What Happens *to* The Party When The Music Stops

The risk to global asset and credit markets.

By Desmond Lachman

In late 2008, at a meeting with academics at the London School of Economics, Queen Elizabeth II famously asked why no one seemed to have anticipated the world's worst economic and financial market crisis in the postwar period. The so-called Great Economic Recession, which had begun in late 2008 and would run until mid-2009, was set off by the sudden bursting of the U.S. housing and credit market bubbles—something that in retrospect was obvious would happen but that, nevertheless, no one seemed to see coming.

It would seem that academic economists, along with most economic policymakers, are now making the same mistake by being too sanguine about the likely bursting of today's everything asset price and credit market bubbles. Their complacency is all the more difficult to understand considering the pervasiveness of these bubbles and today's record global debt levels. Their complacency is also all the more difficult to understand considering that long-term U.S. Treasury bond yields are already now rising sharply on fears that the massive Biden budget stimulus will give way to higher U.S. inflation.

A SHARP ECONOMIC REBOUND FROM THE COVID RECESSION

Among the reasons for complacency in academic and economic policy circles is the fact that the U.S. and global economies have snapped back very much better than expected from the depths of the Covid-19 economic recession. They have done so both as a result of a massive amount of fiscal and monetary policy stimulus. That latter monetary policy response flooded global markets with

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Easy Money

After the pandemic, most Latin American and African countries are now characterized by ballooning budget deficits and by record public debt-to-GDP ratios. Yet despite having highly compromised economic fundamentals, those countries have found little difficulty in raising large amounts of money on generous terms from the international capital market.

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liquidity at a very much more rapid rate than it did in 2009. By driving down long-term interest rates on government paper, the expansive monetary policy encouraged investors to once again stretch for yield and take on more risk.

Further fueling complacency is the prospect of a strong U.S. boom in the latter half of this year on the back of the Biden budget stimulus, continued ultra-easy monetary policy, and the likelihood that most Americans will have been vaccinated by that time. A marked pick-up in the U.S. recovery is expected to have positive spill-over effects to the rest of the world economy.

THE EVERYWHERE ASSET AND CREDIT MARKET BUBBLE

While it is all well and good for the academics and policymakers to take comfort from the positives, this should not blind them to the considerable risks now facing the global economy. This would seem to be especially the case considering how much more indebted the world economy is today and how much more pervasive the asset price and credit market bubbles are today than they were in 2008.

One indication of the unusually large size of today's asset price bubbles has been the remarkable global equity boom that followed the collapse of equity prices in the immediate wake of the Covid-19 pandemic. That equity boom has taken U.S. equity valuations to the loftiest of levels reminiscent of those immediately preceding the 1929 stock market crash. Meanwhile, Bitcoin mania has increased the size of that highly speculative market to over US$1 trillion.

Among the clearest indications of a global credit bubble is to be found in the emerging market economies, which now constitute around half of the world economy. Even before the pandemic, these economies had the shakiest of economic and public finance fundamentals. After the pandemic, most Latin American and African countries are now characterized by ballooning budget deficits and by record public debt-to-GDP ratios. Yet despite having highly compromised economic fundamentals, those countries have found little difficulty in raising large amounts of money on generous terms from the international capital market.

Looking Ahead

With what former U.S. Treasury Secretary **Larry Summers** is now describing as the most irresponsible U.S. macroeconomic policy in the past forty years, we are now all too likely to be at the cusp of a sharper run-up in U.S. Treasury bond yields than occurred during the 2013 Taper Tantrum.

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A MASSIVE DEBT BUILD-UP

Equally troubling has been the tremendous debt build-up around the world. Even before the pandemic struck, many years of cheap money had caused global debt-to-GDP ratios to rise above their pre-September 2008 Lehman bankruptcy levels. After

the pandemic, global debt levels have skyrocketed ever higher as budget deficits have ballooned and as corporations have been forced to go on a borrowing binge to keep themselves afloat in a deep recession.

In addition to a troubling build-up in emerging market debt, a particular area of concern has to be the very highly indebted and systemically important Southern European countries such as Italy and Spain. Those economies now have higher debt levels and very much larger budget deficits than they did at the time of the 2010 European sovereign debt crisis. As was the case during the earlier sovereign debt crisis, they will once again, stuck within a Euro straitjacket, have the greatest of difficulties in reducing their budget deficits and restoring any semblance of public debt sustainability. This would seem to be setting us up for another European sovereign debt crisis.

Closer to home, New York University bankruptcy expert Ed Altman is warning of a looming spike in U.S. small and medium-sized corporate bankruptcies in the wake of the pandemic. Meanwhile, before becoming Treasury Secretary, Janet Yellen had long been warning of over-indebtedness in the US$1.5 trillion highly leveraged debt market.

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ANOTHER TAPER TANTRUM

Today's global everything bubble has been premised on the assumption that U.S. interest rates will remain indefinitely very low. A real risk of the massive Biden fiscal stimulus is that it could soon put an end to the low interest era by inviting a return of the bond market vigilantes at the first whiff of economic overheating. As if to underline this point, in the first three months of 2021, U.S. ten-year Treasury bond yields have increased from less than 1 percent to around 1.6 percent, representing a shaper rate of increase than occurred during the 2013 Bernanke Taper Tantrum.

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As in the past, rising interest rates could prove again to be the trigger for a financially disruptive bursting of the bubble. This makes today's U.S. combination of unprecedentedly large peace-time fiscal stimulus, extraordinarily easy monetary policy, and large Covid-related household pent-up demand all the more dangerous. That combination could give rise to U.S. economic overheating and to a larger spike in U.S. Treasury bond yields than occurred during the 2013 Taper Tantrum. Heightening that possibility would be a Federal Reserve that remained in inflation denial and that was perceived by the markets as being behind the curve.

WHEN THE MUSIC STOPS PLAYING

Despite all the clues pointing in the direction of an imminent end to the financial market party, the question that nobody seems to be asking is what happens when the music of ultra-easy monetary policy stops playing. This is all the more surprising considering that, with what former U.S. Treasury Secretary Larry Summers is now describing as the most irresponsible U.S. macroeconomic policy in the past forty years, we are now all too likely to be at the cusp of a sharper run-up in U.S. Treasury bond yields than occurred during the 2013 Taper Tantrum.

All of this is likely to leave a lot of explaining to Queen Elizabeth when the music does stop playing and nobody will have warned her of the asset and credit market crash that will almost surely follow the party's end. With some justification, she might then ask why did the academic community not learn anything from the bursting of the 2008 U.S. housing and credit bubble? More to the point, why did they not warn her about the dangers of an even greater and more pervasive asset and credit market bubble than that which preceded the 2008 crash? ◆