Gyrating Markets

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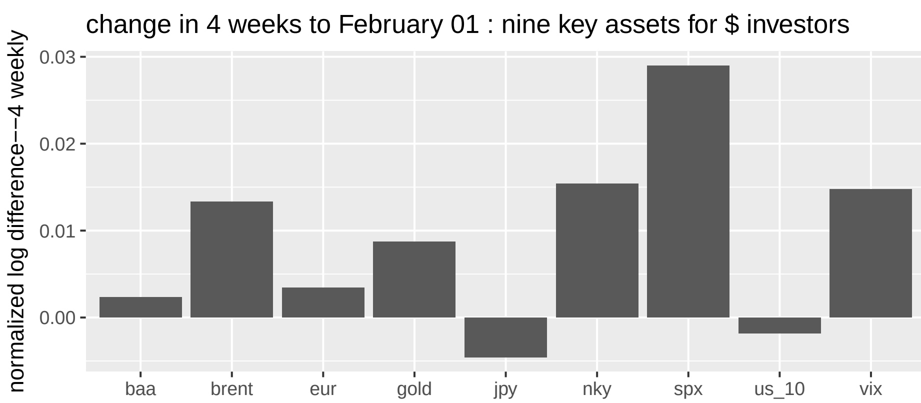
Markets have snapped back from their panic of December. Oil, stocks, and even corporate bonds all bounced back from what now looks like an excess of self-reinforcing pessimism among thin trading ranks during late December.

Suddenly, tighter policies looked to be off the table as long as asset prices remain so vulnerable. In relief, equities, bond yields and risky assets more broadly all regained most of the ground they covered in December.

Most importantly, we learned how these markets, valued richly at super-low discount factors, are subject to big swings on small twitches in macro news.



Market views have traversed an enormous range of potential outcomes over the two month since my last report. To some degree the swings in market values were severe enough to hamper real-world spending decisions.

Meanwhile, oil prices are up again after Saudi Arabia cut production, making room for rising US production. Earlier, the impression of excess supply and slower global demand growth had suggested weaker oil prices.

Lastly, emerging markets are partly decoupled from the macro swings in the center. A big rally in Venezuelan bonds is underway as the endgame for the Maduro regime comes into view. The gains are not systematic for Emerging Markets: India's currency fell hard on worries about populist policies ahead of upcoming elections.

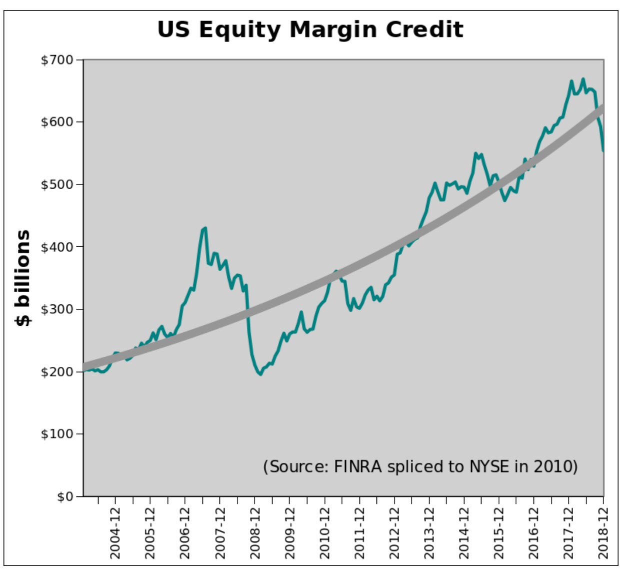
Micro Leverage and Deleverage. By now we have some tracking on investor positioning during recent market gyrations. At the time the news flow was thin, neither slowing growth nor the unique risks posed by US protectionism and heedless fiscal policy, nor the impression of a European political economy unable to operate effectively, nor slowing growth in China were new. But somehow the accumulation of risks suddenly triggered substantial position changes.

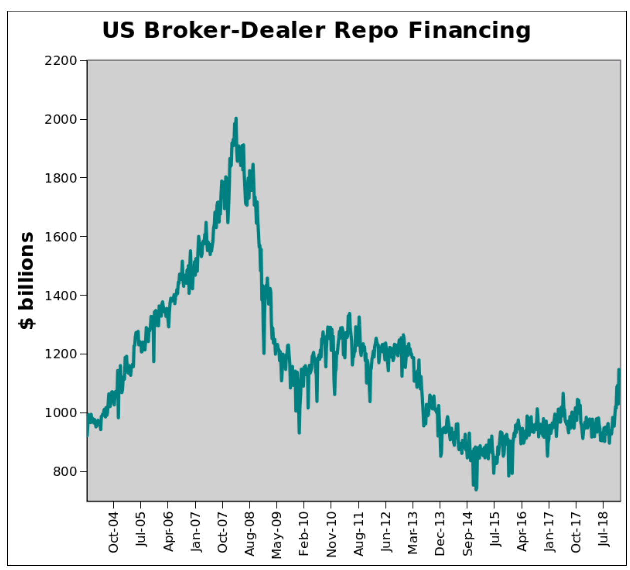
Admittedly, December is always a time of lightly manned trading desks, which could have amplified a panic among junior traders and robots. Whoever was trading, asset prices are a matter of confidence as expressed through investor balance sheets. December's panic can be seen in the rapid drop in margin credit used by equity investors, as reported by the stock exchanges. Allowing for a rising trend, the drop around that trend was sharper than in 2015 and about half the scale of 2008. Investors in US equities sharply reduced their borrowing to hold equity positions. (Chart below, left.)

Meanwhile, other measures of leverage, including that of broker-dears actually went up. Broker-dealers use repurchase transactions to borrow against their bond collateral, to finance their risk-taking and trading inventory. These bond-based deals were used to finance Lehman Brothers and others before they collapsed. Since then repo bond financing has steadily slipped as financial institution risk-taking fell under regulatory pressure. But broker-dealers *increased* their leverage in December, presumably to buy government bonds that seemed likely to rise in value if stocks kept falling. And bond prices did rise, possibly rather more than we would otherwise expect. (Chart below, right.)

On balance, it looks like a localized panic in equities led over-borrowed investors to sell suddenly, either out of caution or on the demand of creditors who saw dwindling collateral value. But this was hardly a generalized deleveraging across markets like we saw in 2008. One proof is that the losses were concentrated in US equities, while bond-related leverage rose at the same time.

Since then both extreme moves have been partly reversed, as we can see in preliminary Japanese investment flows in January (not shown), and market price action. We may have no evidence of a general deleveraging process, but we have clearly stumbled into a time of sudden sharp moves in positioning by the best-informed and centrally placed traders in the system.





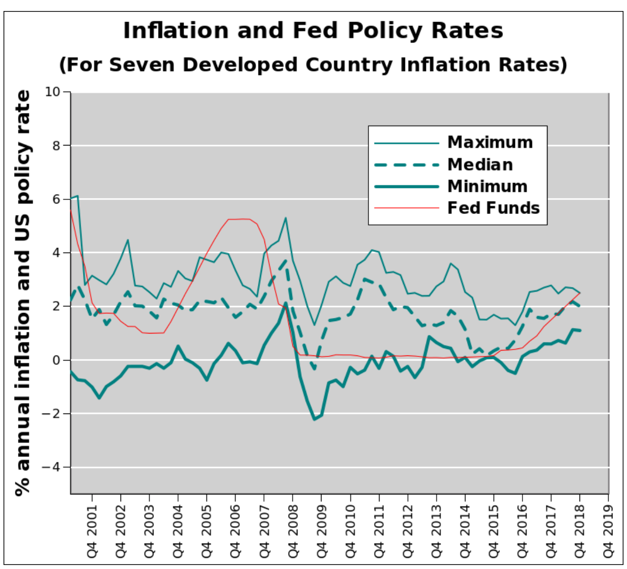
Policy Excess and Macro Leverage. Why are professional traders so jumpy? It could be because of flaws in central bank policy. Central banks have tied themselves to an inflation-targeting framework that is inadequate for our times.

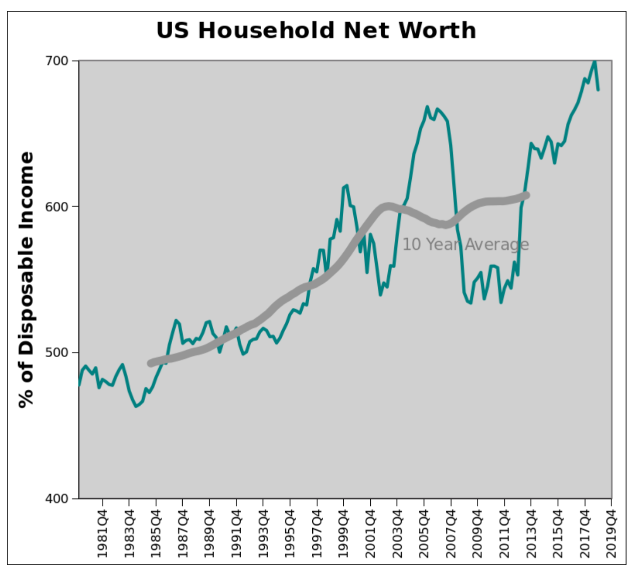
Just glance at the pattern of developed country inflation rates (I took seven leading OECD nations with long inflation histories.) The range of outcomes is collapsing to around a very stable 2% inflation, and the picture is even more striking if you include the big developing nations that are mainly converging on a somewhat higher but historically very low rate of inflation. We live in a world of broad trade that undercuts systematic inflation where ever you look. The same goods are available everywhere, and their prices move with sectoral accidents, not national conditions. And these sectoral accidents are, most of the time, broadly offsetting. (See Chart below, left.)

Under these conditions, Fed and other central bank interest rates may actually have become more effective in influencing currencies and asset values than in moving inflation. From time to time we have inflation deviations, as in 2015 when a great policy error was made as US rate hikes were delayed in face of what was mistaken to be a evidence of a structural decline in global inflation. In fact, OPEC overproduction and an economic collapse in China at that time were the probable and temporary shared global sources of lower inflation. Holding off on rate hikes at the time, delaying the important strategic goal of normalizing credit conditions, created the conditions for a subsequent, and now troublesome, lunge upward in asset values.

While overworking their misguided inflation mandate central banks, particularly the Fed, have under-reacted to asset price cycles. Even a quick look at the cycles in US household net worth show the destabilizing asset price cycles quite clearly. What had been relative stability in this useful aggregate measure of household asset values, including houses and equity, has turned into increasingly big swings that can disrupt economic well-being when they break. (See Chart below, right.)

In the end, the biggest trouble ahead is probably not coming from a new visit to debt-deflation, no matter what traders may have briefly feared in December. Rather, the biggest risk we face involves fixed income markets where easy credit at very low rates held down for too long has expanded credit widely to borrowers, some of whom are almost certainly going to turn out to be deadbeats. I expect correction of this bond excess is where we should look for a great wave of macro, economy-wide, deleverage by final investors.





Macro Surprises. What have been the macro surprises since December? Europe and China are slowing, while US payrolls point to a solid economy at least through January. An inventory jolt was expected to slow offshore growth more than in the US, where a fiscal shock had some yet to be determined effect on demand. Now the question will be whether assorted political risks and the volatility of assets prices themselves can disturb investment planning enough to derail an expected recovery from a shallow downturn.

Surprisingly strong US jobs gains for December point to solid income gains that should sustain the expansion against accidents. Some of these new jobs may have reflected precautionary hiring by employers, finally waking up to incipient worker scarcity. But hiring could slow from here if demand subsides, hurt in housing by higher interest rates and in other investment by the structural instability of a world without US-Chinese trade integration. Taking a mass of federal employees off the payroll on a whim must have impacted their spending to some degree, as well.

European production indicators have turned down hard. With the end of inventory refilling in the US, European exports and export orders fell. This is happening as jobs remain available, unemployment is falling, and incomes rising–all of which should support consumer spending. But a deeper malaise for different populist reasons in Italy, France, and the UK might pull down continent-wide activity if investment planners face a sense of uncontrolled political dysfunction. We already see hints of this result as German capital goods orders, particularly to the rest of Europe, have falling sharply.

In China, output is falling too. The adjustment started with lower exports, followed by a collapse in materials imports. Lower consumption in saturated car and cell-phone markets have added to the weakness. A managed cycle of credit tightening, encouraging credit defaults with the aim of sharpening future credit decisions adds to the recessionary pressure now as we see reports of rising default rates and credit cut-offs. As fast as the downdraft developed, policies came back with infrastructure spending, tax cuts, and reductions in bank reserve ratios. We will wait to see if this will be enough to pull out of the downturn promptly.

Central banks that belatedly positioned themselves for tightening are now back-pedaling or at least insisting they are not locked into their tightening programs. Casting about for easier policies without reversing a long-set decision to stop bond buying in 2019, Draghi talks of a longer wait until the first rate hike, and even the possibility of renewed bond buying again if needed. US policy, too, will probably skip at least the once-expected March hike and the June one is also in doubt now. All these proposals should buttress investor sentiment by showing that monetary policy can still react to a real recession, if needed.

What next for our hyper-active macro-traders? Most recent news suggests slower growth into the new year. As we have mentioned before, a gradual slow-down in global growth as a massive US fiscal expansion passes through the system remains the most likely case. So the news is primed to improve on the other side of recent inventory and trade disappointments. But to be sure we need confirmation that economies are indeed pulling out of their current downswing.

As always, I insist that the key anomaly and great danger in global markets today lies in the wave of outstanding corporate bonds issued during a decade of quantitative ease. I remain fixed on the idea that a disruption here will yield the greatest risk of macro-scale deleveraging. And that will come either through shockingly higher interest rates (now postponed) or through a surge in default risk at the edges of corporate credit (in case of a deepening downturn.) Either way, stay nimble and happy hunting.