Dollar Bond Distortions

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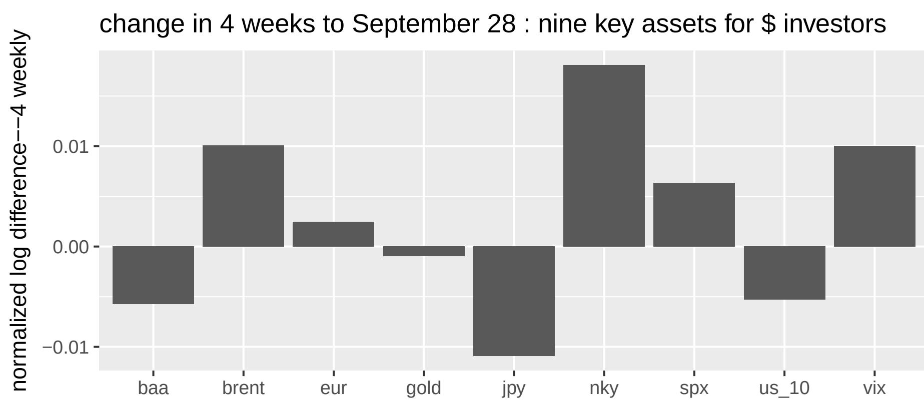
US equities continued to advance, while Japanese stocks jumped. Equity option volatility came down and the yen weakened, all pointing to a broad embrace of equity risk both at home and abroad, particularly by Japanese investors.

Oil prices continue to rise, with a sharp move at the end of the month as US sanctions on Iranian exports look increasingly effective. But other commodities, including copper, were down.

US bonds, starting with government debt, sold off gently as the worst risks of a sustained trade war or a spreading emerging market disruption seemed to fade, for the moment.



Investors continue to iterate between the fear of disruption from the cascading effect of higher US rates, and the growing conviction that this global recovery is strong enough to survive any mild disruption. As the evidence shifts toward sustained economic growth, government bond yields have room to rise.

But how far? The secret to how far bond yields will rise depends on how disruptive higher yields can be for unprepared borrowers. So far, higher yields seem most disruptive in emerging market dollar bonds, Italian government bonds, and many emerging market currencies and equities. Of all these, the biggest surprise may be how default risk is amplified by the rising dollar for emerging market borrowers in dollars. (More on this below.)

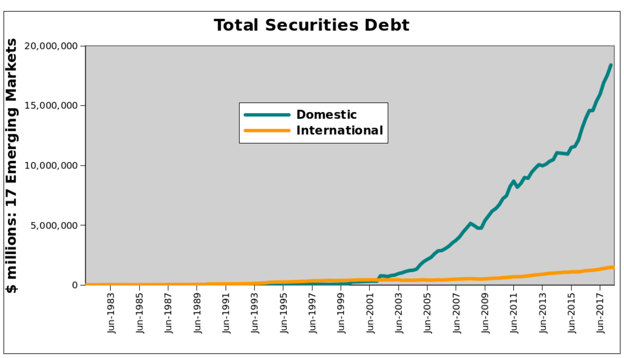
Dollar Bonds for Emerging Markets. We live in a time of proliferating credit for developing nations. As the IMF points out in a recent study [1], lenders and borrowers have every reason to develop new classes of debt that can claim priority over the old, keeping the new form serviced while the old is dishonored. That way a net flow of credit can be preserved and the cost of default reduced.

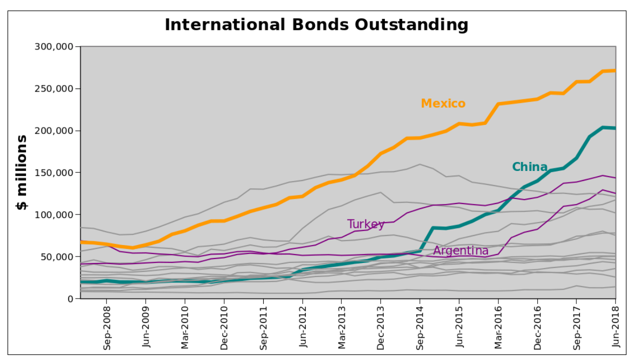
In the past, in the 1990's, bond debts were relatively small and protected at the expense of the big bank loans then outstanding. Now we are in a time of mounting bond debt, incurred by both government and corporate borrowers. Amid these shifting debts, the biggest evolution in emerging markets, as the IMF points out, is the shift to domestic currency debt. Without forex revaluation risk, domestic debts are protected from sudden currency valuation shocks.

At the same time, domestic debt markets become viable with the adoption of policies targeting local inflation, which make holding local debt a plausible proposition. Happily, floating exchange rates can amplify the power of monetary policy, building up confidence in the inflation targets, which in turn, allow investors to depend increasingly on the value of domestic debt claims. Lastly, rapidly developing local currency debt should have priority over foreign debt, further supporting the new assets over the old.

Local and international bonds for both sovereign and local corporate borrowers in emerging markets have been climbing steadily. Taking a sample of 17 large emerging market local and international (mostly dollar) borrowings in BIS securities statistics [2], we can see the most recent surge in their bond debt. (See chart left, below.)

Within the broader evolution toward domestic currency debt, emergency monetary policies after the Great Recession have promoted, for a time, the resurgence of dollar bonds. By soaking up bonds and starving investors of risk-free long-term yields in the US, EU, and Japanese markets, central banks pushed investors into the dollar bonds of emerging governments and corporations. The shift is most apparent for China and Mexico, with their close trading links to the dollar. Highly dependent on exports to the US, dollar risk is less worrisome, for example, for exporters who have access to dollars for debt repayment. The next two largest dollar bond borrowing nations in my sample are Turkey and Argentina, where massive currency movements have interacted very badly with their big dollar debt. Defaults are now likely in both cases. (See chart right, below.)





[1] Abbas, A., Pienkowski, A., & Rogoff, K. (2018) *Sovereign Debt: A Guide for Economists and Practitioners* (Proceedings of a Conference on September 13-14). Washington, DC: International Monetary Fund. Retrieved from https://www.imf.org/en/News/Seminars/Conferences/2018/05/24/sovereign-debt-a-guide-for-economists-and-practitioners

[2] Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, Russia, South Africa, Thailand, and Turkey

How a Credit Crunch Unfolds Crunches always follow a surprise, usually to do with the sudden discovery of the possibility of default in an area once thought safe. Public debts are a prime area for such surprises. An indefinite lifetime for a nation state tends to give national sovereign debts a special character, which obscures the question of what constitutes a danger point for default. While ultimate full repayment of government debt is a remote and theoretical possibility, we might work out what full repayment might look like, and how plausible such a case might be as a measure of risk. Logically true, but not really applicable in our lifetimes, such a theoretical test of sovereign debt sustainability is not practical.

Alternative indicators of default risk are possible. It may be more concrete to say that at some point a political system can become so dependent on borrowing and so reluctant to cut back public spending that the compounding of interest on past debt, plus new borrowing needs, plus a widening risk premium all causes the path of borrowing needs to rise uncontrollably compared with income. Even so, it all comes down to a matter for political economy, because at some point the political cost of primary balance adjustment required to steer back toward stability outweighs the cost of default.

All these considerations and measurements are made more difficult by debt level uncertainty. We cannot even start to assess the risk of government default until we have accurate picture of the full magnitude of public debts and offsetting public assets. Among the debts we should, but often do not, include potential obligations if a vulnerable banking system has to be recapitalized as a public policy matter. And the same value of debt is more risky if denominated in foreign currency that can jump in value in domestic terms.

More practically, you could say this: in a world of growing financial intermediation any one measure of gross debt will be rising for both public and private borrowers. If lenders have only high-debt public sector borrowers available, they may avoid those whose debt ratios are higher than average during a time of rising risk. At such times, cash rates in the safest centers rises until the weakest credit links across the system break. At that point creditors demand forced repayment from targeted borrowers, who go into emergency cash gathering mode, stop all possible spending, and tend to slow global demand growth. Of course, corporate credit is likely to fail before public credit and to trigger even earlier avoidance measures by investors.

For the first big credit break to come among nations with large dollar bonds outstanding was not widely predicted but is easy to understand in retrospect. Once conditions in dollar markets tighten, some marginal dollar borrowers were cut off amid spotty early default experience. As new bond sales were restricted, some dollar bond borrowers find their debt service burdensome, increasing the risk of default. At that point, capital inflows dry up for that country and equities and local currencies weaken. Floating exchange rates, which can be so useful, in moderation, in amplifying monetary policy, can become painful now, amplifying in free-fall the credit risk for the recent wave of new dollar bond debt, both sovereign and corporate.

And so it goes. Depending on the latest evolution of global markets, the weakest link in the system will fail as rates rise and credit tightens. The process is starting, with a few twists, in emerging dollar bond markets.

Macro Surprises. Sustained US mid-year demand is supporting the global recovery. On balance, weaker European and Chinese growth does not seem to be enough to offset US strength yet. But the difference between US conditions and those abroad is growing more stark. Japanese industrial schedules are falling back toward stagnation and Chinese surveys also show a slowing of manufacturing growth. In Europe, the impact of falling exports seems contained by a solid domestic expansion.

US demand seems to holding up based on a still-ebullient small business sector, one that has the most to gain from corporate tax cuts. Solid job gains and slowly rising wages are supporting consumption and postponing any deep dip in car sales. But higher rates, grudgingly passed through into mortgage rates, are crimping home buying. For the moment, I see signs of a renewed, and necessarily short, inventory build as delivery bottlenecks, the threat of random tariffs, and even the expected impacts of hurricane Florence all lead producers to keep running production lines. We shall see how long that supply surge holds up.

A moderating and maturing expansion does not seem to have slowed inflation. Prices are rising most clearly in Europe and Japan, where currencies have fallen against the dollar. Reciprocally, price gains eased off slightly in the US. As Chairman Powell pointed out, we do not really know what the "neutral rate" for Fed policy is, but we do know that it rises with reported inflation. Hence the increasing emphasis in Fed presentations on the need for interest rates above 3.0%, at least for a time. As always I think the truer route to finding appropriate policy comes from looking at ebullient asset prices.

Lastly, default risk is rising, most strikingly on dollar bonds of emerging market borrowers. Indian and Chinese company risk is rising with spotty but surprising default experiences. And higher US rates are triggering sudden re-structuring of carry trades, including one out of Hong Kong dollar funding into US dollar money markets. The system is creaking.

Little has happened to shift my view that the process of raising US and other key country rates will be felt most sharply in bond markets. So far, most bond investors have calculated that any substantial rate hikes would withdraw support for our fragile and debt-ladened recovery, aborting it. Rate hikes can only be brief and cannot get very far.

In fact, global growth did pause at the end of an inventory and trade adjustment at the start of the new year. That served to buttress the views of those who saw limited room for rate hikes. But the world economy has not yet entered a broad new slowing phase. So, higher inflation and more certain central bank tightening are becoming more likely–up to the point where tightening produces a credit crunch and demand shock somewhere across the system. The big puzzle for investors remains whether that shock will come in a series of sharp but contained market sell-offs, in emerging markets for example, or in a generalized one, like the nightmare of 2008.

We are now several months into a sharp but contained emerging market sell-off. The bond value at stake may not be big enough to trigger a global credit event, however. So the interesting question is: when will a similar crunch eventually turn up in the vastly larger US corporate bond market, as rates keep rising and today's fast growth slows down. I say we are tuning up for the bigger game to come.