dependent on wholesale funding fell into doubt. We can only hope the PBOC retains enough credibility to deal with these and other consequences of its long-postponed mini-crunch.

Recent stronger world growth may be a sugar high from a brief inventory event. Underlying US demand is clearly weakening, as we wait for investment to kick in. So we risk a real pause in growth in the US and abroad around mid-year that could disrupt investor views.

Increasingly, the worst case for equities could be one where US rates continue to normalize at a moment when growth slips to a slower pace. QE driven asset values may hold up better in Europe and Japan.

After all that plays out, my best bet would be a slow and widening, more uniform, global expansion. It will depend upon an investment cycle kicking in despite unique political risks in Europe and, increasingly, in the US. And on Chinese success in controlling their unique controlled credit crunch process.