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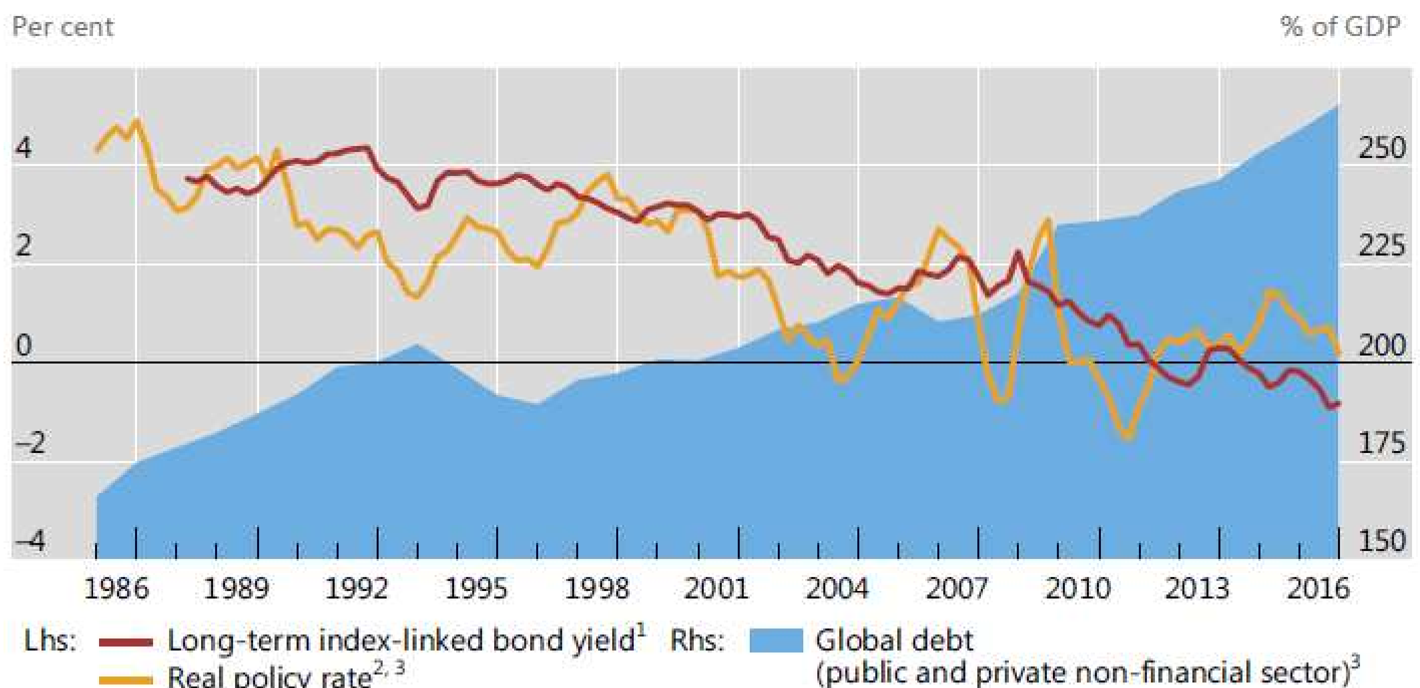
Executive Summary

- BIS working paper highlighted monetary authorities' asymmetrical policies that are "too timid" in leaning against financial booms but too aggressive and persistent in leaning against financial busts, thus giving rise to a debt trap
- Disinflationary effects of globalization induced persistent policy accommodation and encouraged leveraged risk-taking, and the ensuing systemic vulnerability to higher interest rates are at risk from protectionist trade policies
- Tariff-induced price pressure and rising federal deficits as a result of tax reform would exacerbate effects of global quantitative tightening (waning unconventional easing) and threaten the post-crisis "lower for longer" paradigm
- Heightened volatility as a result of higher bond yields would increase the likelihood of dovish Fed policy reactions, for both the U.S. and other advanced economies cannot tolerate higher interest rates under a policy-led debt trap

A debt trap fostered by asymmetric policy responses to globalization

In the working paper "Monetary Policy in the Grip of a Pincer Movement," Bank for International Settlements' Claudio Borio highlighted monetary authorities' asymmetrical policy responses under the macro backdrop of globalization-induced low inflation, a process which is fostering the rise of a debt trap to heighten systemic vulnerabilities.

Interest rates sink as debt soars: a debt trap? Graph 8



[1] From 1998, simple average of France, the United Kingdom and the United States; otherwise only the United Kingdom. [2] Nominal policy rate less consumer price inflation. [3] Aggregate based on weighted averages for G7 economies plus China based on rolling GDP and PPP exchange rates.

Source: Borio and Disyatat (2014), updated.

Borio first noted effects of globalization (which was echoed by Dallas Fed President Kaplan) exerting a structural headwind on inflation to loom over global central banks' policy reaction functions:

> "A likely candidate is globalization, particularly the entry into the trading system of former communist countries and many emerging market economies that liberalized their markets – countries that, in addition, tended to resist exchange rate appreciation. As argued and documented in more detail elsewhere, the entry and greater prominence of such producers are likely to have weakened the pricing power of firms and, above all, of labor, making markets more contestable."

Borio then argued that policymakers may have been "underestimating the influence of benign disinflationary forces" (such as globalization) and "overestimating the ability of monetary policy to fine-tune inflation" to try to bring inflation toward goal in the face of powerful headwinds. In doing so, monetary authorities may also have been underestimating the costs of policy easing on financial stability and inadvertently amplified the financial cycle.

In other words, central banks may have responded to structural trends rather than cyclical developments, and their easing bias also accrued significant costs in terms of financial stability:

> "The second factor is an asymmetrical policy response to successive financial and business cycles in a context of prevailing disinflationary tailwinds linked to globalization. In particular, asymmetrical responses were in evidence around the financial boom and bust of the 1980s – 90s and the one that surrounded the GFC. As long as inflation remained low and stable, there was no incentive for central banks to tighten policy during the financial booms that preceded financial strains in both cases. But there was a strong incentive to respond aggressively and persistently to fight the bust and stave off any deflation threat."

Hence, globalization's disinflationary effect combined with policymakers' easing bias have resulted in "policies that are too timid in leaning against financial booms, but then too aggressive and persistent in leaning against financial busts," which risks leaving authorities with no ammunition over successive financial business cycles, and the rising debt service burden also left the economy unable to withstand higher level of interest rates – a debt trap.

This is precisely the macro context behind the February flare-up in volatility, when higher long-term rates triggered a VaR shock, and the ensuing volatility spike weakened risk sentiment to threaten the myriad of "zombie" firms as well as malinvestments financed by institutional non-bank investors. *The debt trap has been sprung*, but that is not the end of the story.

Protectionist policies to exacerbate deficit-induced rise in bond yields

If the administration proceeds to pursue its protectionist trade policies (25% tariff on imported steel and 10% duty on imported aluminum), the rise in imported material costs as well as a weaker dollar (decline in dollar-denominated global trade, as well as weaker domestic growth) would likely boost goods inflation and buoy interest rates across the term structure. On a macro level, this would ease the aforementioned structural headwind on inflation.

The impact of trade policies would exacerbate effects of higher federal deficit as a result of tax-reform legislation, which led to higher Treasury issuance and pressure on both short and long-end of the Treasury curve (part of Treasury's decision to stabilize the weighted-average maturity, or WAM, of debt outstanding at or around current levels) – if the Treasury plans to issue more front-end paper, a stable WAM would demand higher long-end issuance as well.

These two factors complicated policymakers' desire to limit the upward rise in long-term bond yields (such as Fed's gradual balance sheet unwind and Treasury's capitulation on ultra-long issuance), for there is no mechanisms to "walk back" deficit and deficit-induced Treasury issuance (aside from the unpopular spending cuts), and broadly implemented trade tariffs would likely lift inflation expectations – a scenario which many institutional investors are unprepared against. Instead, low inflation and low long-term rates have been the consensus anchor behind the low volatility thesis.

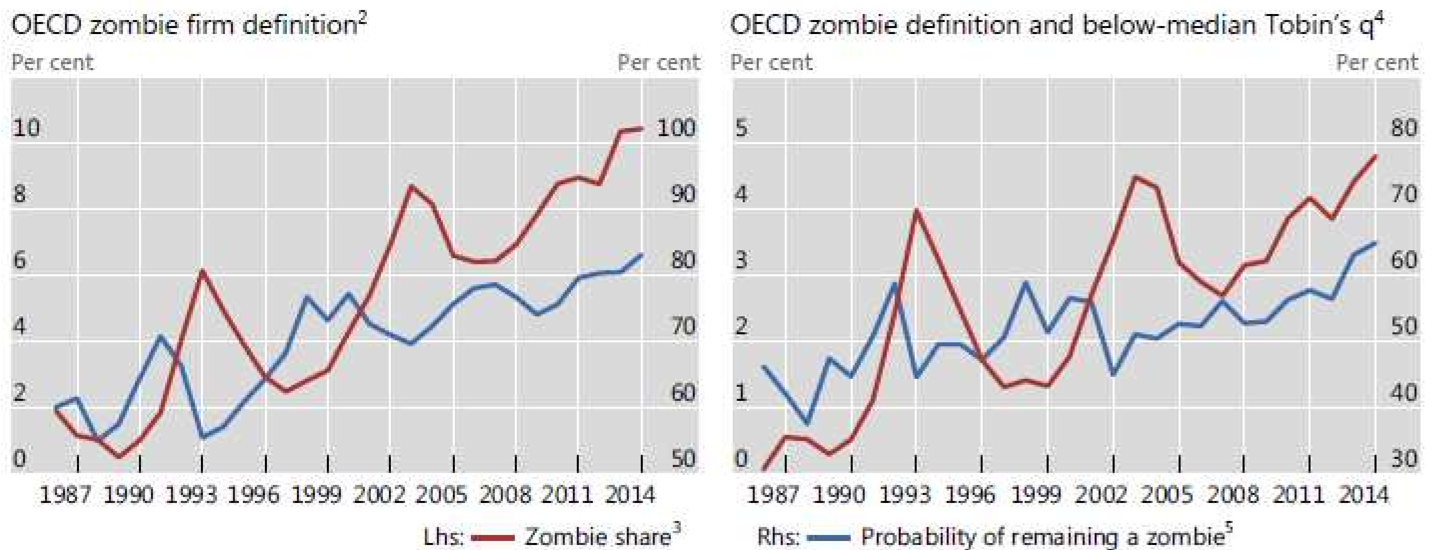
Additionally, looming exit of ECB's asset purchase program and shifting sentiments on the efficacy of QE, such as Bank of England's assessment that QE depressed long-term interest rates to fuel larger pension deficits, argues that support for extraordinary balance sheet expansions are on the wane. The end of the policy-induced term premia (and volatility) suppression will further exert upward pressure on bond yields to threaten a highly leveraged financial system.

Dovish policy outlook as a third order event of higher bond yields

Some market participants view prospects of higher inflation as bullish for stocks and expect the yield curve to flatten further, as Fed's likely desire to counter higher realized inflation would further lift near-term rate hike expectations. While this may hold true in a less leveraged market as well as economies without nearly a decade of policy-enabled malinvestments that thrive on "lower rates for longer," the present macro backdrop would argue otherwise.

The low volatility macro backdrop which fostered a debt trap has kept many vulnerable "zombie" companies afloat, with the corporate bond market (and yield-starved investors) acting as a life-line to the highly indebted entities:

Zombie firms on the rise and surviving for longer[1] Graph 4



[1] Sample includes listed non-financial firms in Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. [2] Zombie firm defined as a firm whose EBIT is below interest payments and is over 10 years old. [3] Ratio of the number of zombie firms to all listed firms. [4] Zombie firm defined as a firm whose EBIT is below interest payments, is over 10 years old and has below-median Tobin's q in its two-digit SIC sector in a given year. [5] Probability of a firm remaining a zombie in the following year, conditional on it being a zombie in the current year.

Source: Banerjee and Hofmann (2018).

Therefore, higher inflation triggering a sustained rise in bond yields across the term structure would induced a tertiary risk-off effect, as "zombie" firms begin to falter amid rising funding costs, which would also weaken investors' desire to "reach for yield" – the very same catalyst behind demand for lower quality, less liquid, and longer duration assets.

A sustained risk-off would then strengthen short-term Treasuries as investors expect policymakers to re-orient toward a more accommodative policy stance and arrest the tightening in financial conditions. Hence, the presence of a policy-induced debt trap implies that the bearish volatility thesis (which is associated with bullish risk-parity and bullish curve flattener expressions) is highly vulnerable to any developments that would shift financial markets away from the "low yields and low volatility for longer" regime.

In conclusion, a combination of protectionist policies and quantitative tightening posts a threat to the post-crisis low volatility status quo.

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