The Telegraph

Fading Trump rally threatened by rare contraction of US credit

Making America Great Again?

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Credit strategists are increasingly disturbed by a sudden and rare contraction of US bank lending, fearing a synchronised slowdown in the US and China this year that could catch euphoric markets badly off guard.

One key measure of US corporate borrowing is falling at the fastest rate since the onset of the Lehman Brothers crisis. Money supply growth in the US has also slowed markedly. These monetary and credit signals tend to be leading indicators for the real economy.

Data from the US Federal Reserve shows that the $2 trillion market for commercial and industrial loans peaked in December. The sector has weakened abruptly as lenders tighten credit, especially for non-residential property. Over the last three months it has dropped at a rate of 5.4pc on annual basis, a pace of decline not seen since December 2008.

The deterioration in the broader $9 trillion market for loans and leases has been less dramatic but it too is shrinking, falling at a 1.6pc rate on a three-month basis. “Corporate lending has ground to a halt and I am staggered that the Fed is raising rates. They have made a very big mistake,” said Patrick Perret-Green from AdMacro.

Credit experts at several big US banks have issued warnings over recent days, albeit *sotto voce*. "We've been surprised how little attention the slowdown in US bank lending has garnered," said Matt King, global credit strategist at Citigroup.

While they are not yet alarmed, their concerns are worth heeding. Credit has tended to pick up signs of trouble several weeks before equity markets in recent episodes of financial stress.

"Without another big dose of momentum, the cracks in the global reflationary consensus are liable to grow bigger. All around, existing trends are being called into question," he said.

Net corporate bond issuance has also stalled, indicating that borrowing by US firms as a whole is in decline. "So much for a Trump-driven expansion. Beneath the surface, we think a seismic battle is taking place," he said.

Elga Bartsch and Chetan Ahya from Morgan Stanley said the credit squeeze is a warning sign and needs watching closely. "On our estimates, the credit impulse turned negative at the end of 2016. We have not seen such a sharp deceleration in bank lending to US corporates since the Great Financial Crisis," they said.

"Historically, credit downturns have led recessions. The plunge could reignite concerns that a highly leveraged US corporate sector may react strongly to even limited interest rates increases," they said.

Monetary tightening in the US so far this cycle has been equal to 13 rate rises under the Fed's Wu-Xia model, which includes the effects of withdrawing stimulus from quantitative easing. Nobody knows where the pain threshold lies in a global financial system that is more leveraged than at any time in history, including Fed officials themselves.

A study by the International Monetary Fund of 122 recessions in rich economies since 1960 shows that these slumps are typically preceded by a slowdown in credit starting to four to five quarters earlier.

Morgan Stanley said there may be less to worry about this time since the M1 money supply is more or less holding up. This indicator has "reliably contracted" before eight of America's post-war recessions.

Yet the M1 data is far from healthy. Simon Ward from Henderson Global Investors said his early warning indicator - real six-month M1 money - turned negative in February. It has ticked up a little in March but not enough to prevent what would normally be an economic relapse later this year.

He expects a slowdown lasting two quarters or so that may rattle the unprepared, but it should stop short of a US recession and will not necessarily derail the current global expansion. Even so, investors cannot count on the perennial Fed 'put' to rescue Wall Street this time. "It's going to be tougher this year. Labour markets are tighter and central banks are in a more hawkish mood," he said.

The growth rate of broad M3 money and 'Divisia M4' tracked by specialists tell a similar tale. Both have been sliding in fits and starts for months. This is creeping into measures of economic output. The Atlanta Fed's instant gauge of GDP growth for the first quarter has dropped from 3pc at the start of the year to just 1pc.

The latest Markit PMI survey of US business was the weakest in six months. New job creation in the service sector was the worst in three years. “The US economy is struggling to sustain momentum," said Chris Williamson from IHS Markit.

Money and credit are certainly not flashing warnings of an imminent crisis, but they are hard to square with the exuberant view of investors that the world is on the cusp of an accelerating economic boom.

That boom may already have peaked. The massive stimulus injected by the global authorities last year to counter the Chinese currency scare and any fall-out from Brexit is by now fading, and it is too early to tell whether business will pick up the baton.

Any soft patch could all too easily combine with a slowdown in China as the country taps the brakes after an extreme episode of fiscal pump-priming in 2016. Regulators are clamping down on property speculation and trying to rein in forms of pyramid lending, causing a sharp rise in Shibor lending rates.

The worry in China is a maturity mismatch. Huge sums have been borrowed on the short-term markets. These debts have to be rolled over constantly to cover long-term liabilities. It was this sort of mismatch that brought down Northern Rock and Lehman Brothers.

"Liquidity tightening increases the tail risk of a China hard landing. In a nutshell, many of those who participate in financial speculation in various asset markets have leveraged up through shadow banking and are now at high risk of defaulting," said Nomura.

Weak US indicators are clearly at odds with the Trump rally on Wall Street, which has pushed equity valuations to nose-bleed levels.

Kevin Gaynor from Nomura says his model of asset pricing suggests markets are in effect assuming global growth of 5pc and earnings increases of 30pc a year. These are heroic. "There is a time decay on this new temporary equilibrium," he notes acidly.

What is so disturbing is that each extra dollar of new debt now generates just $0.17 of extra GDP in the US, down from around $0.75 in the 1960s. Much of the corporate debt built up in this cycle has been to buy back stock or pay dividends.

Analysts say US companies may be holding back on investment until they have more clarity on Donald Trump’s tax policies. The stock markets are ignoring this - or looking beyond it - betting on a pent-up spring-board effect as soon as the right signal comes from Washington.

But the longer the delay goes on, the greater the risk that any economic slowdown will start to feed on itself. Nor is there any guarantee that the White House and Capitol Hill will in fact deliver the fiscal stimulus and tax cuts expected this year, or at least not on the scale originally suggested by Mr Trump. Goldman Sachs has rolled back its expectations drastically.

Deficit spending is anathema to the Tea Party in Congress. The defeat of President Trump last week on the American Health Care Act is a foretaste of what may lie ahead.

The battles over spending are likely to be bitter, and they go beyond the usual problem of gridlock on Capitol Hill. What is taking place is an ideological struggle over the future shape of the United States.

Mr Trump effectively snatched the Republic Party in a hostile takeover last year. He has not built a governing coalition in Washington, or even tried to do so. His efforts are going into 'draining the swamp'. This elemental failing is making itself painfully evident.