Fiscal Injuries and the Credit Cycle

Lars J. Pedersen

3 December 2018

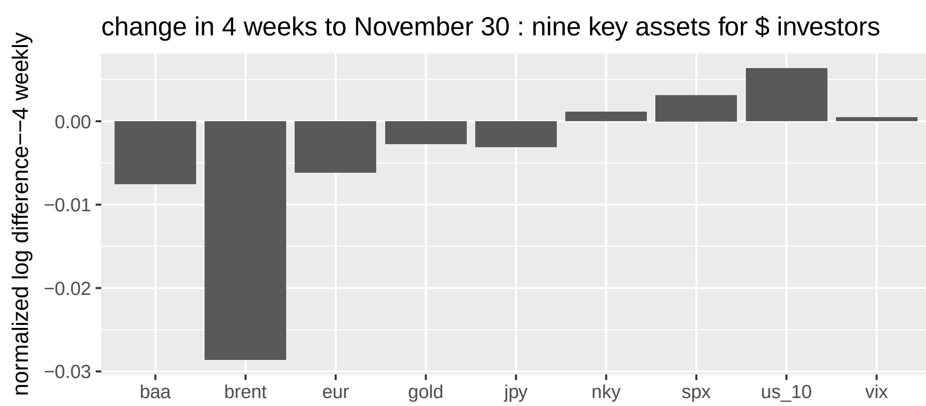
bash-economics.com

- **What Markets Just Said**
- **Treasury Borrowing Needs**
- **A Fiscally Wounded Recovery**
- **Macro Surprises**

Oil prices fell sharply over the month. Something changed in oil markets, driving up US crude inventories, and investors reacted sharply.

In the final week of the month, US equities surged, presumably on the momentary view that a weakening world economy, possibly foreshadowed by falling oil, postpones the day when interest rise enough to pose a real risk to asset prices, and to equity values in particular.

US government bonds rose marginally with the softer news as yields inched down. Meanwhile, corporate bond spreads remained under continuous widening pressure.



Whatever the reasons for rising oil inventories, record long speculative positions in oil have certainly have been liquidated, exaggerating the oil price drop.

Equities bounced back in the past week after a soft November and disastrous October. Like in other asses classes, equity losses have been concentrated on segments: recently suspect tech companies and energy producers. Margin credit for equities came down sharply in November.

Meanwhile, the deepest sell-off in emerging markets was in Mexican bonds, while the Brazilian exchange rate also fell. Incoming populist governments in both countries do not assure investors, but Mexico as an oil exporter was sold more aggressively. Several other emerging markets recovered strongly, in line with the sharp rotation we have been seeing.

Treasury Borrowing Needs Amid these cross currents, we just heard from a welcome new voice in global financial reporting, the Federal Reserve's Financial Stability Report.[1] Its welcome terseness and limited pretensions properly reflect how little we can ever know about the pre-conditions for financial distress. But the one thing we can be pretty sure of is that bank holding companies have been forced to increase their capital and prepare for orderly dissolution, so a crisis along the lines of 2008 is unlikely.

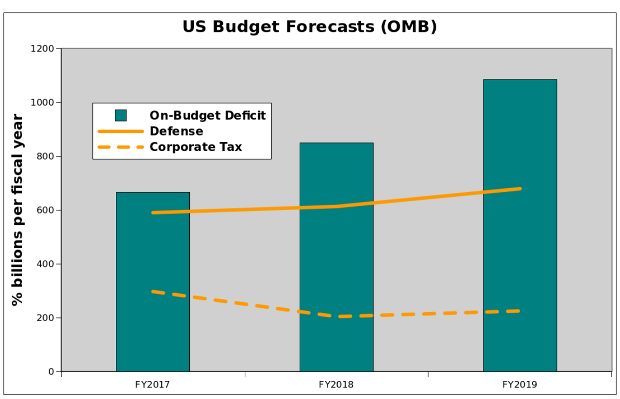
The next crisis is never exactly like the last one, of course. For me the greatest weakness in this cycle is still to be found in corporate bonds, which have surged in volume under the great anomaly of quantitative ease. The areas of most concern are investment grade credit that is on the cusp of falling into high yield, and leveraged loans. The Fed's new report notes the high outstanding volume of corporate credit, and particularly the surge in leverage loans, and remarks that default-related spreads are unusually low.

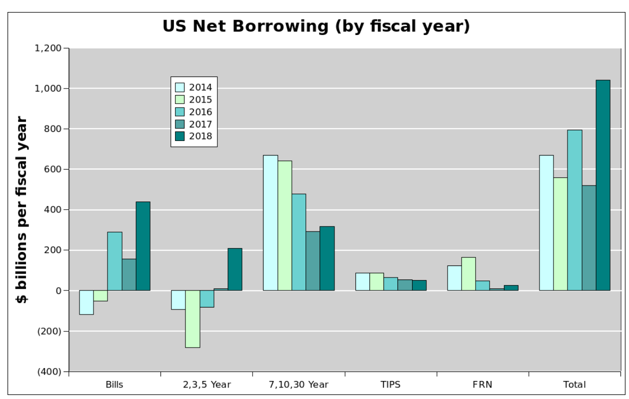
In the Fed's framework a stretched financial sector is not a necessary problem, but it can easily become one in case of a surprise. One contributing factor to any bond market shock will be the turn toward bigger US deficits. Federal deficits are up, and in a cumulative way that will only be fully visible in fiscal 2019 as military spending kicks in, in addition to corporate and individual tax cuts already visible. Deficits substantially higher than $1.0 trillion a year are highly likely from 2019 onward, even on relatively optimistic assumptions.

In addition, total Federal borrowing from the public is larger than the deficit because of the need to replace bonds rolling off the Fed's balance sheet with the end of quantitative ease. At about $360b in Federal debt rolloffs per year, that boosts the total financing need to about $1.5 trillion in 2019, sharply higher than in recent years and highly unusual during a recovery. (See Charts below.)

To meet its borrowing need, this administration has chosen to rely heavily on Treasury bills. In fact, almost the entirety of the difference in funding needs between FY2017 and FY2018 was met with an unprecedentedly high $400b in net bill issuance, pushing total US Treasury rollovers to $2.0 trillion a year.

An accident is waiting to happen here. One possibility is sharply higher Treasury yields that could surprise corporate markets and create an accident for some borrowers who look unlikely to cover their rising debt costs. Or, alternatively, the surging supply of safe government debt could provide an attractive alternative to corporate credit risk, particularly under weaker growth. Either way the interaction of rising Federal financing needs and excess corporate debt with a low spread cushion creates the conditions for a sharp corporate bond market repricing, one that could to be just starting.





[1]Board of Governors of the Federal Reserve System (November, 2018), *Financial Stability Report* Washington D.C.

A Fiscally Wounded Recovery. Earlier this year US Treasury and the IMF traded competing theories about how to judge US fiscal policy as both recognized, even by mid-year, that a substantial increase in near-term US deficits was inevitable.

Taking the positive view, US Treasury claims that big tax cuts, a better designed corporate tax, and deregulation should all solidify a stronger growth trajectory. If so, higher incomes and taxes should accrue that automatically tend over time to reduce the near-term deficits of FY2018-2019. Assuming an unchained private sector will find its own ways to use its tax windfall for investment, that could boost all of national income over time.

A slightly less positive take, from the IMF, is that the tax cuts are an inefficient give-away of fiscal revenues. Funds that could have been used for education, training, and infrastructure, items that certainly improve nation productivity, will not be available in a deficit constrained world. As well, the net effect of the tax cut give-aways, overwhelmingly accruing to the rich, might not be so effective in instigating investment and productivity growth as claimed.

Inevitably, this tax cut plan increases income inequality while covering the lost revenue with greater bond issues. Presumably the rich beneficiaries of the tax cuts will be in a position to buy these additional bonds, so our system can rebalance there. And suddenly cash-rich companies can back away from net borrowing, which also tends to make room for the added government debt. But for a system that is dogged by the ills of creeping inequality, a solution that imposes future burdens on average tax-payers to service debt with which to pay out the rich might actually be a great obstacle to long term growth.

Near term, other harms emerge. For me, the big positive impact of a populist president on US asset prices came because of his announced willingness to engage in deficit spending *if necessary* in case of any relapse into recession and deflation. By closing off a case that investors had perhaps overworried, that led to a step-jump in asset values. But an unnecessary plunge into deficit spending in an expansion, reduces precisely that fiscal freedom going forward. Now the risk is that an unexpected downturn will create at least the momentary impression of ominously rising debt and deficits. Suddenly, investors will require painful cutbacks to be assure that all debt trajectories will be sound. In effect, we have stored up a deeper cyclical downturn than necessary.

At this moment, slowing global growth related to fears of trade disruption and falling commodity prices can lead to downward revisions of trend growth. That can adversely impact projected tax revenues and magnify the impression of fiscal decay in the US. Any awareness of how vulnerable the economy is to a downturn, now with limited room for fiscal relief, will be the final cost of recent fiscal folly.

Among the outcomes here, a deeper cyclical downturn than investors had foreseen could well be another spark for a re-evaluation of corporate credit risk that the Fed's stability report warned us to look for.

Macro Surprises. Until the last few weeks, a global trade hiccup was seemingly underway after inventories completed a replenishment cycle, but activity seemed to be stabilizing. Since then, a wave of sharply weaker data puts this stability in doubt. Particularly worrisome are a collapse in coal, iron ore, and steel prices in China on top of strikingly weaker oil. Key global indicators, including Taiwan's export orders, Japanese exports, and US chemical activity have also turned down.

Is this is a reaction to the deep disruption of global trade promised by Mr. Trump? If so, it should have led to a final wave of shipments into the US customs area ahead of higher tariffs, becoming a surge in US inventories. Both imports and inventory movements were in line with this explanation, with a near neutral impact on US GDP, as they offset each other in GDP accounting. But the once-time induced surge in activity abroad may be followed by a deeper pause than I expected, and which seems to be unfolding. As well, investment planning abroad could halt to see what global trading environment investors will, in fact, be facing. Even in the US, uncertainty about what is real and what is hot air from Mr. Trump on trade could well bring a precautionary pause in business investment.

Strikingly, US final demand has been holding up through this whole process. Jobs continue to pull discouraged workers into the work force, and wages are rising slightly ahead of inflation. But at least a measured slow-down from recent strong growth is increasingly likely. Besides the uncertainly hanging over business investment, housing construction seems set for a pause. Mortgage interest costs are up about 30%, with a corresponding reduction in what new home owners can afford for the same monthly income.

European growth was held back by a pause in car sales and German production delays ahead of approval of new pollution control rules. But the softness seems to have spread further. Sharply lower investment intentions in Italy during the populist tussle with Brussels over local fiscal room, and a sudden dip in French consumer sentiment are worrisome. Overall, global trade uncertainty is compounded for Europe by the unpredictable effects of possibly decoupling by the UK and Italy from the European economy.

In China, all survey indicators are softening. What expansion we see seems increasingly dependent on a new wave of local government bond borrowing. Particular areas of demand weakness include cars, where a long upturn is pausing, and housing, where construction has been booming until very recently. Seeing the problem early, the PBOC has taken strong measures to lower reserve requirements, and to require state banks to keep a share of private lending in their new business. Almost certainly, after encouraging defaults to create caution in the extension of leverage, the PBOC is now back-pedaling to stop a default aversion panic that creates, as we know it can, compounding liquidity failures across the system.

All this softer news implies some ease on global inflation pressures, more abroad than in the US. Seeing the risks of weaker growth in the US, and possibly responding to boisterous advice from Mr. Trump, the Fed looks set to hike in December and then pause in March and possibly June, to just be sure a broader global slowdown is not unfolding.

Meanwhile, bond default risks continue to mount. Last month saw strains in funding GE, and a remarkably high rate payed by Unibanco for a new loan. Besides these specific cases, shale oil producers are likely coming under scrutiny again as they did last time oil prices came down precipitously. Corporate bond default risk is gathering momentum.

Investors seem to be over-coping with relatively minor oscillations in their world view. Two months ago it was too much growth and the fear of inflation and higher rates. Now it seems to be a sudden trip-up in global growth.

I claim that whatever surprise emerges, the predominant move in asset prices will be down. This comes because the great anomaly of massive quantitative ease is coming to an end, and with it the broadly higher asset prices it brought. We are living in a time of sudden and substantial asset price drops, hopefully in one segment at a time.

My case rests on the judgment that central banks are unlikely to be easily deterred in normalizing monetary conditions. They are reversing a policy of the last decade and can hardly afford to overreact to monthly or even quarterly changes in the macro path. So, global asset markets will have to adjust to a less friendly environment, one drop in inflated asset values after another.