Politics and the Credit Cycle

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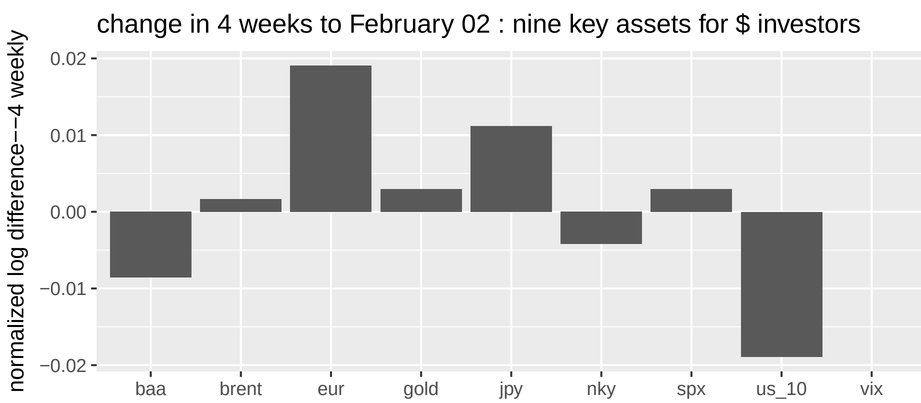
Until last week, investors responded to higher global growth mainly by selling US bonds and the dollar. We also saw other, mainly isolated, signs of unease with the great financial bubble, most prominently in the crash of bitcoins since mid-December.

Last week, the erosion in bond and dollar values suddenly spread into a broad equity drop. Losses spread across almost all risky assets, including emerging market ones that had seemed excluded from losses for most of the month.



While the vast majority of assets available for US investors fell in value last week, the scarce exceptions were mainly inflation-adjusted bonds that can reward investors for higher inflation.

As government bonds have been the first and leading victims of repricing, corporate bonds have begun to follow. Generally the highest risk of default comes in the late cycle when investment in bad projects is most likely, so this mid-cycle correction seems due more to the risk of capital losses in all bonds, including corporates.

So far losses have not yet included sovereign emerging market bonds, and emerging market high yield is just beginning to be affected. But that could just be a matter of time, because the biggest emerging market currencies have already started to weaken.

Politics Over Policy. I must admit that the sharp rally in US equities coming after adoption of new corporate tax law surprised me. Perhaps my disdain for the Republican Party that fielded a candidate like Trump has colored by judgment. Markets, I felt, were bound to under-perform under a divisive government that was intent on taking economically disastrous policies for cheap short-term gain. Make America a Banana Republic.

I did not think the tax law would pass. A party which governed on the basis of dividing the public would find no help from Democrats, I reasoned. So it would not be able to find the near-unanimity necessary within its own party ranks to pass a tax reform bill, which notoriously features big winners and losers. In fact, Republicans did so only by skipping the tax hike part to pay for cuts, relying instead on a big dose of deficit financing. Republicans' urgent need to pass a law ahead of upcoming mid-term elections trumped all historical urgent concerns about deficit financing.

Certainly, personal and corporate tax bills will come down for the rich. Corporate chiefs who face lower personal tax rates, higher equity prices, and higher personal bonuses have been delighted. They will certainly claim loudly that any investment they make is the direct and exclusive result of the new law. Some mention the possibility of socially responsible use of the great windfall they have been given. But, I wonder. Business investment for normal cyclical reasons has been long overdue, anyway.

Truly revolutionary change in terms of turning the corporate tax into an efficient consumption tax were jettisoned early. What remained was mainly a deep cut in taxes, mostly for small domestic companies (the big ones have been escaping taxes for years). Still, a cut in taxes on some capital should increase investment by some companies. But the law includes big structural changes with complex impacts on growth, some of which are offsetting. Experts raise their GDP growth after the new law by between 0.1% to 0.75% a year, well within the error rate in quarterly reporting.

Politics and credit always interact. Assertions of a substantially upgraded US profits and some better growth became a rationale for higher asset valuations. But the real underlying reason for sustained speculative flows may be found in the deliberate pace at which central banks are pulling back their exceptional bond buying measures. After all, if growth takes off faster than central banks can normalize policy, spiraling asset values will further reinforce growth, pouting the central banks further behind, etc.

Central bank caution, a Republican Party focused on survival after Trump, and a sudden disregard for fiscal deficits at the wrong time in the cycle all came together to give us a startlingly strong set of financial markets into the beginning of the new year. But what comes next?

A Hurricane Boost. Consumer spending surged in 4Q, partly due to a rush by consumers replacing lost durables after the hurricanes. Spending out of insurance payouts like this is not a burden on already stretched consumers. But car sales, and second hand car prices have already been falling back since. It was a one-time event.

What might have been a more than 4.0% fourth quarter growth based on one-time consumer and more sustainable investment spending was held back by imports and inventories. For a surprise surge in demand to be met by these short-term buffers is normal. More important, and much more uncertain, is how the economy develops in the first quarter, when demand will ease off but trade and inventories are unlikely to sap output the same way. On balance, GDP growth near 3.0% has been my main case for growth over the whole of 2018.

Investment spending is gradually picking up. Home rebuilding after hurricane damage will be paced out over a year or so even if it turns out that many damaged homes were not insured and take longer to replace. As well, the economy-wide rise in mortgage rates now coming could have a broad effect holding back new buyers, and halting home price appreciation. Besides housing, other investment looks stronger. Office construction is on a sustained upswing that paused only briefly for the hurricanes to pass. Business equipment investment is turning up as expected as the cycle progressed and as labor becomes scarce. Full depreciation of some investment under the new tax law should also accelerate spending, particularly by small business. On balance, consumption and housing may struggle in 2018, offset by higher business investment.

Inflationary pressures should mount as labor markets steadily tighten. Several minimum wage and corporate wage hikes will come into effect at the start of the year, adding to the apparent pressure. Lastly, a weaker dollar will increase import prices. Already, underlying median and other core prices are rising gently.

Fed policy will be responding to inflation and the politics of higher deficit spending. If the new tax law indeed unleashes substantial fresh investment beyond what was expected, then growth could be higher and wage pressures greater. At least as important, the Fed will have to recalibrate policy to the risk that additional plans, like those for infrastructure, may fall back on deficit spending that now seems to incur so little political cost.

The Euro Holds Down Inflation. Activity is still accelerating in Europe. Most recently, surging US demand lifted European orders and export shipments. Other areas are a little less certain: construction orders and car sales both dipped in late 2017. Car sales may be a particular concern if buyers postpone spending until electric cars become fully available, because gasoline powered cars may eventually be banned in some areas. But these are concerns at the edges of an otherwise solid expansion.

Mainly, the expansion is solidly grounded. Unemployment grinds down, steadily lifting earned incomes and spending. Investment has turned up far earlier than in the US and export orders for investment goods are solid. Lastly, despite every caution, the national politics of Europe is driving public spending up as taxes come in and financing pressures evaporate. The prize here goes to Greece, where the government, amazingly, now plans new private bonds to begin to repay emergency EU and IMF credits. On balance, the forces of the pro-cyclical European state-supported expansion are solidly in place.

Inflation trends are diverse. In countries with low costs after labor market reform, like Germany, wages are rising solidly. As a gesture of solidarity with higher cost Europe, German politicians may even encourage bigger wage gains this year. Meanwhile only glimmers of wage and inflation pressure are visible in still-lagging Southern Europe. Lastly, a rising Euro could reduce inflation more than expected. For the moment, Euro-wide inflation shows little movement.

Without rising inflation, the ECB has time to tighten. When it does so, policy can be expected to go sedately through the stations of tightening policy laid out for us by the Fed. Zero net bond buying is expected by September-December, with rate hikes starting in 2019. On this time-table, which the ECB modulates with extreme caution, the beginning of net bond sales out of portfolio is likely by 2020. It will all take time.

Lingering costs of Europe's long recession, and the panic over mass migration, still scar the political landscape. Next on the political calendar will be elections in Italy. Many parties, including several on the right, have a shot at winning a plurality of votes and the responsibility of making up a coalition government. For now, I assume these coalitions will exclude anyone planning to either leave the euro or run grossly non-compliant fiscal deficits. But this is not certain until the votes are in and a coalition formed.

Urgent Matters in China. Electricity, freight and industrial value added statistics are all growing more slowly in China after the 19th Party Congress. With the political field cleared, postponed adjustments now possible. That includes tighter credit, a probable dip in car sales as sales taxes return to normal, and limited export gains. At the same time, firm administrative measures to shut steel mills and remove home heating stoves using coal, have not gone well amid stories of frost-biten children.

Similarly, crash efforts to tighten up on financing excesses after the Congress are also having a rocky time. Total social credit growth has hardly slowed as home mortgage and construction credit was solid through year-end. But an effort to ban bank-brokered loans between companies (entrusted lending) seems to have led to an explosion in internet finacial company lending, something that may not be captured in China's statistics. And this explosion turns out to be a rich source of new ponzi-schemes on a variety of internet platforms.

A key political goal, justifying the regime, is to move the vast public to a higher standard of living. One obstacle to that goal is the explosion of urban real estate prices that creates enormous disadvantages for families who move in late. Efforts to force builders into constructing for-rent housing on which the builders retain land value appreciation and the residents get a low rent is straining cash-hungry builders. Another intractible problem in achieving higher standards of living involves rapidly declining pension fund viability in some provinces. China's working age population is falling fast compared to the elderly to be supported, suddenly threatening some of these pay-as-you-go schemes.

While dealing with deep structural problems, officials are understandably determined to avoid any trade disruption with the US. Claims of Chinese protection and theft of US intellectual property remain outstanding and could trigger unpredictable US measures. Suggestions that China could defend itself against any trade sanctions by aggressive reserve management have surfaced. Selling dollars for euros is plausible and may be helping the euro now. Alternatively, the sale of long-term dollar assets for short-term paper with less risk of capital loss would tend to exacerbate the longer-end sell-off we are seeing. What we have seen so far could be warnings of more to come.

So we got a new tax law by disregarding its financing cost. Fiscal insouciance on this scale marks a great sea-change from the obsession with deficit control which dogged us through the Great Recession. Now, the same politics means a credit-financed infrastructure program is quite possible, cementing a stronger US recovery and guaranteeing an even more inflationary bias to the US economy.

After a long pause, which for me dragged on since mid-2017, investors finally realized that the balance of risks has shifted from deflation to inflation. Central banks will be bound to follow. So far, quantitative ease has driven down government bond yields, and cheapened long-term corporate bond finance. Cheap bond finance allowed stock buy-backs, mergers, and other uses of cheap credit to drive up equities. Now, as bond yields rise, we can expect to uncover excesses and losses.

So, the road to an asset bubble correction passes through higher bond yields. Along the way, bond yields will find whatever level creates a correction. The whole process becomes much more likely as growth trajectories firm up, inflation becomes visible, asset prices rise to unexpected heights, and central banks walk back from quantitative ease.

For years, investors could count on the idea that any sudden removal of ease could trigger an asset price correction that would plunge us back into recession, deflation, and a return to central bank ease. No longer, because the expansion is so solid. It is a big change.