A scare on US bond markets

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The instability of US financial markets, and the potential for a major financial crisis, has again been illustrated by a series of recent events in the bond markets.

The week before last, as rumours spread through the market that one or more major financial institutions were on the brink of collapse, the New York Federal Reserve was forced to issue a statement denying that it was organising financial support. Major financial houses, including Lehman Brothers were also forced to issue similar denials.

While the market has since calmed and the near-crisis appears to have passed, at least for now, the circumstances that led up to it make clear it will not be the last.

The specific circumstances involved the development of peculiar conditions in the bond market. In normal times, the yield on long-term bonds (the effective interest rate) of 10 and 30 years is higher than those of a shorter duration.

However, in recent weeks the market has been experiencing a so-called inverse yield curve in which yields on long-term bonds move lower than their short-term counter-parts. The general expectation in the market was that with an increase in interest rates by the US Federal Reserve, the yield rates would revert to more normal patterns. That is, the price of long-term bonds in the market would fall, and their yields would accordingly rise.

Basing themselves on this expectation, major financial institutions had been selling short. That is, they had been selling bonds they did not have in anticipation that the price would fall, whereupon they would be able to enter the market, buy the bonds they had previously sold at a lower price and realise a profit.

But events did not turn out as expected. Instead of falling, long-term bonds continued to rise, creating the conditions where the institutions which had short sold would be faced with massive losses as they sought to meet their commitments.

The peculiar situation appears to have been compounded by the announcement by the US Treasury that it would begin buying back bonds as well as reducing future auctions as part of a debt-reduction program.

The amounts involved in the short-selling operation were not small. It has been estimated that the total “short” position of the hedge funds, brokerage and investment houses in 30-year bonds was a massive $7 billion—the largest amount since the US Commodity Futures Trading Commission started keeping records.

Commenting on the crisis in an editorial last Monday, the *Financial Times* pointed out that while buying back debt when budgets are in surplus sounds like good financial housekeeping, the US debt managers had “nearly succeeded ... in causing a financial panic with their plans.”

“While many possible endings to the long US economic cycle have been mooted, the idea that the US Treasury might prompt a financial meltdown had not occurred, even to the most bearish pundits. Perhaps they should moot some more.”

Coincidentally, the near-crisis took place days before a PBS television program detailing the collapse of the US hedge fund, Long Term Capital Management, in September 1998. On that occasion, the US Federal Reserve Board intervened with a $36 billion bailout operation to prevent a “systemic” crisis in the US and global financial system.

As the program made clear, the risk evaluation formulae on which LTCM carried out its activities were based on long research and sophisticated mathematics. The problem was, however, that they were all grounded on the expectation that in the event of fluctuations in the market, conditions would return to the historical norm.

In the first years of its operations, LTCM returned large profits. But then, in the words of the program's narrator: “In the summer of 1997, across Thailand, property prices plummeted. This sparked a panic that swept throughout Asia. As banks went bust from Japan to Indonesia, people took to the streets—events so improbable they had never been included in anyone's model.”

Then came the Russian default in August 1998 for which LTCM's models had similarly not accounted.

Such is the speculative character of the operation of US and global financial markets that in the coming period seemingly “abnormal” events—something as apparently innocuous as a buy-back operation by the US Treasury, not to speak of an eruption of the class struggle—could well spark a major financial meltdown. The warning signs are already clear.