Who Got the Memo?

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- **Who got the memo: the BIS Annual Report**
- **Starting to allow US QE to roll off**
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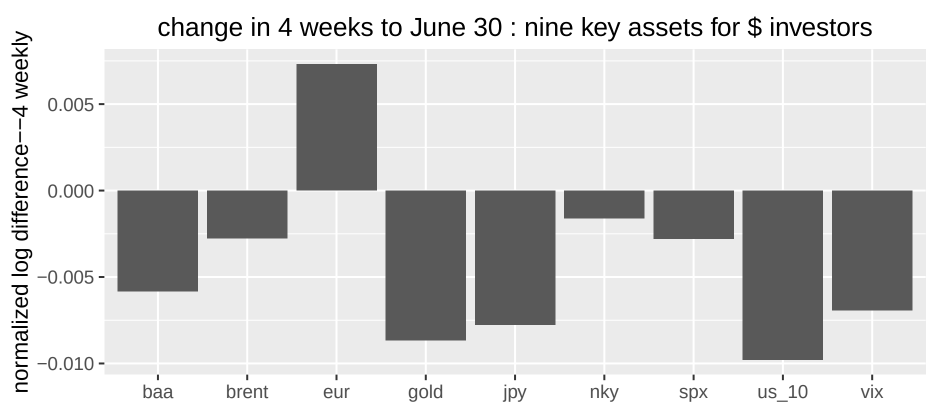
Investors began to expect tighter policy last month. US government bonds were sold as higher yields are expected and gold, which is without yield, fell.

Losses spread like ripples. Corporate bonds fell less than government bonds, and equities were even less hurt. Equity VIX volatility remains low.

Much of the global growth surprise has come from Europe. The euro continues to march up against the dollar and more so against the in yen.

Oil markets have become increasingly choppy, down over the month but up in the latest week.



Weaker oil prices in May did not buy much time to delay policy tightening, as it turns out. I explain one possible reason why not in the following pages: central bankers may have concluded, on their own schedule, that asset inflation is coming to the point where it does more harm than good.

Meanwhile, the last seven-month surge in asset prices has taken us to a point of increased market risk, even before the central banks started shifting their stances. Investors bidding up weak assets creates this kind of risk every time, most apparent today in small but sudden drops in gold, bitcoins and clones, and in sudden unexplained drops in certain illiquid Hong Kong shares.

Commonwealth currencies, with their independent central banks best positioned to follow the Fed with rate hikes in the new environment were up strongly. All inflation forwards, which had been drifting disconcerting down, bounced back up.

Who got the memo: the BIS Annual Report. Central bankers are talking tighter policy. In part they may be responding to the process of jointly reading and commenting on the last BIS Annual Report, the central bank of central bankers' view of global credit system developments.[1]

Considered from a longer point of view, as taken by the Annual Report, central bankers must consider the great struggle they waged to recover even partly from the vast damage done by the financial excesses and crash of 2008. They are roughly agreed that crash had to do with excessive credit fueling some demand and much financial engineering that in turn fueled asset demand, including for housing.

We have spent nine years forcing an economic recovery in the face of the 2008 debt overhang by means of intensive manipulation of credit and the monetary system, including vast purchases of government debt by core central banks. We did finally achieve an asset value recovery, and, reluctantly and as a side-effect, a recovery in demand, but only the merest signs of a recovery in inflation.

Central bankers have to weigh the direct costs of very easy credit conditions in re-creating a credit and asset price bubble against the indirect benefit of even higher asset values in bolstering the real economy. No one can know exactly how to navigate this balance, because we have no precedent. But central bankers seem to be coming to the conclusion that a tipping point has been reached where super-charged policy may be doing more harm in fostering a credit and asset bubble than additional good is done for the long-run real economy.

So central bankers across the system are talking about and taking tightening action. These come either in regulatory, or rate, or quantitative terms. The most extreme regulatory tightening is underway in China, while in the US deregulation is a Trump-Republican priority so changes in quantitative ease and rates will be more important. In several Commonwealth nations, mortgage borrowing rules have been toughened and several are considering rate hikes. Even at the ECB, the possibility of reducing massive quantitative ease has begun to be discussed. Only Japan remains alone continuing its massive program of quantitative ease.

United States

ACTIVITY	CREDIT	POLITICS
Current quarter expected to rebound	Equity earnings up with oil Treasury deregulation roadmap for banks BIS warns on credit growth Under easier regs, banks plan big payouts	Congress legislates Russia sanctions
Slower CPI inflation Lower employment and wage gains Weak car sales and used prices	US banks cut car lending as risk rises Retailers face short term debt coming due	Trump backs Saudi against Qatari "terror" Comey testifies that Trump lies on Flynn Mueller now investigating Trump-Russia Debt limit vote needed by Sep-Oct

Europe

A solid drive toward more employment Record positive sentiment	ECB new bond buying schedule in Sept UK calls for anti-cyclical capital buffers Draghi: no need to consider lower rates	No early Italian election, after all Macron sweeps legislature with new party May flops in general election Merkel urges European self sufficiency
Weaker real wages as prices spiked UK real wages fall, with weaker pound	Banco Popular Tier1 bonds drop as it fails -Stock and Snr bonds go to zero Germany to close Italian bailout loophole	Fall elections possible in Italy Brexit talks begin May pay-offs for DUP support

China

Solid business earnings, mostly SOE CPI up but PPI falling Some export recovery	MSCI includes prime shares	No more NK tests Party Congress going ahead smoothly
PMI weaken Car sales stay low Real Estate prices topping out	Anbang Insurance chief arrested Moody's downgrades China Wanda and other shares drop suddenly Banks to asses credit for offshore buying $6b crash in small HK company shares	Hostile response to US steel protection

[1] Bank for International Settlements.(June 2017) *87th Annual Report.*

Starting to allow US QE to roll off. Ending the great inventory slowdown of 2015-6 gave production a boost in late 2016, but this technical event was bound to fade. When it did it was bound to reveal a relatively sluggish underlying demand situation, as an increasingly unequal society supports only limping consumer demand. Weaker car sales is only the most obvious symptom of the problem, but retailers broadly are also under pressure.

Spending might recover with friendly investment policies. That might happen through expected Trumpist tax cuts, deregulation, protectionism, and a balanced budget–not all of which is consistent. If so, a massive surge in investment, including in oil, might overcome any slowing in consumption. But those optimistic expectations have not materialized so far in the data, as capital goods orders seem to be actually topping out.

In fact, several parts of the internally inconsistent Trump-Republican agenda are impeding rather than supporting growth. Promised draconian cuts in health insurance will reverse a surge in medical services and employment. A brewing reduction in the pace of high-rate student borrowing, for which there will be no relief, will slow down educational hiring. Separately, state and local governments suffer from high debt including pension obligations that are crippling their ability to fund to investment projects.

Even the great promise of fresh investment spending could be in trouble. Radically different tax plans have been offered that can force responsible project managers to wait to see which ones will prevail to impact specific projects. With the poisonous politics of health care, and our self-imposed debt limit coming upon us quickly by September, the boost that investors expected from vaguely Reagan-Redux policies are starting to fade.

Investors have been caught further off guard by the way Ms. Yellen and the Fed Board are tightening policy. Slower underlying demand and a dip in inflation were dismissed at the time of the Fed's last rate hike. Rates were hiked, at least one more hike this year is suggested, and a plan to allow the Fed's vast government bond portfolio to begin to roll off is likely to come into effect this year.

Our politically-inspired asset bubble may have itself changed the stance of monetary policy. It does so because a widening recovery means supercharged asset values as a tool for recovery are no longer needed, and because the bubble itself begins to risk a damaging new crash that could really derail the recovery. So the risk-minimizing Fed policy is to start tightening policy now, as soon as a sustained global recovery, offshore and in the US, seems in place. Given the Trump administration's taste for deregulation in banking, that puts all the weight in the US on higher interest rates and a plan to start letting the Fed portfolio begin to run off.

When to end bond buying in Europe. Aided by the global inventory lift, a broader recovery has emerged and gained internal traction in Europe. Exports are solid, construction is picking up in Germany , and job gains are spreading broadly to support incomes and spending. Even the pop in inflation, which curtailed real income growth, seems not to have slowed the process. Recent gains have accelerated in the closely linked nations of Eastern Europe.

Helping sentiment is a break in the run of populist and nativist electoral wins. With Macron dominating the French political landscape, some fundamental reforms and substantial new items of European integration are possible. Military procurement could be simplified and specialized, some form of European-wide public debt and some economic stabilization are all possible now. Even Ms. May may have row back from her earlier claims for a sharp break from the increasingly attractive union.

Meanwhile, delayed bank resolution efforts showed mixed results. In Spain, Popular Bank was resolved in line with EU rules designed to put initial losses on investors and depositors–although only the most subordinate capital was actually hit. In Italy, a less European solution was adopted using loopholes to take over two Veneto banks with government funds and guarantees. I sympathize with the Italians, who held on after 2011 when their banking system was under strain and did not seek an EU support package that would have burdened the system at the time. Now, with a delay, they rightly want resolutions without triggering banking system outflows, including of large depositors.

With the economic recovery, some glimmers of inflation, and a better political situation, European thoughts are turning to a less extravagantly easy monetary policy. At Sintra, Draghi mentioned the need to tighten policy with recovery to maintain a neutral stance. Many saw this as another very early sign of tighter policy in the form of less bond buying next year, to be formally announced in September or October. In the UK, where inflation is clearly excessive, the Bank of England had a split vote on raising interest rates.

A regulatory crunch in China. Growth is slowing down after a remarkable surge. One factor is a drop in car sales that has led to lower assemblies. Home sales prices have stabilized amid dropping sales and lower construction levels, too. Lastly, the lift of higher global trade is likely to be passing, to weaken upcoming production. But the recovery continues in rail and electricity use, the last of which is an indication of a wider, service side, economy that is surging to take over from older manufacturers.

The administered credit crunch continues amid these cross-currents. Credit excess is obvious in terms of the pace of credit growth, and gradually the details of how this credit has been extended become clear. One avenue is arms-length lending by entrusted funds tied to banks. Their funding in wealth management products conflates many risks with high supposed returns. Related products are also sold by insurance companies against portfolios of high risk assets. Just as in US shadow banking, the dwindling quality of final credits risks being obscured by layers of relending. Other abuses include management buying up equity control in smaller companies with bank debt, and cross guarantees of debt between companies. In all cases there will be some mixture here of ponzi finance, and some high risk bets finally based on equity or real estate asset values.

A Chinese credit crunch involves direct administered action. Particularly flagrant insurance companies are told to cease selling their universal products. Because they have sold a a great amount of these short-term products, they will face a roll-over problem. In a related move, regulators asked banks to reconsider their credit to companies deemed to have invested excessively abroad, triggering credit concerns and sharp equity sell-offs. Similarly, officials have intensified their Macro Prudential Analysis report due last month but delayed. By suddenly blocking certain funding flows, the local equivilent of a disruptive partial credit crunch is achieved, but without the generalized panic and economic slump that we know and love.

Because this is an administered process, the credit crunch can hopefully be relaxed if panic develops or economic weakness emerges. But a dispute with the US over steel dumping will only increase the sense of unease in local markets about this balancing act of sustaining growth while rolling back a long period of credit excess in an orderly and non-recessionary fashion.

As central banks tighten policy they will increase asset price volatility. Because asset prices have recovered at least as much as desired, my worry is that central banks are no longer likely to actively counter asset volatility as they one did. One example could be a surprisingly deep US equity correction that leads to surprisingly little relaxation in the Fed's tightening program.

Meanwhile, risk is certainly building at the edges of the system, in Chinese stocks in Hong Kong, in US municipal banruptcy risk, and in tech stocks and bitcoins. I expect to see a rising tide of these little, so far non-systemic, sell-offs.