When In a Minefield...

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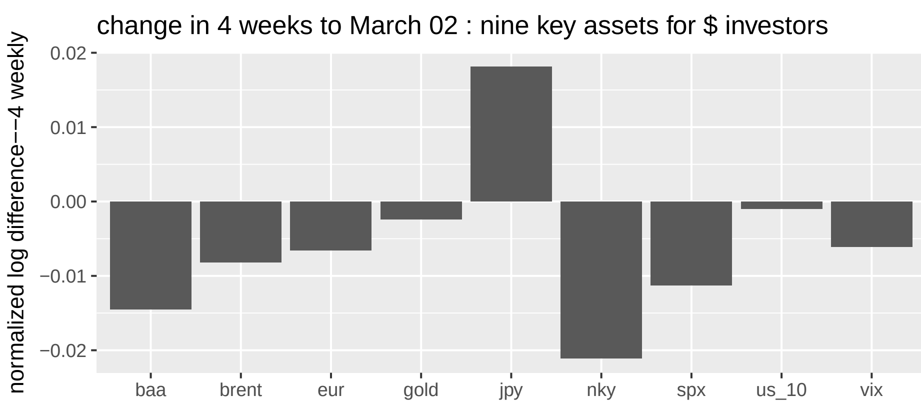
We saw very volatile trading after the flash equity crash that started off the month. A move up in expected interest rate paths seems to have hit a trigger point that shocked equity derivative structures using volatility, amplifying the sudden collapse

Equity volatility itself spiked, but then fell back so suddenly the extent of the shock does not show in month-on-month comparisons. I examine the volatility spike in more detail below.

Some system-wide risk avoidance began to show up in the reaction of Japanese investors. Japanese stocks fell and the yen rose sharply, revealing a broad step back from risk into cash by these key investors in global markets.



Inflation compensation in US bonds came down with the sudden arrival of equity risk. If, as I expect, increasingly confident central banks are hiking rates regardless of any equity dips, that could cap rising inflation.

The Canadian dollar fell sharply after the US proposed general steel tariffs. Highly integrated North American industries are particularly vulnerable to Trump's latest protectionist moves. Meanwhile, all South African assets were up with the final departure of Jacob Zuma from the presidency.

...Step Very Carefully. We just hit a land mine for this credit cycle in the form of the overnight collapse of $5-10 billion of value in reverse VIX ETPs. One thing I know is that unexpected losses on this scale create a sense of risk aversion across markets. And that risk-aversion can cascade into further losses.

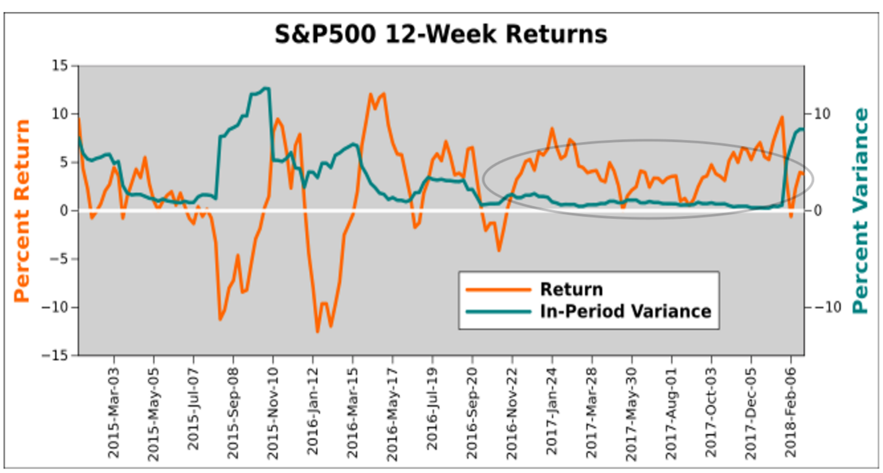
Always, funds chasing an asset drive that asset up in value. For reverse VIX instruments this involves various financial structures that decompose the main thrust of the investment, which is to profit when volatility falls. Ultimately, these structures must find their way to a trader who sells shares when price rise and buys them when prices fall. Actively trading this way will make money for the ultimate investor in a market where daily price moves are small. Eventually, large scale funds deployed in the trade will create such a overhang of buy and sell orders that they create the low-volatility environment.

I hope my readers can see that this is closely related to currency carry trades. A high-yielding market with a fixed exchange rate will find investors attracted to its paper as long as the exchange rate fix is not crippling growth. In the meantime, these flows will accumulate as reserves, strengthening the system until the exchange rate becomes obviously unrealistic. In exactly the same way, low volatility in equity markets has encouraged a trend, until it does not. (See Chart below, showing the unusually low actual variance in equity prices compared with the sustained high returns recently.)

All of these structures work in a world of steadily rising asset valuations. At a more general level, rising asset values reward balance sheets that have borrowed or used cash to hold as much of the rising securities as possible. These leveraged balance sheets, tucked away all across the system, have been richly rewarded and all show higher net worth. But this deeper structure is also at risk if asset values become volatile or decline. Suddenly balance sheets, wherever we find them, will be at risk of losing net worth and will fall into a panic of deleveraging, once gain. The question now is whether we are at the brink of such a broader deleveraging.

A trickle of information about failing leveraged balance sheets is already emerging, before rate hikes even begin in earnest. Several European companies suddenly failed as their exploding leverage became unsustainable. Several Chinese companies have had their domestic credit cut off for recklessly accumulating random foreign assets. Several are selling their trophy foreign assets as fast as they can. Broader leverage is already under strain, and on a more global scale than in any earlier cycle.

I expect the coming normalization of interest rates to work through the exploded reverse VIX ETPs, other products, and the broader process of asset purchases with borrowed money. We just hit a land mine of this process, and I judge that we are in a big mine-field. Step carefully.



Wages, Productivity, and Trade. Consumer spending did indeed slow into the first quarter, after the hurricane-recovery surge of late 2017. So much political capital has been freight aboard the idea of a surge in American demand under Trump, however, that it is awkward to point out how little of the recent surge in consumer spending is repeatable. Car sales have dropped sharply, as have retail sales.

Still, very low unemployment rates have now taken us to a position where workers are comfortable holding out for a raise, as we see in the Employment Cost Index and in reports of how hard it is to find qualified labor. I would expect businesses to find they have to pay more just to keep labor, to the advantage of workers at the expense of business profits. Employers will have great difficulty fighting this outcome, which has also become embroiled in the politics of the moment.

Key to Republican claims to ownership of a boom is the idea that lower taxes will lift profits, and then investment, and then productivity, from which higher wages can be easily paid. Unfortunately, history shows that productivity gains come sometimes as much as five years after an investment surge. Any jump in investment spending, including for infrastructure, will first impact demand for workers in the capital goods sectors, or importers of the new equipment, or inflation.

In this environment, a new team has come in at the Fed. Fed Chairman Powell showed a willingness to address the mistimed fiscal push, saying it flies in the face of all convention. Oddly, he seemed to get very little push-back on the idea that policy needs to be normalized–Republican legislators seemed to welcome this as proof of the normalcy of their policies. They even espouse higher wages as a win for their corporate tax cuts. Rate hikes beyond what is now expected do not face any political fight, yet.

Lastly, an increasingly erratic Trump slapped high tariffs on steel and aluminum imports. He seems to have taken on board apocalyptic arguments about "easily winning a trade war". In fact, trade wars always impede productivity because they block the otherwise lowest cost way of doing business. This comes just as the supposed productivity gains from the tax cuts have become the central claim of Republican politicians arguing that widening fiscal deficit in a late expansion is harmless. Taken together, we are in a situation that is increasingly vulnerable to inflationary accidents.

Europe Staggers to Another Election. Growth remains solid, although European PMI indicators dipped slightly from a high level in February. Exports are up to the US and China, consumption is rising as the considerable pool of unemployed workers is steadily drained, and public spending remains stubbornly pro-cyclical–all contributing to a continued recovery. Meanwhile, labor costs should rise in Germany after this wage round is completed, given the increasingly aggressive labor demands.

A strong euro will postpone the inflationary effects of the recovery. As I have been arguing, national inflation processes have an increasingly important global component, tempered by the local exchange rate. At the ECB, the rising euro is an annoyance and the source of some unusually strong complaints, presumably since the ECB feels frustrated in delivering the full weight of lower real interest rates and a lower exchange rate to the laggard nations of this recovery.

Politics should settle down with the completion of this round of national elections. A grand coalition deal in Germany was ratified by the SPD membership over the weekend, and yesterday's general election in Italy was inconclusive. I assume that coalition-building in Italy as in Germany will produce little change but some shifts at the margin. Meanwhile, Brexit negotiations drag on with UK demands increasingly self-contradictory and impossible to implement.

Once the coalition building is completed, important matters of European constitutional design are pending. One is a plan to formalize sovereign debt haircuts in case markets reject unsustainable funding needs for one country or another. Another is proposals to realign the European Budget without UK contributions after it leaves the Union, possibly by cutting back on transfers to the populist governments in Poland and Hungary. Lastly, various proposals to establish a euro risk-free public debt instrument are surfacing that imply a joint Euro-wide obligation, at least for a limited sum. Again, the European project may move forward by way of completing the monetary system.

How to Run an Official Credit Crunch. Premier Xi just had the two-term limit on the Presidency of China removed, opening the way for a third term. Because he does not belong to an established faction, he had faced the risk that his foreseen eventual departure in his second term would leave factions to quarrel without fear of repercussions, freezing governance as we saw in Premier Hu's second term. And China can ill-afford paralysis as there is much to be done.

First, policy needs to rein in uncontrolled credit growth going to zombie companies, ponzi schemes, and other loss-making uses. So far the emphasis has been on cutting down entrusted lending by big companies among themselves, insurance company funding of offshore trophy asset purchases, indirect borrowing by local governments through credit guarantees, and a variety of internet based lenders and bitcoin sites. Together these measures have been bearing down on credit growth in late 2017, but that was followed by an explosion in January of this year as banks got their new lending quotas for 2018. I assume the surge in bank credit went to needy borrowers that had been otherwise cut off. It is unlikely to be repeated.

As credit growth is increasingly regulated, growth has become softer. A ban on heavy industy in Northern China during the smoggy winter months adds to the weakness. Finally, a shift to longer and more expensive Lunar New Year holidaymaking is apparent in the data for weaker manufacturing and stronger services PMI's in February. So we have some reason to expect at least a mild rebound in March. Hunting for the next new thing, the electric car industry, cell phones moving to G5, and other projects are all attracting investment that may not, however, reach the scale to replace the vast dinosaurs, incluing steel, that need to be closed.

In the midst of these urgent credit and economic shifts, the prospect of a trade war with the US is very unwelcome. US tariffs on steel and aluminum from the entire world are really aimed at Chinese overcapacity, which lowers world prices and indirectly pushes products into the US from all markets. So the biggest losers from US tariffs will be all the other industrial countries where surplus Chinese steel will become even cheaper. Chinese retaliation for the US move is unlikely, but spreading tariffs are possible, an enormous potential harm to world trading patterns.

The stock market shock of early February was partly a flash-crash created by interacting volatility bets and instruments. But I think it was more than that, a reaction to policies of heedless fiscal expansion, and now inflationary trade tariffs into a recovery, all tending toward more inflation.

Ours is a system with growing potential energy arising from the long period of low rates and official bond buying aimed relentlessly at getting to higher inflation. As we achieve the objective, asset prices will have to work their way down to accomodate higher interest rates. Its going to be choppy here for a while.