Confirmed Tightening

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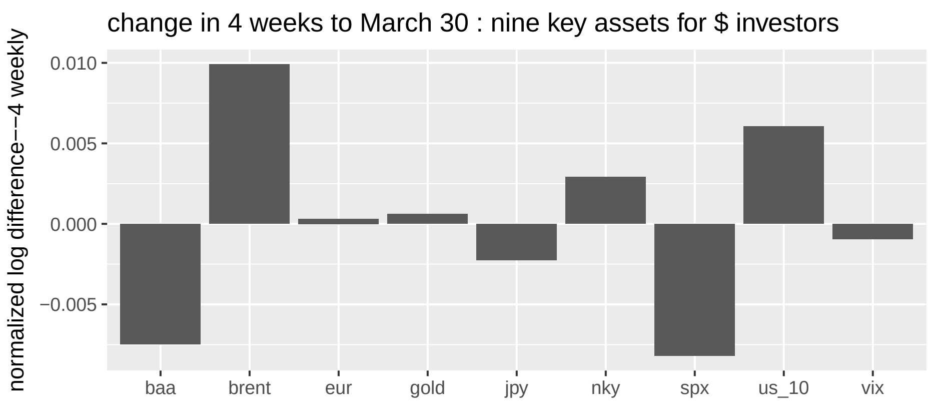
Last month's flash-crash in equity volatility products was indeed followed by further skittishness. A series of equity frights came from possible trade war, and the coming regulation of Facebook.

US government bond yields fell in the final few weeks of the month, as investors went back to bonds as a safer alternative to stocks. But riskier corporate bonds began to sell off sharply at the same time.

Oil price rose, partly on the prospect of a US policy lurch into confrontation with Iran that could interfere with its oil exports. Higher prices clash with any implied lower path for policy rates that bond markets have produced.



Several shocks to equity valuations were linked to the unstable policies of Mr. Trump. His recent lurch into arbitrary tariff policies threatens gains from global trade, a major potential offset to the supposed productivity gains that might follow from lower taxes.

Before the dust could clear on that risk, we had revelations about the misuse of social network communities, weakening confidence in some of the ways in which technology is monetized.

Meanwhile, a widening sense of financial caution continues to spread among investors. Several emerging market currencies and equities began to suffer losses, while dollar sovereign bonds sold off, too, into month-end.

Why So Many Surprises? Short-term credit markets have been showing signs of unease that may be amplifying investor responses to any surprise. Below, I present some details of short-term private credit prices in commercial paper, including prime AA commercial paper rates for 90 days, and the spread for riskier A2P2 paper. Other money market indicators, including OIS-Libor spreads tell a similar story.

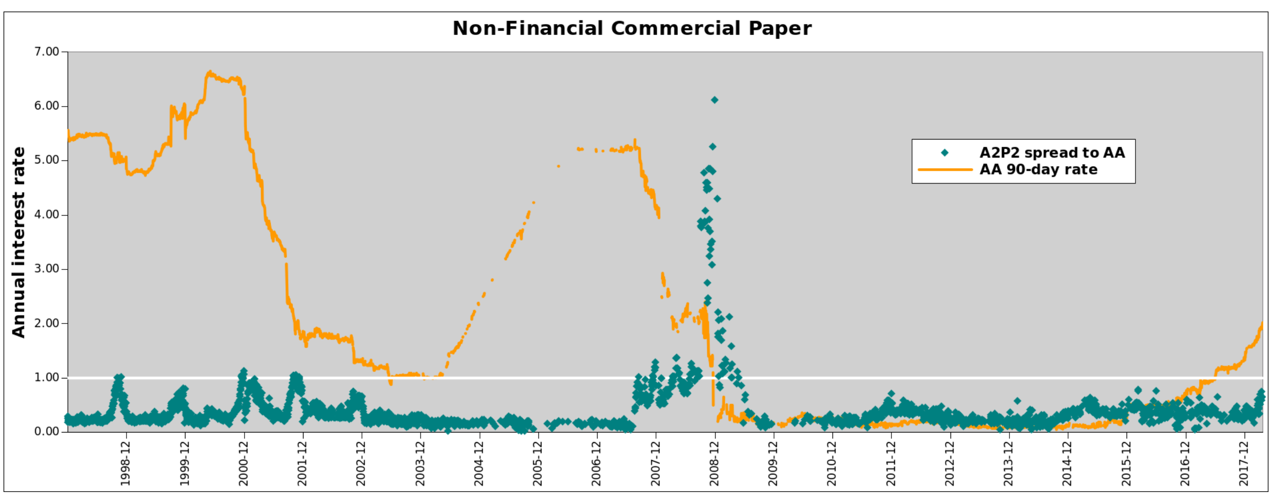
In these short-dated markets investors depend more on their right to accept short-term repayment than on detailed research into credit. So, under conditions of unease they can suddenly cut off suspect borrowers. Up to 2000 this was seen in periodic, year-end squeezes. Before 2008 the natural role of credit risk in short dated markets was suppressed by the great European special purpose vehicles that later blew up spectacularly. This time around we are beginning to get short-end credit spread pressure earlier than normal. Credit spreads between AA and A2P2 commercial paper are out to about 0.75% last month, a level seen in 2011 when Greece got into trouble and 2015 as destabilizing Chinese capital outflows developed.

Today, any area where elevated bond sales have financed dodgy projects is at risk of coming under sudden suspicion. The footprint of these elevated bond sales is clearly visible in several recent high-leverage business failures, and others like Tesla cars are clearly at risk. Emerging market countries have also been borrowing heavily through bonds, with spotty failure to pay already surfacing. And, lastly, the great pool of private equity investors lined up to match their own money with additional cheap bond funding to gain control of companies has been a big support for equity valuations.

With this background of impending risk, two areas are putting particular overall pressure on US short rates and spreads. One is the need of foreigners to hedge US investments to lock in bond returns against currency risk. As US rates began to rise, foreign investors can borrow at the short end and receive at the long end to lock in a spread in their favor. But this creates fresh demand for short term funding in commercial paper and neighboring markets that is adding to upward pressure on short rates.

The other source of short-term funding strain will be rising US government financing needs. US Treasury has chosen to fund its rising needs heavily at the short-end, creating a rapidly growing short-term rollover requirement. This, like the hedging, can squeeze out any blemished short term borrower through rising short-term credit spreads.

So, broad pressures on US short-dated commercial paper markets may have contributed to the oversized jumps in all asset prices, including equities, that we have been seeing.



Getting on With US Tightening. It has been a contradictory quarter. Consumption spending nearly stopped growing in the first quarter as the emergency replacement demand for hurricane replacement wound down. Clashing with this slowdown is a continued solid pace of employment and declines in initial unemployment claims. My best understanding is that the surge in hurricane replacement needs was first met with inventories and imports, after which higher production followed.

Underlying demand is advancing moderately. Mortgage rates are up, for both long and shorter-term mortgages, which should close out some new buyers. Credit card delinquencies are up, too, indicating consumer strains. So the expansion will increasingly depend on business investment funded with the tax cuts. Meanwhile, inflation continues rising, starting with imports and in services. Once last year's unusual price cuts fall out of the annual comparisons, inflation close to 3%–or well above the policy target–is highly likely to be reported by mid-year.

Partly reflecting the predictably higher inflation to come, Jerome Powell concentrated on rate hikes in his first press conference as Fed Chair. He only came to the Fed in 2012, and seemingly does not share Yellen's crippling fear of renewed financial collapse. He reacts to the presumed demand push of upcoming tax cuts by pointing to higher rates, presumably regardless of any moderate equity market correction.

Meanwhile, the state of emergency in Mr. Trump's mind has led him to fire officials, replacing them with congenial extremists he has heard on TV. Policy on North Korea, infrastructure spending, budgetary priorities, and trade tariffs are all in a state of flux. In this volatile environment, two particular shocks emerged last month. One was the growing realization that a trade war, so readily advocated by Trump, can have deeply negative supply side consequences–and is certainly inflationary. Secondly, revelations of how Facebook's repository of social network information was weaponized by Trump supporters casts doubt on that company's fundamental business plan. How it survives a coming round of investigations and regulation is a big additional uncertainty for equity prices.

Setting the Euro Timetable. Activity is slowing and inflation is stuck in Europe. Several confidence indicators in Germany and in Europe have turned down as respondents consider the risks of a disruption to Europe's exports in a world of random Trump tariffs. So far steel and aluminum tariffs have been lifted temporarily for European producers, but this may not last. In response, European reactions may include a tax on US tech company sales in Europe.

As their economies recover, officials are thinking of ways to design away the sources of crisis in 2011. A joint unemployment payment plan, or a joint infrastructure spending plan that can be stepped up in depressed areas are among the ideas advanced to deal with country-specific shocks. Similarly, plans are advancing, amid some Italian pushback, to force up capital requirements for long-term NPLs. All these plans will require further steps: any joint spending plan will call for more effective joint supervision of national budgets, any increase in bank reserves will be easier if true cross-border bank control is made possible.

Reacting to its solidifying recovery, the ECB is rolling out specific plans for backing out of its negative rate and asset buying program. It looks like the June ECB macro forecast will set up the conditions for an announcement to stop asset purchases completely at the end of September. Then, by March or June 2019 we can expect the first rate hike, and by about September 2020 we can expect the rollover program on debt holdings to be capped, allowing debt to run off as is now the case in the US. By specifying its slow-moving plan, the ECB obsessively seeks to avoid any shock re-rating of bond yields upward.

Lastly, political union is moving ahead very slowly. Germany has a coalition, finally, but Italian politicians are still struggling to sort out their issues. On balance, coalition politics seems unlikely to produce any decisive changes since that would require strong leadership and assumption of responsibility that is impossible in a coalition. Not helpful at this point is what looks like an administrative coup to appoint a Junker underling to EU commission head through extraordinary means.

Xi at the Helm. Chinese activity has been unusually volatile, even compared to earlier lunar new year periods. Business bounced back in the new year, as shown in higher electricity use and a jump in exports, but the new year holiday also seems to have become more extensive, leading to an unusually deep manufacturing shut down in February. And US tariff measures against Chinese steel exports either directly or reshipped from elsewhere into US markets have brought down local steel and coal prices.

Bureaus have been reorganized and restaffed for the upcoming five years, or more, under President Xi. China's entire administrative structure has been reorganized to cope with new problems at a more advanced level of development. The new structure will interact with a revived communist party as China explores an heavily administrative organization for its future. At the same time, some elements of legal stability as opposed to unhindered administrative judgement are discussed, but I see little action.

Liu He, appointed as vice premier and chief economic advisor, may point to future policy choices. His publications include some detailed analyses of US financial crises as a chronic and repeated feature of deregulated capitalism, including the aggressive adoption of new technology, and periodic spikes in income inequality. Against this backdrop he sees credit surges as an endogenous event in the US, as it certainly has been in China. He also sees the need for aggressive pre-emptive deleveraging and regulatory measures to prevent a crash in China. It may surprise some to find him quoting both Marx and Hyman Minsky in his work. But not necessarily wrong.

While He tried to contact the Trump administration on his last trip here, he missed the coup by anti-globalists who have since pushed Trump into steel and aluminum tariffs. Other tariff measures are forthcoming that seem to be designed to block China's advance into high-quality manufacturing. That US objective is probably unattainable, and its persuit will lead to reciprocal trade measures that can only damage trade and efficiency in both countries.

Xi himself seems to have authorized a near-complete shut-down of exports to North Korea that has brought a hasty change in that country's attitudes. Whether Trump can reach a denuclearization deal with the North before our mid-term elections is something we shall see, but it would certainly be a great coup, and could buy time for any Chinese trade adjustment with less harm than otherwise.

Investors are obviously jumpy here. First we had the disappointment of bitcoin, then of inverse VIX contracts, and now tech equities, including Apple and Facebook.

Eventually a reasonable return on cash will make it attractive compared to overvalued assets. Despite all the momentum in asset prices, rational speculators are going to have to calculate their downside from staying in too long in long term assets compared to the safe alternative.

For now, my operating assumption is that this is a process of rotational weakness that will go through overvalued asset markets one at a time. During this process, I expect no pause in the plan, long overdue, of gradually raising policy rates in the US and soon in Europe.