OFF THE NEWS

The Crackup of Today's "Everything Bubble"

by Scott Bessent

A decade-plus of zero/negative interest rates across the developed world encouraged extremely risky behavior among households and financial market participants. Importantly, this behavior was not limited to venture capital/regional banks. Rather, it touched nearly all areas of the economy, and created what has been termed an "Everything Bubble." This bubble is now starting to crack as asset markets reprice to a world of materially higher interest rates.

As the Fed moved to aggressively tighten monetary policy last year, interest rates surged, saddling the U.S. banking system with large unrealized losses ($600 billion to $700 billion). This creates numerous problems:

■ Bank losses on securities portfolios are not evenly distributed. Combined with losses on commercial real estate lending, some U.S. banks may be insolvent.

■ Diminished capital ratios due to securities losses are likely to lead to much tighter credit conditions. Already, this appears to be happening. This will impact the real economy with a lag and result in a recession later this year.

■ A rapid migration out of regional banks and into mega banks. Smaller banks will have reduced credit capacity, and in our opinion, mega banks will simply invest their newfound funds in the government and government-guaranteed securities, rather than increase lending.

■ The Fed's new back door bailout lending facility, BTFP (Bank Term Funding Program), will likely encourage all-sized banks to invest in the U.S. debt markets risk-free and duration-free, crowding out the private sector and leading to an even greater credit slowdown.

■ The BTFP is both a form of yield curve control and an instrument for rapidly growing the U.S. money supply—both of which will likely transfer volatility from the interest rate markets to the foreign exchange markets. The Fed has been put in a difficult situation.

■ Market commentators seem focused on the Great Financial Crisis. The more relevant analog seems to be 1989–1991: a war, the savings and loan crisis, and a real estate crunch. Of course, the Fed then was able to lower rates by 500 basis points from 10 percent to 5 percent.

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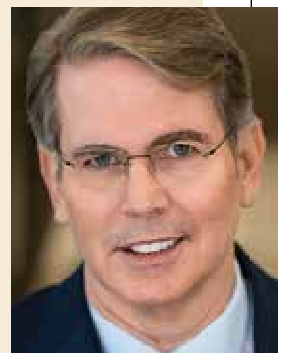

Key Square Group founder **Scott Bessent.**

What If Berlin Has to Choose Sides?

ECB strategists in particular and European economic policymakers in general are fixated on the implications for Europe of the Biden Administration's U.S. Inflation Reduction Act of industry subsidies and other taxpayer-funded support. European policymakers see the IRA as welcomed action. They are using it as a means of building political support to expand the European Union's budget through 2027 with spending totaling as much as €2 trillion.

This infatuation with the Biden Administration's IRA has had a particularly strong effect on German policymakers. During the pandemic and with rising energy costs, German households and businesses received significantly more financial support than officially acknowledged. A lot of the energy-related payments to households and firms came from a "shadow budget" that is not discussed in public. ECB policymakers estimate that the shadow budget and official budget together produced about €500 billion in subsidy support during the energy crisis.

That's the upside. The downside is that German policymakers are deeply concerned that in an environment of high interest rates, a lot of business models used by German industry will become unsustainable. "We are going to see a lot more zombie corporations," a German strategist said.

But the biggest fear among German policymakers is that Washington's IRA will cause German industry to relocate even more to the United States where it can enjoy significantly lower energy, labor, and other costs. "Germany's energy-intensive industries have already made the move. Soon we'll see chemicals and other industries relocate to America," the same strategist said.

One final point of German concern: With Germany having decoupled from its dependence on Russia, its relationship with China is what policymakers are calling a "bridge in transition for the German economy." Despite fierce political resistance back home, German Chancellor Olaf Scholz recently went to China to enhance his country's dependence on China's industry and markets. So Germany's economic leaders are nervous. Their energy and chemical industries are going to the United States while large parts of the rest of their industrial base are increasingly dependent on a relationship with China. Germany's nightmare scenario is to wake up one day to find that China has invaded Taiwan and Berlin has to take sides.

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Brainless in San Francisco

In the wake of the collapse of Silicon Valley Bank, some prominent European bank supervisors privately say they were stunned by the level of "incompetence" of San Francisco Federal Reserve Bank supervisors. In its early stages, the San Francisco regulators tried to argue that troubled SVB was a special institution that represented only a small segment of the market, so its problems would not spread. To which one European supervisor replied: "That's what they said in 2007 about the subprime mortgage situation."

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The Reason Xi Is Traveling the World

If you look behind the public swagger, Chinese President Xi Jinping has reasons for concern. The world could soon face a liquidity crisis. The U.S. trade deficit is shrinking fast. The rest of the world's trade balances, therefore, are being affected. On top of that, China appears to have no remedy for dealing with its real estate bubble.

In Japan, if the three-decades-old low-to-zero interest rate policy collapses, the economy could see not only a liquidity crisis but a financial crisis.

In the United States, the Federal Reserve with its aggressive tightening is likely to drive the economy into recession or close to it. The U.S. trade deficit is decreasing, creating a dollar shortage problem for the world. Throughout the world, central bankers, including those in China, are powerless to respond.

Meanwhile, the phenomenon that has benefited large parts of the world—particularly China—is the ability of the U.S. economy and the dollar to tolerate large trade imbalances. That phenomenon is fading away. At the same time, Chinese exports are dropping. The property bubble is in the process of collapse. Some make the case that the Chinese bubbles today are four times larger than the bubble that produced the collapse in Japan in the 1990s.

China is not only reaching a plateau, it may have begun a process of contraction. The drop in exports led in recent years to an aggressive over-centralization and an inability to plan for further innovation.

China's President **Xi Jinping:** *world traveler extraordinaire.*

In response, President Xi Jinping and other Beijing officials are roaming the world offering up China as the global peacemaker and solver of all problems economic. Translation: Xi desperately needs money. He is looking for investments. He lacks enough dollars to keep the economy moving forward, so he and colleagues are desperately seeking new economic partners, including the Saudis and even some of the former Soviet satellites.

But make no mistake, Xi knows that global liquidity is likely to reach a crisis point soon. Dollars will be in short supply. And all of this is happening as the G20 is quickly fading in relevance as regional blocs take over, all to China's disadvantage.

It is all a good reason for the Chinese leader to travel the world with swagger. The industrialized world leaders may be scratching their heads with confusion, but Xi's domestic audience no doubt loves it.