



Chickens Come Home to Roost

A decade or more of zero or negative interest rates, combined with quantitative easing (QE), has resulted in a mis-pricing of risk over a prolonged period of time across many asset classes. This is becoming more apparent now as central banks tighten monetary policy aggressively. One consequence of QE and super low interest rates had been to force pension funds and others to use leverage to offset very low bond yields which made it very difficult for them to meet their liabilities.

The difficulties being experienced in the UK Gilt market can be traced back initially to the Bank of England announcement in early August that it was going to commence quantitative tightening (QT) in October and start selling its large gilt portfolio built up from QE. Obviously, the surge in borrowing and thus new bond supply, arising from the very expansionary UK mini-Budget announced in late September, poured oil on the gilt fire. But, trouble was brewing anyway for leveraged pension funds as Gilt prices fell in the face of the prospect of QT, not to mention high inflation which also weighs on long-dated bond prices.

The surge in inflation has its origins in supply chain difficulties, the impact of the war in Ukraine on commodity prices and an unleashing of pent-up demand post COVID. However, an overly accommodative monetary conditions, with too much money chasing too few goods, has added to the inflation dynamics. Meantime, the impact of exceptionally loose monetary conditions has also been evident in the house price and stock market booms of the past decade as well as governments' ability to build-up high levels of cheap debt and very tight spreads in credit markets.

All this is now unwinding as monetary conditions are tightened and borrowing costs surge. The IMF last week warned of the risk that financial turmoil could erupt as rates rise, with widespread debt distress in vulnerable emerging markets in particular.

Unwinding QE is going to prove a difficult exercise for central banks. Even in the US, the Federal Reserve has not been able to run down its holdings of mortgage backed securities as quickly as it had envisaged. The ECB has avoided any mention of embarking on QT. No doubt



the problems seen in the UK in regard to leverage and the use of liability-driven investment strategies are also present in EU markets. Central banks are going to have be patient on implementing QT and allow their large bond portfolios to run down very slowly.

The loose monetary policies of the past decade, of zero or negative interest rates and QE, were initially introduced as emergency measures to help stabilise financial systems, which was justifiable. However, they then became part of the toolkit to fight low inflation, especially in Europe and Japan. They are non-standard policy measures, though. As such, they should only be in place for short periods of time.

The lessons of leaving them in place for such a long period are now clear. It has led to a mispricing of assets, the mis-allocation of capital and weakens financial stability. Withdrawing the policies after a long period is also difficult and causes major dislocation as markets correct, as we have seen this year.

Oliver Mangan
Chief Economist,
AIB

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