

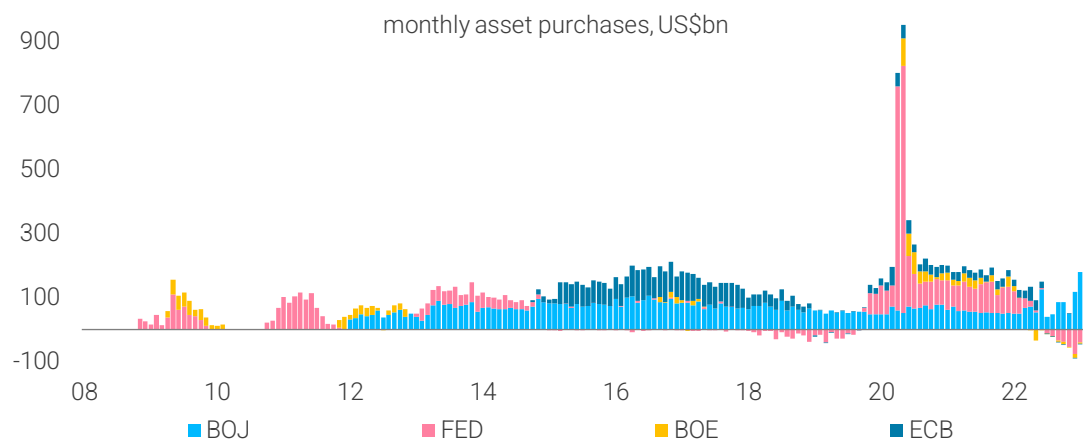


Macro Picture

THE BUMPY PATH OUT OF ZIRP

Dario Perkins

After a decade of ZIRP, the path to higher interest rates was always going to be bumpy. Even if recent ruptures in global markets trigger a mild recession and a short-term retracement in monetary policy, they will not be sufficient to kill the new secular bear market in bonds. US banks, commercial property and global USD lenders are the main areas of vulnerability.

Chart 1: Finding it hard to kick the QE habit?

Source: TS Lombard estimates, Fed, ECB, BoE, BoJ

BREAKING POINT

Monetary tightening has started to break things, especially in sectors that previously benefited from a decade of zero interest rates (ZIRP) and regulatory diversion. By focusing on the resilience of the large systemic banks after 2008, policymakers ignored vulnerabilities in other areas of finance – such as smaller banks, private capital, commercial real estate and global dollar lending.

BANKING CRISIS

The tensions in global banking provide the most immediate threat to the world economy. Tighter lending standards would amplify the impact of monetary policy, curbing the supply of credit to SMEs. While commercial real estate is particularly exposed, that sector's macro footprint looks relatively modest – particularly compared with the residential property boom of the early 2000s.

POLICY WHIPSAW

Central banks have become a source of macro volatility and must now find a way to manage their immediate trade-off between high inflation and financial instability. With the path out of ZIRP proving bumpy, market narratives have swung back to recession risk and disinflation. But this current episode of financial stress will not derail the longer-term bear market in bonds.

THE BUMPY PATH OUT OF ZIRP

With central banks raising interest rates aggressively, investors have been on the lookout for things that would “break”, in either the world economy or – more likely – global markets. While UK pension funds were arguably the first victims of this latest round of monetary tightening, there is no doubt that the stress in global banking poses the more serious threat to the trajectory of the world economy. Investors and policymakers who were around during the global financial crisis are no doubt experiencing a distinct sense of déjà vu, with a series of banks falling like dominoes, leading to a number of hastily arranged bailouts and M&As. Realistically, however, any similarities to what happened in 2008 are largely superficial. Not only have policymakers greatly enhanced the resilience of the large, systemically important banks since then, but they have also developed a much better understanding of the risks these institutions pose. Today, the real vulnerability in global markets is to be found not in a rerun of what happened in 2008 but rather in policymakers’ continued efforts to fight the last war. In focusing on the systemically important banks, the authorities missed – and perhaps actively encouraged – new dangers to emerge. The obvious weaknesses are in the areas that benefited from regulatory diversion after 2008, particularly if they had business models geared towards permazero interest rates. Smaller banks, private capital markets, commercial property and global dollar lending are the logical trouble spots.

While a (systemic) 2008-style crisis is unlikely, the current episode of stress in global banking certainly has the potential to amplify the impact of tight monetary policy by restricting the flow of credit to the real economy. Small US banks are particularly vulnerable to this dynamic, with the combination of high-profile bank failures and increasing pressure on deposit rates set to deliver a sharp deterioration in banks’ funding conditions. Small and regional banks are not large lenders in aggregate, but they are especially important for local SMEs. Over the past decade, banks – both in the US and elsewhere – have built up considerable exposure to commercial real estate (CRE). Going forward, the banking-CRE nexus is perhaps the most important vulnerability in the global financial system, having the potential to cause both significant damage to banks’ balance sheets and substantial losses in the international property sector. We would not rule out a repeat of what happened during the S&L crisis during the 1980s and the early 1990s, when the US suffered multiple years of poor bank profitability and repeated bank failures. The good news, however, is that commercial property does not have a large macro footprint. Unlike the residential property boom in the 2000s, the buoyancy of CRE failed to generate an obvious construction boom, which means we are unlikely to see large-scale job losses associated with the sector.

Central banks face an immediate trade-off between safeguarding financial stability and continuing their battle with inflation. While the stress in the banking system is deflationary, it will curb inflation in a way that is both uncontrolled and intractable, risking unnecessary hardship. There are various estimates for what this credit squeeze means for “effective” interest rates, but the reality is that such an exercise is guesswork and central banks no longer have a firm idea about the true “tightness” of policy. To regain control of the disinflationary process, the authorities must restore calm to the banking sector – even if that means, counterintuitively, targeted asset purchases, bailouts and, potentially, rate cuts. The Bank of England’s intervention last autumn provides the template. The BoE patched up the UK financial sector and maintained its monetary squeeze, but it never reverted to its previous levels of hawkishness. The only question is whether a pause in monetary policy will be sufficient to calm the stress in global banking or whether central banks will need to actively reduce interest rates in order to offset the squeeze in credit conditions. We suspect that caught between their PTSD from 2008 and their fears of repeating the mistakes of the 1970s, the authorities will choose to preserve financial stability. The path away from ZIRP was always going to be bumpy, and central banks have themselves become a source of volatility over the past three years. But a mild recession – which is the risk – would provide only a short reprieve for the secular bear market in bonds.

1. BREAKING POINT

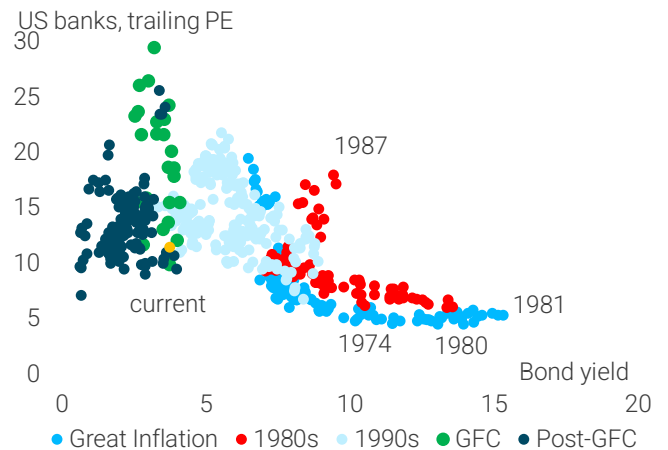
Central banks have been raising interest rates aggressively for just over a year. During that period – the fastest and broadest monetary tightening episode in history – investors have been anxiously waiting for something to “break”, either in the world economy or, more likely, in global markets. Everybody knew the authorities have a habit of “breaking things”, especially when they focus on lagging macro indicators like jobs and inflation. In the minds of most, the only question was where these problems would appear first. Would it be in real estate, private equity, US tech or perhaps some hidden leverage in [various other COVID bubbles \(including cryptocurrencies, NFTs and meme stocks\)](#)? And the thing that has broken is the one thing investors typically overlooked – global banking. Investors ignored this risk because, after what happened in 2008, stringent new regulations should have prevented another serious accident in that part of the system. So, what went wrong? What does this mean for central banks as they try to battle inflation at multi-decade highs? And is the world now headed back to zero rates and perma QE?

Chart 2: Bank stocks plunged during “crisis”



Source: Datastream, TS Lombard

Chart 3: Bank valuations vs interest rates

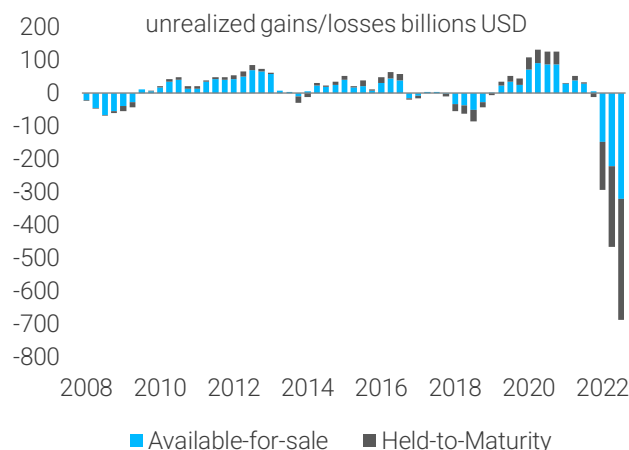


Source: Datastream, TS Lombard

Another canary snuffs it

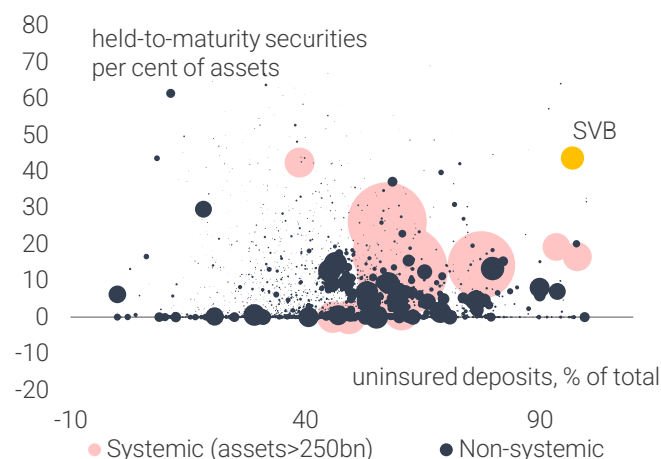
Hindsight is a wonderful thing, but it now seems alarmingly obvious that [financial contagion would start at a bank in Silicon Valley](#). Closely tied to the tech boom of the last decade and especially leveraged to the idea of permazero interest rates, Silicon Valley Bank (SVB) – and several of its peers – were acutely susceptible to US monetary tightening. Tech companies in the region had flooded the bank with large (uninsured) deposits, which the institution placed in long-dated US Treasuries and MBS, as it sought to eke out yield differentials. Higher interest rates provided a double hit to their business model, killing the profitability of their customers and simultaneously undermining SVB’s capital position. Usually, of course, it does not matter if banks make losses on their holdings of government bonds – particularly if they can hold them to maturity. But when SVB customers started withdrawing their funds en masse, [egged on by social media and coordinated through WhatsApp](#), the bank was forced to realize those losses, creating an explosive feedback loop of bank runs and fires sales. This dynamic is as old as banking itself.

Chart 4: The US banking chart that caused a storm



Source: FDIC, TS Lombard

Chart 5: Silicon Valley Bank was unusual

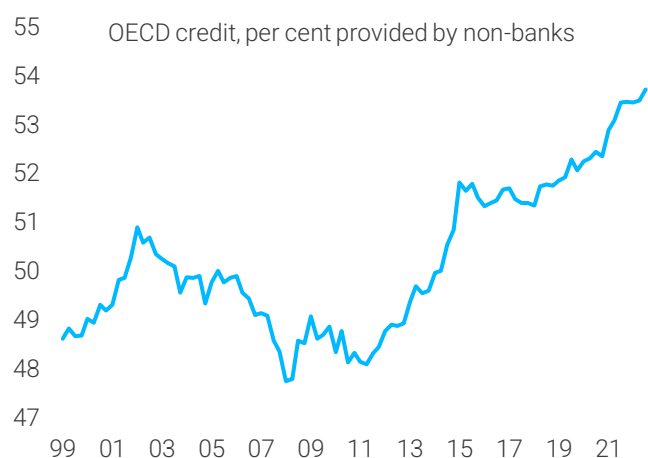


Source: The Economist

Broader problem in banks

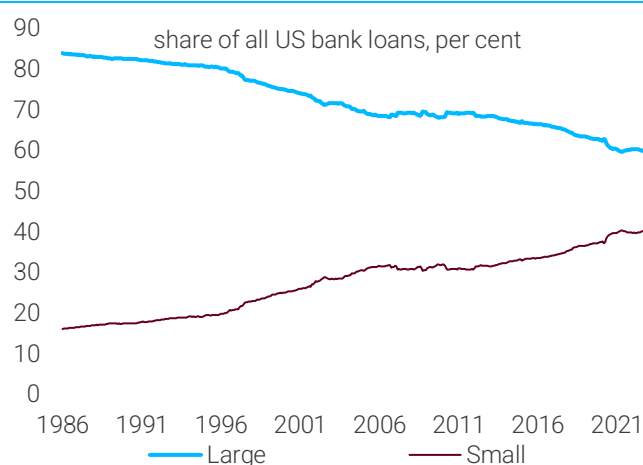
While SVB and its peers were uniquely exposed to COVID bubbles, this latest calamity has highlighted a broader problem in global banking – duration/interest rate risk. Analysts everywhere are now scrambling to calculate the interest-rate exposure of other institutions, with some eye-catching (but flawed) estimates already doing the rounds. In aggregate, of course, the banking sector has built up significant holdings of government bonds over the past decade, in large part because that is what the regulators wanted them to do. These securities were supposed to be safe, particularly in an environment where inflation was expected to remain low. But as some timely academic research has shown, the banking sector's exposure to “duration risk” is more complicated than just the value of the bonds it is holding. These institutions have also written fixed-rate mortgages, which means their profits gets squeezed when interest rates rise. Policymakers who took comfort from the idea that a rising share of fixed-rate mortgages would protect homeowners from rapidly rising borrowing costs (avoiding a GFC-style dynamic) forgot to consider who was ultimately on the hook for this shift in the structure of the mortgage market.

Chart 6: Credit migrated out of global banking



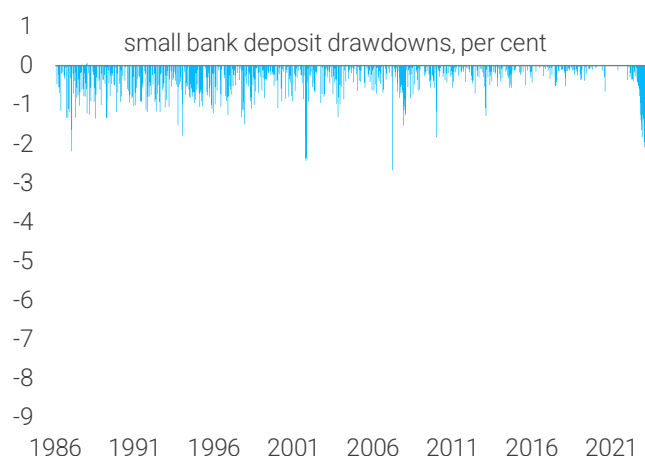
Source: BIS, TS Lombard

Chart 7: Another example of regulatory diversion

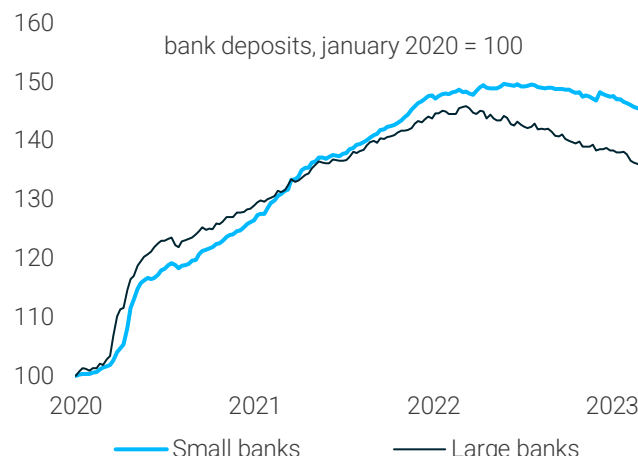


Source: Federal Reserve, TS Lombard

With unrealized losses and costlier mortgage books, banks need to find ways to protect their margins, which usually means squeezing their depositors. So, they must try to keep deposit rates low, at least until their business models and balance sheets have adjusted to higher interest rates (note: higher interest rates are not a problem per se). In the current environment, this is proving difficult: not only have rates moved unusually quickly, but yield curves are deeply inverted (making maturity transformation costly) and depositors are starting to seek attractive returns elsewhere. Even if the largest banks, which tend to have stickier deposits, can protect their margins, many smaller banks will not find it easy to do so. The SVB failure has amplified this danger in the US by encouraging smaller depositors to move their funds into larger banks. While SVB had a particularly nasty combination of large uninsured depositors and unrealized losses (Chart 5), it is by no means the only bank – in the US or elsewhere – that is vulnerable to sudden shifts in market sentiment. What started as a “run” on SVB rapidly became a loss of confidence in global banking. Even some of the largest banks in Europe experienced sustained market pressure, despite tougher regulatory rules and a clear penchant for interest-rate hedging.

Chart 8: Historically rapid deposit flight in the US


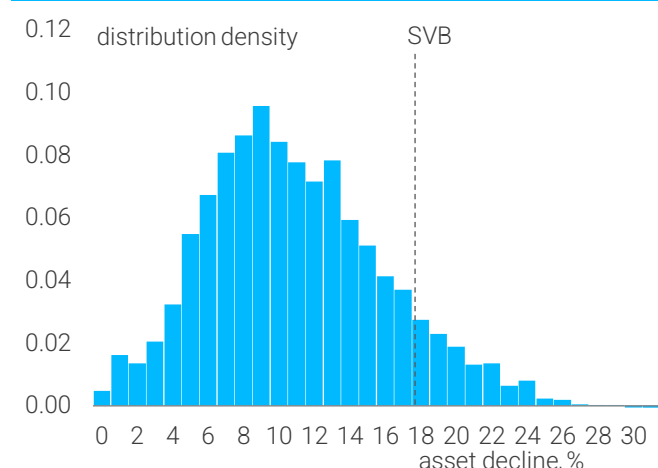
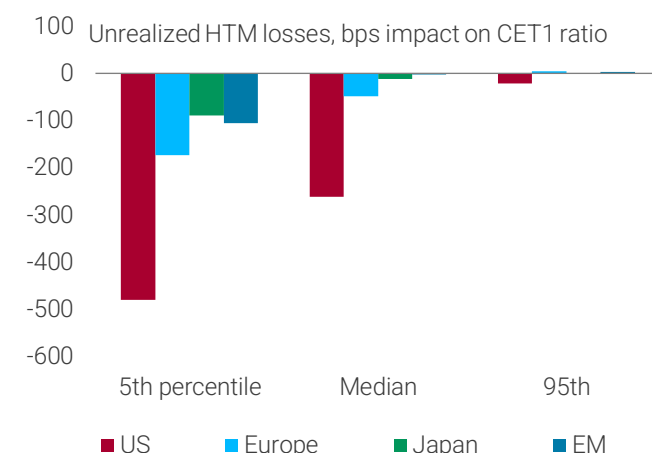
Source: Federal Reserve, TS Lombard

Chart 9: Deposits still much higher than in 2019


Source: Federal Reserve, TS Lombard

2008 is not the template

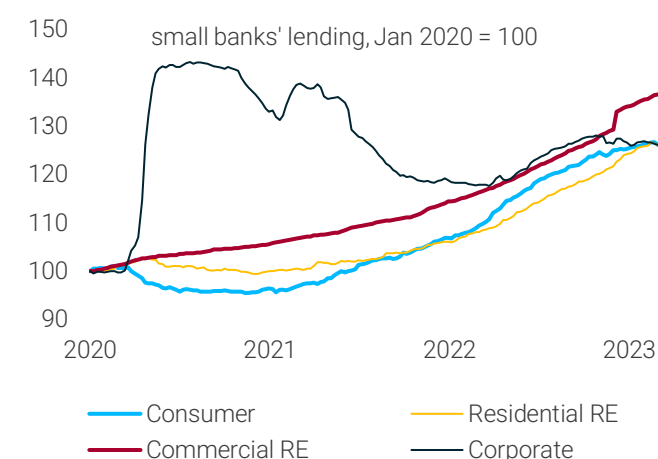
While the UK pension funds were the first victims of this latest round of monetary tightening, suffering a short-lived crisis last autumn, the recent stress in global banking is certainly the more serious event in terms of its potential impact on growth and inflation. As we discovered during the financial crisis, banks are critical infrastructure for the smooth functioning of the economy. For this reason, it is not surprising that the turmoil of the past few weeks has caused uncomfortable flashbacks to what happened in 2008, with widespread fears of a “domino effect” that could lead to multiple bank failures and a massive contraction in credit. Hasty bailouts and M&A have only added to the sense of déjà vu. For the most part, however, the similarities between now and 2008 are superficial. Back then, the authorities had no real understanding of the links between financial markets and the real economy and held an extremely naïve view about the dangers posed by systemically important institutions. Central banks were run by academics, using models that ignored the role of banks and credit markets. The situation today is different: not only are policymakers acutely aware of systemic risk, but they have also imposed strict regulations on the institutions that were at the heart of the turmoil 15 years ago.

Chart 10: Other US banks are vulnerable

Source: [Monetary Tightening and U.S. Bank Fragility in 2023](#)
Chart 11: Market losses leave banks exposed


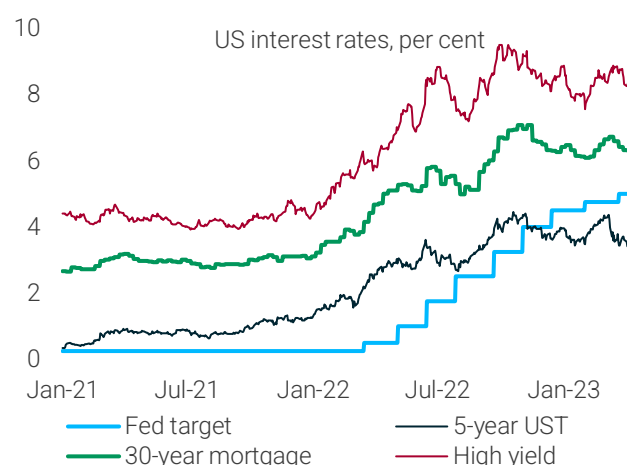
Source: IMF Global Financial Stability Report April 2023

New vulnerabilities

Today, the true vulnerabilities are in the areas that policymakers overlooked after 2008 – those parts of the system that have benefited from regulatory diversion, with business models overly geared to permazero interest rates. That was the real lesson from the failure of SVB and the link between what is happening now and the crisis UK pension funds experienced in the autumn ([which was the original canary in the coalmine](#)). Financial risk is inherently viral – it mutates to avoid government regulations. When US regulators focused on making the big banks safer, they made them less competitive, which is what pushed credit creation into the smaller banks. And with so much of the international regulatory effort concentrated on avoiding a repeat of the 2008 banking crisis, the authorities simply diverted global credit provision and systemic risk to new areas – the “non-banking sector”, which covers the interplay between capital markets and institutional investors ([The Buyside Bubble](#)). Sometimes, policymakers even worked at cross-purposes, encouraging investments tied to ZIRP while simultaneously trying to stoke inflation.

Chart 12: Small US banks during COVID era


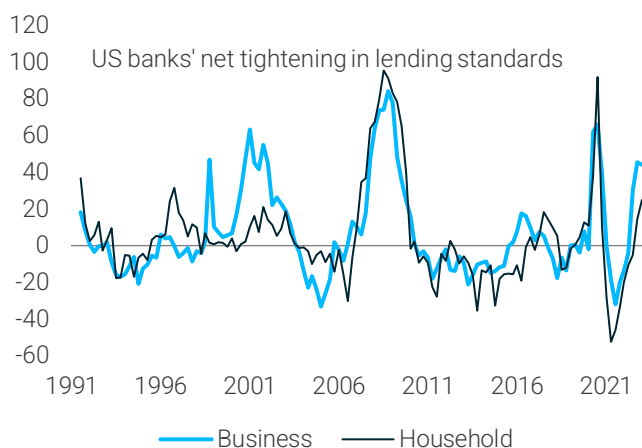
Source: Federal Reserve, TS Lombard

Chart 13: US interest-rate transmission


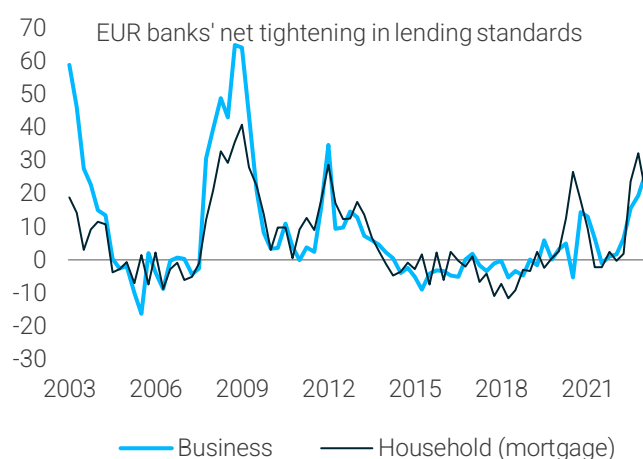
Source: Federal Reserve, TS Lombard

So, to be clear, the risk we face today is not a rerun of what happened in 2008. It is a more subtle threat – an acute sensitivity to higher interest rates, particularly in the parts of the financial

system that did not play a central role 15 years ago (such as small US banks, private capital provision, commercial property and certain cross-border US dollar lending activities, particularly among those banks that have taken over from Europe in the provision of global “eurodollar” credit). While the risks to the global economy are relatively modest, certainly compared with what happened 15 years ago, these vulnerabilities are significant enough to shift the trajectory of monetary policy and global GDP. In the current environment, we are paying particularly close attention to the nexus between banking and CRE, which is the likeliest source of financial pain as the world tries to make the adjustment to higher interest rates.

Chart 14: US credit tightening


Source: Federal Reserve, TS Lombard

Chart 15: Euro-area credit tightening


Source: ECB, TS Lombard

2. BANKING CRISIS

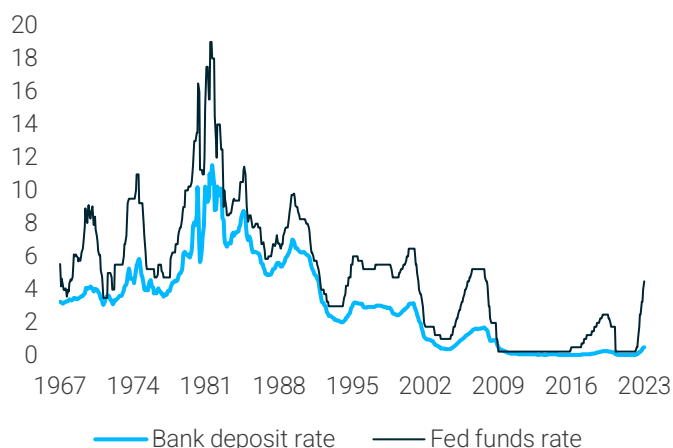
Even without a systemic banking crisis, the current episode of financial stress could still have a material impact on the outlook. Banks everywhere will be looking to tighten their lending standards, which could amplify the monetary squeeze. Longer term, however, the bigger threat to the banking system is on the asset side of its balance sheets, particularly where banks have accumulated significant exposure to commercial real estate. CRE prices have already started to decline and default rates are set to rise, particularly in the traditional office sector, which has experienced a structural decline in occupancy levels following COVID-19. While the macro footprint of commercial property is relatively modest, certainly compared with the residential boom of the early 2000s, we could still see significant financial losses within the sector itself, with blowback to the investors – banks and non-banks – that funded the post-GFC boom. The likeliest scenario is a slow-burn, multi-year squeeze on bank profitability, with steadily souring asset portfolios, rather than another precipitous crash. The US could even experience a repeat of the S&L crisis, which triggered the failure of many small and regional banks in the 1980s and 1990s.

Tighter credit conditions

Banks were reporting a notable tightening in their lending standards even before the recent crisis – presumably because they were anticipating an economic downturn. The events of the past month are set to accelerate that trend. Though it is difficult to monitor lending standards in real time, smaller US banks are likely to have been particularly aggressive in restricting their provision of credit to the real economy. Chart 8 shows that smaller US lenders have suffered significant

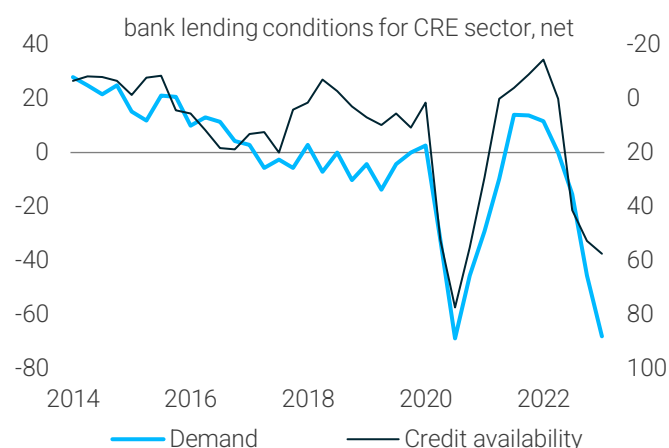
deposit losses, which means a deterioration in their profitability (net interest margins) – since they will ultimately have to find new (costlier) sources of funding. Yet these financing pressures are by no means specific to smaller banks. The larger US banks, too, have experienced notable deposit outflows, primarily because their deposit holders are now seeking higher returns in other financial instruments, such as money market funds, which can deposit their cash at the Fed's Overnight Reverse Repo Facility (ON RRP), at a significantly higher interest rate. To stem these outflows, US banks will have no choice but to offer higher interest rates to depositors. Similar pressures are emerging in Europe, although it is harder to move money out of EU banks.

Chart 16: Banks trying to fleece depositors



Source: Federal Reserve, TS Lombard

Chart 17: CRE lending standards now tighter



Source: Federal Reserve, TS Lombard

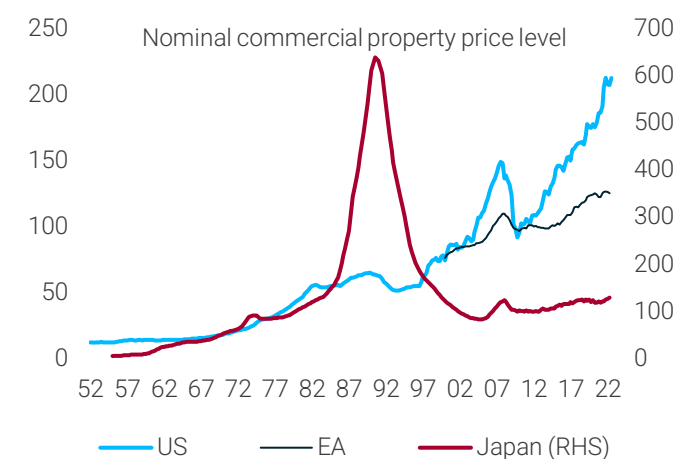
Impact on the economy

It is difficult to assess the precise impact of credit tightening on the real economy. Much will depend on the behaviour of the large US banks, which have not suffered the same level of stress as their smaller peers. Still, even a banking crisis centred on smaller banks could have repercussions for SMEs, which, in turn, would undoubtedly have an impact on overall business investment and employment. Chart 6 shows smaller US banks have been responsible for much of the lending that has taken place over the past decade, gaining market share at the expense of their larger counterparts. The good news, however, is that these smaller banks have concentrated their lending activities in CRE, a sector that has a surprisingly modest macro footprint – especially compared with lending to the much larger *residential* property sector. While commercial property prices have surged over the past decade, there has not been a commensurate boom in construction activity or employment. Chart 23, which plots US non-residential investment in structures (i.e., buildings), shows no obvious (economy-wide) misallocation of resources towards the sector, which is an important contrast with the systemic boom-bust cycle in residential property of the early 2000s. A CRE bust could have limited spillovers. To put it bluntly, the main impact of lending to CRE has been to inflate the wealth of investors in that sector – another example of a bubble primarily focused on asset valuations rather than the real economy.

Risks to commercial real estate

Even if the macro fallout from CRE is “contained” (the use a word that has unfortunate connotations with the early phase of the subprime crash), we could still see significant losses in the sector – which is bad news for lenders. Rising vacancy rates will reduce revenues in the

sector, while borrowers will need to refinance their existing debts at higher interest rates (Chart 22). Of course, we are talking here about a risk that most investors are now fully aware of. REITs prices have already fallen dramatically; and in recent weeks, there has been a bull market in sellside research warning about the dangers in CRE. But since this sector is the likeliest catalyst for further banking stress, it is worth reciting the potential “macro-prudential” vulnerabilities in the sector. And for this endeavour, we can draw on some [comprehensive analysis from the IMF](#), which recently made CRE one of its top risks to global financial stability.

Chart 18: Commercial property bubble?


Source: BIS, TS Lombard

Chart 19: Germany particularly vulnerable?

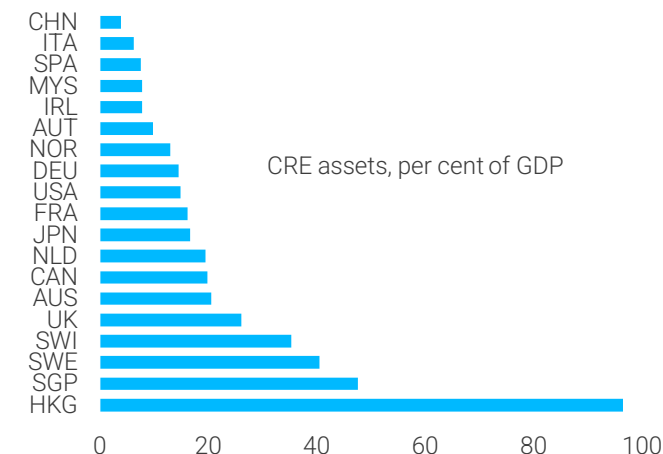

Source: BIS, TS Lombard

The IMF outlines three main financial vulnerabilities associated with commercial property:

- (i) **Banking solvency channel:** Banks are exposed to credit risk through their CRE loans, as well as to credit and market risks through their commercial mortgage-backed security holdings. A downturn in the CRE market worsens the credit quality of borrowers by affecting the strength of their income streams and balance sheets. In the event of borrower default or a large drop in commercial mortgage-backed security prices, banks incur losses and their capital positions are weakened, which may prompt them to reduce the credit supply.
- (ii) **Collateral channel:** Commercial property is an important form of collateral for nonfinancial corporations to obtain credit from financial institutions. A decline in the value of this collateral during a CRE downturn is likely to limit their borrowing, curtail their investment and generally dampen economic activity. At the same time, the collateral channel could reinforce the bank solvency channel because a drop in collateral values would increase the loan-to-value ratios of existing CRE loans, which in turn raises the value of banks' risk-weighted assets and reduces their regulatory capital ratios (banks would have to raise their loss provisions for CRE).
- (iii) **Doom-loops in the 'non-banks':** CRE debt and equity investments by nonbank financial institutions such as insurers, pension funds and investment funds constitute another channel that affects financial stability. If CRE prices decline, investors see the value of assets held by them fall and they are less willing or able to provide new financing (insurers, for example, are subject to regulatory solvency constraints). In addition, investment funds may face redemption pressure from end investors following a drop in performance, which may lead to fire sales of CRE

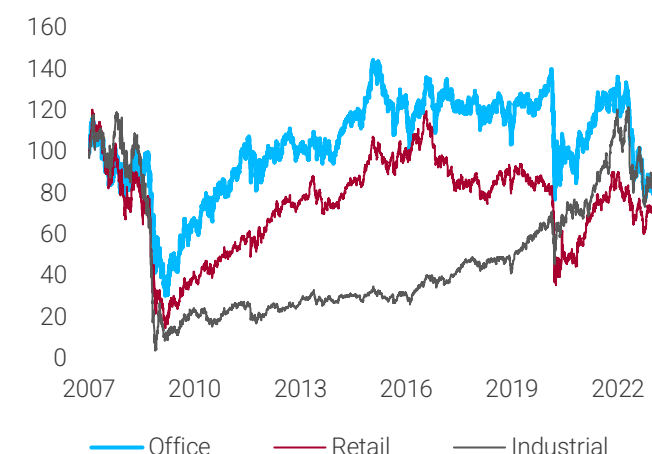
assets. Given the high illiquidity of CRE and the large maturity mismatch of property investment funds, the impact on prices, in turn, could be significant. According to the ESRB, 70 percent of the total assets of EU real estate investment funds are illiquid.

Chart 20: International CRE exposure



Source: IMF Global Financial Stability Report 2021

Chart 21: US REITs down significantly

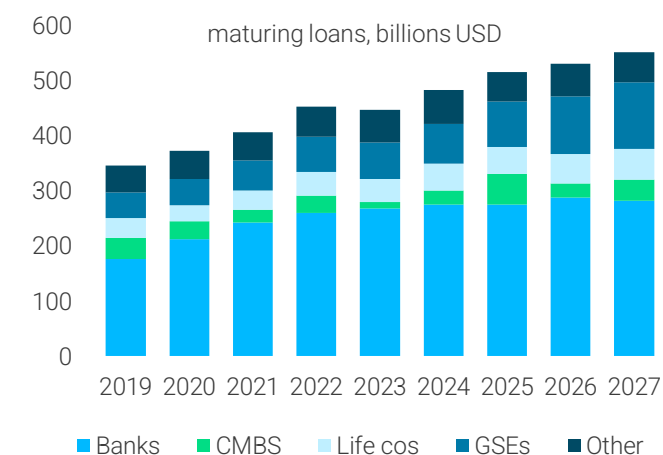


Source: Bloomberg

Slow-burn muddle-through

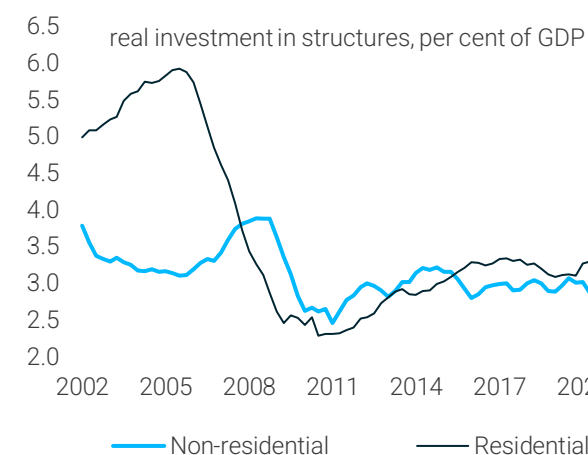
How is this all likely to play out? Obviously, it will be important to monitor these risks closely in the months ahead, particularly if a genuine recessionary dynamic takes hold. But since policymakers are acutely aware of the threats, we suspect the likeliest scenario is a sort of slow-burn (muddle-through) doom loop between deteriorating bank profitability and large losses in specific parts of CRE. Banks are likely to restrict lending to the sector, which will amplify the decline in property prices, which, in turn, will feed back into bank balance sheets (leading to a further tightening in credit conditions). It is important to bear in mind, however, that we are talking mainly about vulnerabilities in specific parts of CRE, namely traditional office blocks and retail malls, especially older buildings in unfavourable locations. And even if asset values were to decline significantly, this would follow a decade of appreciation. Significant net equity in the sector could still prevent a major spike in default rates, even at higher interest rates. Moreover LTV ratios have been conservative in recent years, well below historical norms.

Chart 22: US CRE refinancing needs

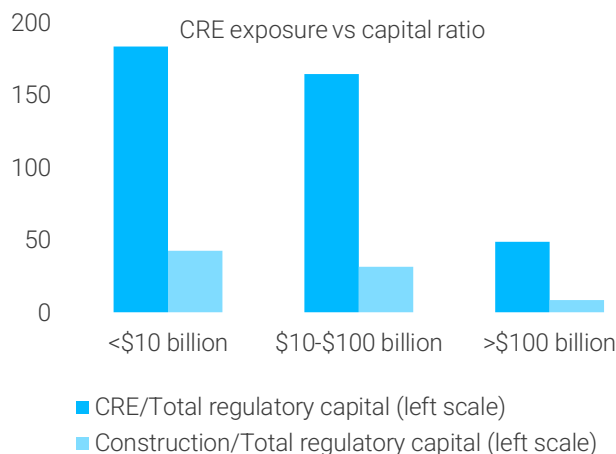


Source: Morgan Stanley via ZeroHedge

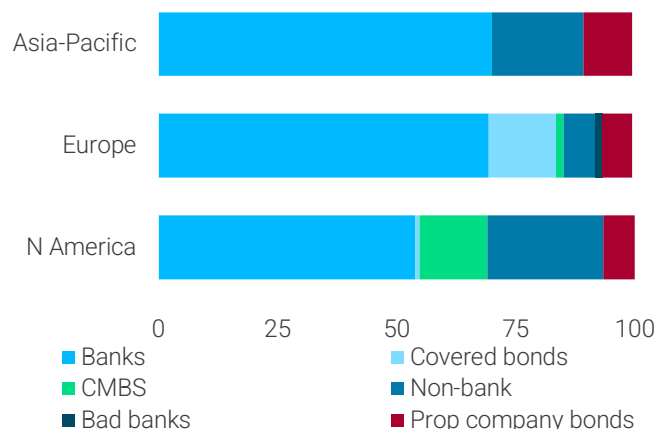
Chart 23: No subprime misallocation of resources



Source: BEA, TS Lombard

Chart 24: Small US banks particularly exposed


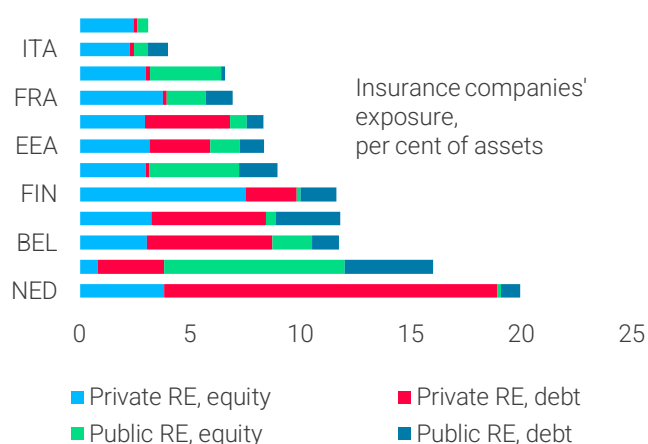
Source: IMF Global Financial Stability Report 2021

Chart 25: CRE exposures by financing type


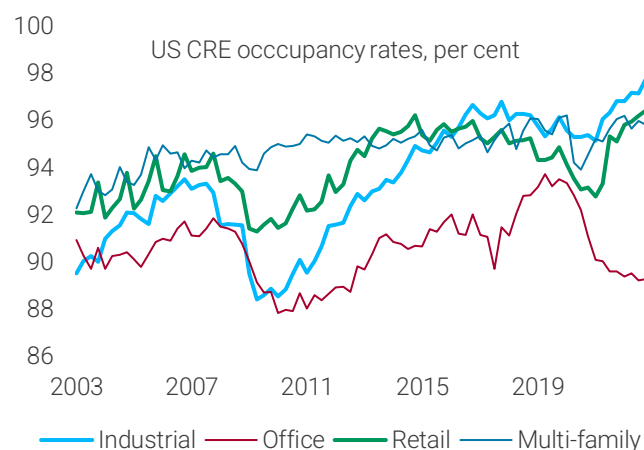
Source: IMF Global Financial Stability Report 2021

The S&L crisis redux

The closest historical precedent is not a repeat of the precipitous global banking collapse that happened in 2008 but rather the more gradual Savings and Loans (S&L) crisis that occurred in the US during the late 1980s and 1990s. Indeed, the pressures banks face today are eerily similar to those of 40 years ago, particularly in the US, where the problems are concentrated among smaller regional institutions. The S&L crisis included the failure of more than 1,000 savings and loans associations (around a third of the total) between 1986 and 1995. These were institutions that, like banks, accepted deposits and made mortgage, car and other personal loans to individual members, usually in their local communities (in the UK, we call these building societies). As Chart 28 shows, the number of bank failures during this period was higher than in any since the advent of federal deposit insurance, with a total cost to US taxpayers that exceeded US\$160bn.

Chart 26: European insurance sector exposed


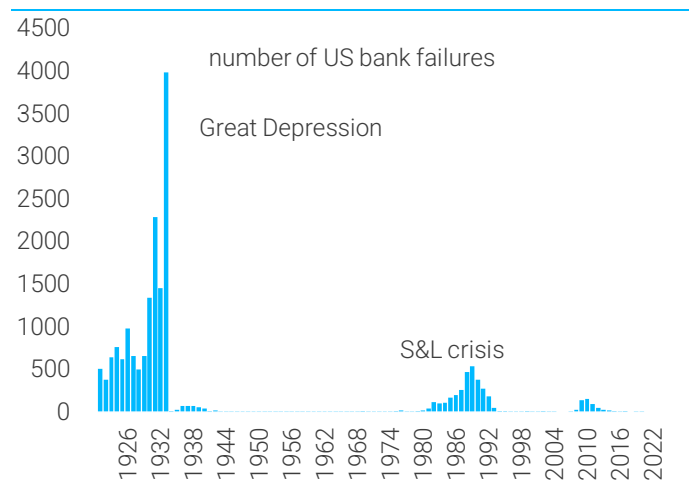
Source: IMF Global Financial Stability Report 2021

Chart 27: Office sector looks vulnerable


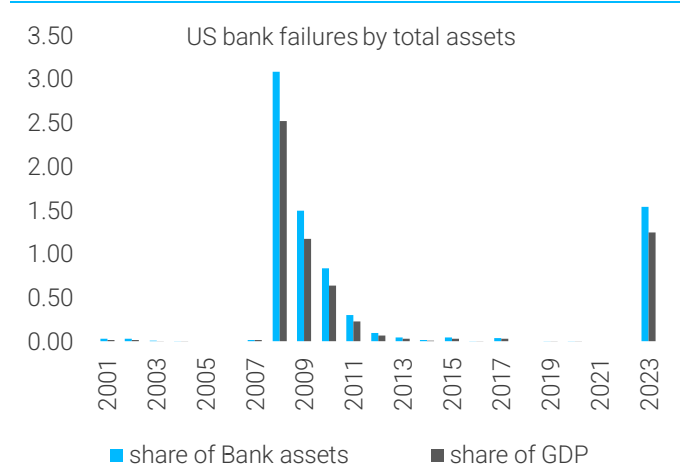
Source: Bloomberg, TS Lombard

While various regulatory failures contributed to the S&L crisis (including Regulation Q, which initially enforced caps on deposit rates), the underlying issue was that these institutions suffered massive losses due to duration risk, which crystalized as the Volcker Fed hiked interest rates aggressively. S&Ls had issued long-term loans at fixed interest rates that were lower than the

newly mandated interest rate at which they could borrow. As their own borrowing costs increased, the S&Ls could not attract adequate capital from deposits or the savings accounts of their members. Attempts to attract more deposits by offering higher interest rates only compounded their profitability problem, further squeezing net interest margins. The end result was that a huge number of these institutions became insolvent. Chart 30, shows that the pressure on the S&Ls came into two waves, first an immediate hit to their balance sheets as a result of higher interest rates – which is arguably what many banks are facing today – and then a longer slow-burn deterioration as a result of NPLs and souring asset values (particularly for CRE in states exposed to energy prices and agriculture). Regulatory forbearance, which allowed many insolvent thrifts to remain open and even engage in riskier activities in a futile attempt to goose their profitability, only delayed and ultimately magnified these problems.

Chart 28: US bank failures


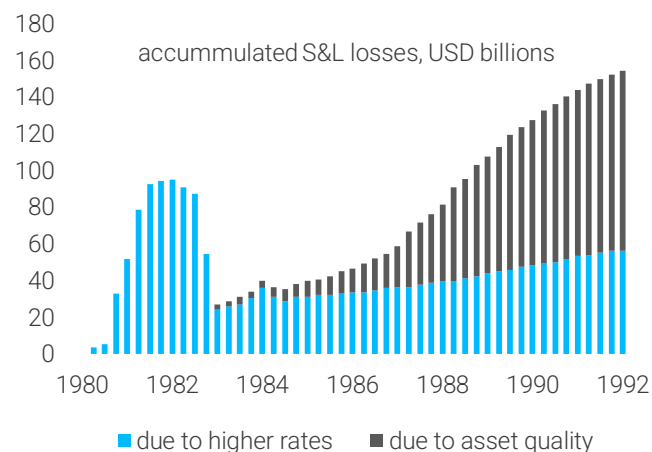
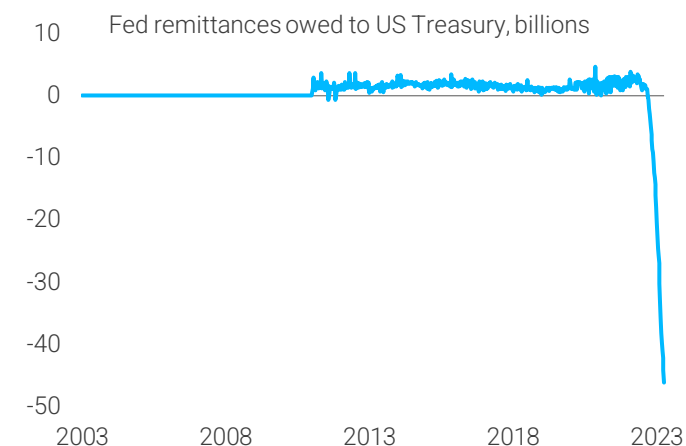
Source: FRED, FDIC

Chart 29: Recent failures in context


Source: FRED, FDIC, TS Lombard

3. POLICY WHIPSAW

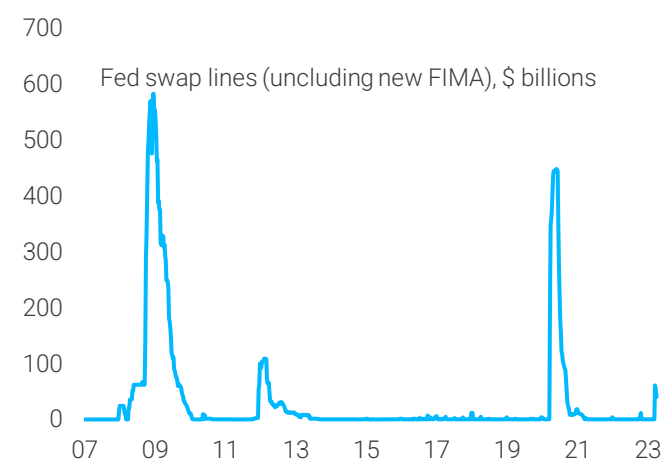
The current problems in global banking and CRE are symptomatic of the sorts of financial risks that have built up over the past decade, the result of regulatory diversion and the widespread expectation of permazero interest rates. There are likely to be similar vulnerabilities in other – perhaps more opaque – areas of the global financial system, including the international eurodollar markets. And rising financial risk presents a dilemma for policymakers, who must try to manage an emerging (short-term) trade-off between inflation and financial stability. Central banks are caught between their PTSD from what happened in 2008 and their desire not to repeat the mistakes of the 1970s. The Bank of England's response to its pension fund crisis last autumn provides the template for how the authorities are likely to respond to this dilemma. Central banks will have no choice but to support financial stability in order to maintain their grip on monetary conditions, which is their only hope for delivering a gradual and orderly disinflation process. Otherwise, they will inflict unnecessary hardship on the real economy. The risk is that monetary policy has already become a source of macro volatility and that central banks could soon get whipsawed in the opposite direction, with an (unnecessary) recession that forces them to actively reverse course. Ultimately, however, we do not think the world is headed back to ZIRP.

Chart 30: Two waves of S&L crisis

Source: [Ely and Company](#)
Chart 31: Fed making unrealized losses, too


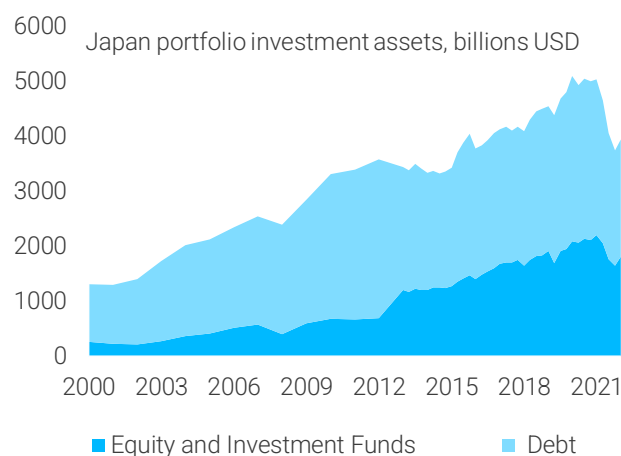
Source: FRED, TS Lombard

Other latent duration risks

SVB's biggest problem was the combination of maturity mismatch, flighty depositors and unrealized losses on long duration assets – a dynamic that could soon play out in global banking more generally. The bank had a business model geared towards zero interest rates. We are seeing similar issues in CRE, as higher interest rates compound structural problems and create a dangerous nexus between CRE borrowers and banks. But after a decade of zero interest rates and endless QE, it is likely that there are other financial activities that are vulnerable to similar dynamics, particularly if we are moving into a world of structurally higher interest rates. The eurodollar market – i.e., global, dollar-based credit provision – is a prime contender. Back in 2008, the sudden evaporation of dollar liquidity triggered one of the most acute phases of the banking crisis. European banks, in particular, suddenly lost access to dollar funding, which forced a massive uncontrolled retrenchment in their balance sheets. This is one of the main reasons why world trade collapsed, since European banks played a central role in trade finance. The good news is that post-2008 regulation has forced Europe's banks to curb their eurodollar activities, reducing this vulnerability. The bad news is that other lenders stepped in.

Chart 32: Global dollar strains?


Source: Federal Reserve, TS Lombard

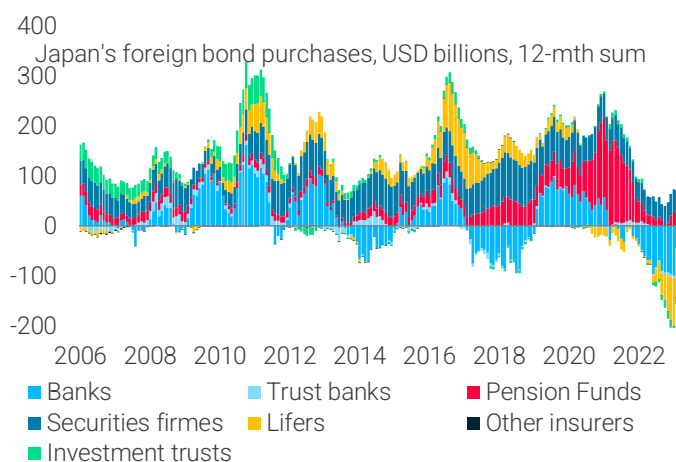
Chart 33: Japan's large foreign investments


Source: IMF Global Financial Stability Report April 2023

Japanese Lehman?

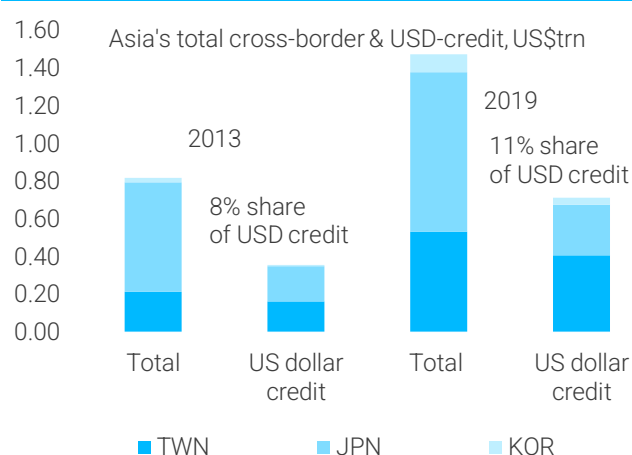
While European banks have reduced their dollar lending exposures over the past 15 years, Japanese banks have expanded their activities in the eurodollar markets ([Aldasoro, Ehlers and Eren, 2018](#)). Japan's banks did this, in large part, to [accommodate the BoJ's massive QE programme](#), selling domestic government bonds to the central bank and using the proceeds to purchase higher-yielding US agency debt, Treasuries, euro-area government bonds and US corporate paper. While these activities are less dangerous than what the Europeans were doing in the early 2000s – when Europe's largest banks were buying asset-back securities that would eventually turn toxic and illiquid, and funding those positions in short-term money markets – they still leave lenders exposed to significant duration risk. As US interest rates rose, the holders of such securities will have accumulated significant losses on those assets. And there are other international lenders in a similar situation, including in the “non-bank” sector. [The entire eurodollar credit system has migrated into capital markets since 2008](#), with many large pensions funds and insurance companies (particularly in Asia) all involved in the same basic USD carry trade.

Chart 34: Japan's global carry trade



Source: IMF Global Financial Stability Report April 2023

Chart 35: Asia's USD carry trade



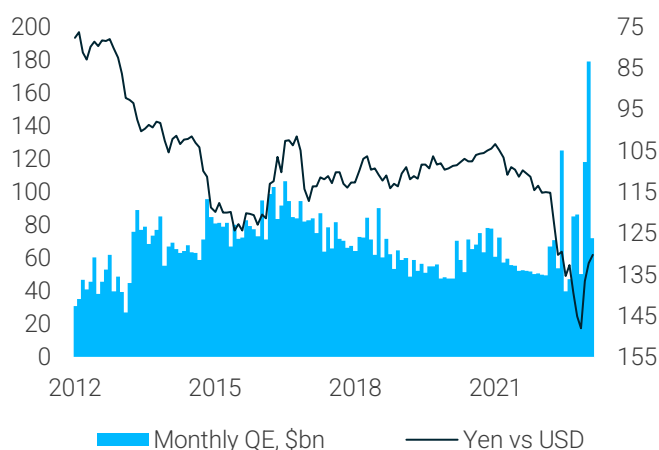
Source: IMF Global Financial Stability Report (2019)

Unlike SVB and its peers in domestic US banking, Japanese banks and global international investors do not need to worry about flighty depositors. But as losses have increased and hedging currency risk has become costlier, they have significantly curtailed their lending to the eurodollar system. This has eliminated an important bid for global fixed-income markets, but it has not led to the sort of asset “firesales” that could trigger a more dangerous dynamic. The Asian investors who purchased USD and euro securities seem willing to hold them to maturity. There is some concern, however, about what might happen when the BoJ ends its QE programme. Japan's inflation rate has increased markedly since the second half of 2022; and, with a new governor now installed (Ueda Kazuo), the end of QE could encourage Asian investors to pull back even more significantly from global markets. We suspect these concerns are overblown. Genuine monetary tightening still seems a long way off in Japan, and any decision to end QE is more likely to reflect dysfunction in the JGB market – a severe shortage of available securities for the BoJ to buy – rather than a realistic first step towards higher interest rates.

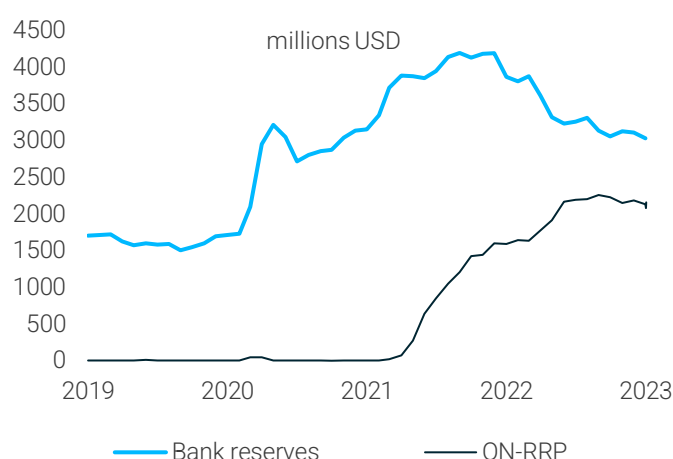
Strains in Fed swap lines?

While we do not expect a major incident in the eurodollar market, there have recently been some signs of renewed funding stress. The Federal Reserve even had to announce a new dollar funding facility, designed to plug some gaps in its existing network of swap lines. Worryingly, one counterparty has already maxed out its US\$60 billion allocation, [which has attracted a lot of attention among experts in the global dollar plumbing system](#). Unfortunately, we do not yet know

the source of this sudden demand for dollars. Large parts of the eurodollar system remain opaque, particularly where they involve borrowing from EMs and the developing economies. China's role in the eurodollar system is especially fuzzy, with large exposures often concealed from international datasets. Our [recent Global Financial Trends analysis](#), for example, found evidence that Japanese banks had been channelling dollars into China's property developers via the Cayman Islands. With China's housing market facing a severe structural downturn, this could be another area of vulnerability in the global financial system, especially if recent pressures in US money markets force Japanese banks to withdraw these funds. Worst case, we might even see a new "doom loop" emerge, this time between Chinese property developers and Japanese banks.

Chart 36: BoJ QE to defend yield cap


Source: BoJ, TS Lombard

Chart 37: MMF using ON-RRP instead of banks


Source: Federal Reserve, TS Lombard

The policy response

The various strains in the global financial system – especially the recent tensions in the banking sector – have created a difficult dilemma for central banks. With inflation staying high and significantly above their targets, the authorities were planning to continue tightening monetary policy. But now they have genuine doubts about whether higher interest rates are consistent with their other objectives, namely financial stability. In the end, of course, the tensions we are seeing in banking and property markets will help bring inflation down. Yet this could happen in a way that is largely intractable. Credit tightening will add to their monetary squeeze, raising effective interest rates, but the authorities have no way to calibrate and evaluate these effects. In reality, central banks are losing control of the disinflationary process – an obvious contrast with what they expected at the start of the year, when they hoped to reduce inflation in a gradual and controlled manner. Central bankers are control freaks, and this is not the outcome they wanted. A banking squeeze would bring inflation down faster, but with unnecessary collateral damage.

The BoE template

The authorities will not be able to re-establish their grip on the disinflationary process unless they can ease the current stress in the banking sector. The BoE, which faced its own mini financial crisis last autumn, provides the template. In order to keep monetary policy tight, the bank was forced to expand its balance sheet, albeit temporarily, in order to prevent a "run" on UK pension funds, which have been caught out with a business model that erroneously assumed permazero interest rates. In order to provide this support, BoE officials tried to distinguish between their efforts to safeguard financial stability and their monetary actions designed to curb inflation. But, of course, this boundary between these policy objectives is somewhat artificial. And there is no doubt that the mini crisis ultimately changed the trajectory of UK monetary policy. The BoE, which had been extremely hawkish before the pension-fund drama, eventually adopted a more

measured and careful approach to monetary tightening. It ditched the hawkish rhetoric and even made a concerted effort to talk down market expectations for monetary policy, reducing its terminal rate. Since the strains in global banking could have a much bigger impact on the real economy than any crisis in pension funds, there is now an even stronger case for recalibrating monetary policy.

PTSD vs ghosts of the 1970s

The short-term trade-off between financial stability and inflation is obviously putting central bankers in a difficult position. They are fully aware of what happened in the 1970s, when central bankers were not sufficiently aggressive with monetary policy, allowing inflationary psychology to become entrenched. Back then, central bankers suffered from “fiscal dominance”, which meant there was pressure from governments to keep interest rates low. The authorities today have repeatedly stressed their desire to avoid the same mistakes. But perhaps we now have a case of “financial dominance”, with central banks caught between the ghosts of the 1970s and their Post Traumatic Stress Disorder (PTSD) from what happened in 2008. Given the banking crisis is much fresher in the minds of policymakers, we suspect this will end up as the dominant force. Unless the strains in the banking sector quickly disappear, central banks are going to ditch their hawkishness of the past 12 months. From now on, we should expect gradualism to reign – there is a good chance, in fact, that the tightening cycle that started in 2022 is now basically over.

Central bank whipsaw

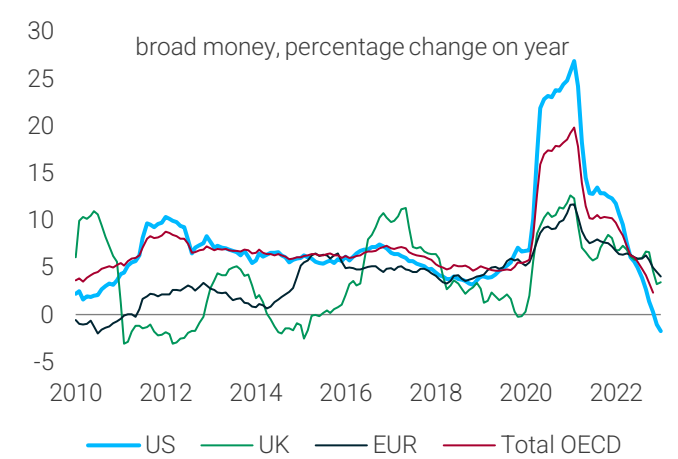
Looking forwards, the only question is whether a monetary pause will be sufficient to alleviate the pain in the banking system. If the recent tightening in credit conditions is substantial, it is possible that central banks may need to actively offset the damage to the real economy by cutting interest rates. The underlying issue is that monetary policy has become a source of macro volatility in recent years. By raising interest rates so aggressively, the authorities have amplified what was already a heavily distorted and artificial business cycle. Given the damage this has inflicted on the global banking system, it is possible they went too far and will now get whipsawed in the opposite direction, having to reverse some of their recent monetary tightening. It is important to point out, however, that there is an element of self-correction in this dynamic. Rather than because of bad debts or some deep underlying imbalance in the financial sector, the recent strains are mainly the result of interest rates rising too rapidly. A quick reversal in monetary policy would readily alleviate these problems, without the need for a long or deep balance-sheet recession.

Chart 38: Global ‘liquidity’ drying up



Source: Fed, ECB, BoJ, TS Lombard

Chart 39: Global monetary contraction



Source: Fed, ECB, BoJ, OECD, TS Lombard

Headed back to ZIRP?

Bond-market permabulls will argue that the current stress in the global financial system is a sign that the world cannot cope with higher interest rates, which means we are headed back to ZIRP and [a Japanese-style liquidity trap](#). We do not share this view – for several reasons. First, the next recession is likely to be relatively mild. As we explained in [a previous Macro Picture](#), fat profit margins and labour shortages curb the incentive to shed large numbers of jobs, while record unfilled vacancies give central banks the opportunity to significantly reduce labour demand without a big rise in unemployment. Second, private-sector balance sheets are in good shape, especially after a decade of deleveraging. Third, the COVID mini bubble has not caused a huge misallocation of resources, in contrast with previous – more traditional – economic cycles. And fourth, if a true recessionary dynamic breaks out, which would mean a contraction in employment, central banks would cut rates quickly to limit the economic fallout. Despite their claims to the contrary, central banks are not going to repeat what Volcker did in the early 1980s. Today there is [no political appetite for a sharp rise in unemployment](#), even with lingering inflation.

A final point to remember is that higher interest rates per se are not a problem for banks. The real issue is the speed of the adjustment after a long period in which interest rates were incredibly low and – more important – were expected to remain low for the foreseeable future. Banks face an immediate squeeze on their profitability, but over time they will be able to adjust to higher interest rates. The bonds they bought during ZIRP will expire, and they will replace them with higher yielding securities, while the loans they write will include higher interest rates. More generally, we do not accept the idea that “record global debt levels” have locked the world into a permazero interest-rate environment. Many DMs have reduced their private debt levels since 2009; and with nominal wages and profits growing at a faster pace, they can – over time – absorb higher borrowing costs. The path out of ZIRP was always going to be bumpy. Central banks probably made the adjustment even more difficult than it needed to be and may soon get whipsawed in the opposite direction, with an unnecessary recession that forces them to reverse their monetary tightening. But we are not headed back to ZIRP. Even with yields retracing, the secular bear market in bonds is set to remain the dominant financial trend of the 2020s.

Bottom line

The most rapid episode of monetary tightening in modern history has finally started to “break things”, just as many investors thought it would. After the mini crisis in UK pensions last autumn, higher interest rates are now also threatening the stability of the global banking system, which is potentially a much bigger deal for the real economy. It is no coincidence that the main vulnerabilities are appearing in areas that benefitted from regulatory diversion (small banks in the US, institutional investors elsewhere) and had business models leveraged on the idea of permazero interest rates. While there is not going to be a repeat of what happened in 2008, it does highlight the problems associated with the transition to secular higher interest rates. As far as the banks are concerned, the main risk is a doom loop between tighter credit conditions, weaker economic growth and continued asset deterioration – particularly where there are large exposures to CRE (again, smaller banks in the US could suffer most). But given generous liquidity support and the relatively modest macro footprint of CRE, we think this will play out as a slow-burn S&L-style crisis, which will allow policymakers to “muddle through”. In the meantime, however, tighter lending standards also have implications for monetary policy. Central banks must try to balance financial stability risks against their continued anxiety about inflation. This will deliver a more gradual approach to interest rates, with the authorities now inclined to put monetary policy on hold while they wait to assess the damage they have already caused. The risk is that, having overshot to the upside, the authorities will soon be cutting rates. The path out of ZIRP was never going to be easy, and monetary policy has now become a source of instability.