Nick Beams
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Nervous tremor on Wall Street

The sensitivity of highly indebted financial markets to even the hint of a rise in interest rates, and a "tapering" of asset purchases by the Fed, was on display following the meeting of its policy-making body last week.

A sign for a Wall Street building, Wednesday, May 19, 2021, in New York. (AP Photo/Mark Lennihan)

There were two main take-aways from the meeting: the majority of its policymakers consider rates could start to rise in 2023, as opposed to the previous forecast of 2024, and the central bank is now talking about cutting its purchases of financial assets.

The Dow Jones index had its worst week since October last year, falling by more than 500 points on Friday, down 3.45 percent for the week, while the S&P 500 declined 1.3 percent for the day, losing 1.9 percent for the week, ending a three-week stretch of gains.

After Asian markets fell—Japan's Nikkei 255 index lost 3.3 percent—Wall Street rose on Monday, with indexes recovering most of their previous losses.

Last week's decline came in the face of the fact that the Fed took no action as a result of its meeting, but merely indicated that it may be prepared to do so in the future, and reassurances from Fed chair Jerome Powell. He said forecasts of rising rates, contained in the so-called "dot plot," in which members of the policy making body indicate where they think rates may go, were not a policy commitment and had to be taken with a "large grain of salt."

The nervousness increased on Friday, when St Louis Fed chair James Bullard told the business channel CNBC he could see an interest rate rise happening in 2022 rather than 2023.

Bullard, who is not currently a voting member of the Federal Open Market Committee, but will be next year, told CNBC that there was "more inflation than we were expecting" and it was "natural that we've tilted a little bit more hawkish here to contain inflationary pressures."

Bullard indicated that by the end of 2022, there could be two to two-and-a-half years of inflation running at around 3 percent. This would meet the Fed's new framework of allowing inflation to run above its target rate of 2 percent, for some time, after which it would take action to try to bring it down.

Amid the gyrations, the multibillion-dollar question remains: what effect will even a small rise in rates, or a reduction of Fed asset purchases, have on highly-indebted corporations and financial markets?

Since the market collapse in March 2020, when the $21 trillion US Treasury market, the bedrock of the global financial system, froze, the Fed has been purchasing financial assets at the rate of $120 billion a month and has kept interest rates at virtually zero. The result is that the central bank has expanded its balance sheet from around $4.5 trillion, at the start of 2020, to more than $8 trillion, with the level set to rise to $9 trillion by 2022.

This has brought about a debt binge in all areas of the US financial system, with non-financial corporate debt alone now standing at $11.2 trillion, an amount equivalent to around 50 percent of US GDP.

The overall sentiment in the market, as is the case in all speculative bubbles, until they burst, is that the “good times” will persist, as the Fed continues to pump out more money, enabling the historically unprecedented enrichment of the financial oligarchy to continue.

The latest monthly survey of fund managers of the Bank of America found that investors were “bullishly positioned for permanent growth, transitory inflation and a peaceful Fed taper.”

But some warnings are being sounded. The chief economist for Moody’s Analytics Mark Zandi told CNBC that there could be a significant market correction of between 10 and 20 percent.

“The headwinds are building for the equity market. The Federal Reserve has got to switch gears here because the economy is so strong,” he said.

However, Zandi maintained this would not bring about a recession, because the downturn would be about over-extended asset prices, rather than more fundamental issues. But this optimistic outlook ignores the fact that the broader economy—as indicated by the escalating levels of debt—has become completely dependent on the flow of ultra-cheap money from the Fed.

The truth is that if there is a significant fall in the financial markets no one, least of all the Fed, knows where it could end up.

In remarks reported in the *Australian Financial Review* last week, Citi’s global market strategist Matt King said there could be major market instability later in the year.

“The standard view is that provided central banks exit slowly, and taper slowly, we should be fine. I think it’s harder than that, and that we’re now seeing the same underlying paradox that we saw in late 2018.”

In December of that year, markets experienced an abrupt 20 percent fall, when the Fed indicated that it had more interest rate increases planned for 2019, after four rises each of 0.25 percentages points over the previous 12 months, and that it would continue to wind down its asset holdings at the rate of $50 billion a month.

At that time, King noted, growth in the US economy was at 3 percent, there was a big boost from the Trump tax cuts and the S7P was making record highs.

“But suddenly, there was a 20 percent drop in the S&P 500 that threatened to destabilise the economy. And the Fed was forced to think again.”

As a result of the market plunge, Powell backed away from further interest rates and announced cuts in July 2019, fully six months before the pandemic arrived, and ended the asset wind-down.

King said the paradox was that “the more effective policymakers have been in driving up valuations, the more dependent markets have become on the continuation of that same stimulus.”

Consequently, they had become vulnerable not only to a shrinkage of central bank balance sheets, or a rise in interest rates “but just to a slow-down the stimulus.”

These remarks point to one of the central contradictions of the financial system. The more money that is poured into it—raising the price of financial assets—the less is the rate of return on them. This forces investors into ever more risky assets to secure their desired returns, creating the conditions for a crash should the money supply be reduced.

King noted that conventional economic theories hold that markets are an efficient mechanism, which anticipates future dividends and then discounts them, to establish the present value of an asset.

He said it was “simpler than that. It’s all about these money flows.”

That being the case, even a small reduction of these flows can precipitate a major crisis.

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