BIS warns of sudden end to “uneasy” financial calm

Nick Beams
8 December 2015

The Bank for International Settlements (BIS) has warned that what it calls the “uneasy calm” which has settled over international financial markets following the turbulence of August and September could erupt into new turmoil as deeper economic forces come to the surface.

The signs are already in evidence. The *Financial Times* has reported that the corporate bond market has been hit by “rate fears” as the US Federal Reserve seems set to lift its base interest rate for the first time in a decade at its meeting later this month. At the same time, an article in the *Wall Street Journal* said the stock market was “missing the warning from junk.”

It said high-yielding, or junk, bonds were heading for their first annual loss since the financial crisis of 2008, reflecting concerns among investors that the US economic expansion of the past six years and the stock-market boom were on “borrowed time.”

The BIS warnings came in its quarterly review issued on Sunday. The head of the banks economic department, Claudio Borio, said calm had reigned over financial markets in the past two months, as stock markets recorded their strongest one-month rally for some years in October. It appeared that the previous turbulence was more like a brief summer storm, rather than autumn thunder heralding a long winter. However, the outlook could change rapidly.

“Very much in evidence, once more, has been the contrast between the hectic rhythm of markets and the slow motion of the deeper economic forces that really matter,” he said.

Borio was referring to the slowing of global economic growth, particularly in emerging markets which have played such an important role in sustaining world output in the period since 2010. The leading economic indicators pointed to weakness ahead, with Brazil and Russia already in the throes of a “severe recession,” while activity in China has shown little sign of strengthening.

Besides lower growth, the financial vulnerabilities of emerging markets had not gone away. “The stock of dollar-denominated debt, which has roughly doubled since early 2009 to over $3 trillion is still there,” he noted, warning that in terms of the domestic currencies concerned debt had increased because of the appreciation in value of the US dollar. That tendency will continue with an expected increase in the Fed base interest rate later this month likely to send the dollar higher.

In conditions where there is a divergence between US and European monetary policy—as the Fed moves towards tightening and the European Central Bank is reducing rates—there could be a sudden increase in the demand for the US currency. Borio pointed out that even with hedging to take account of currency movements, there was a premium being charged on those wishing to borrow in dollars.

While funding continued to be made available, the present situation indicates “potential market dislocation” which “may call into question how smoothly US dollar funding conditions will adjust in the event of an increase in US onshore interest rates.”

There could also be dislocation in the US as well, with the review noting that, while it had fallen since August, margin debt—incurred when investors borrow money to buy shares and then have to pay a margin on their debt if the price falls—still remained “within reach of the previous record highs seen in the run-up to the dotcom bust more than 10 years ago.”

In “extraordinary conditions,” where interest rates remain “exceptionally low,” Borio said it was not surprising to find that markets were unusually sensitive to central bankers' every word and deed. The latest example of that sensitivity came last week when the announcements by ECB president Mario Draghi on the next stage of European quantitative easing were much less than had been anticipated on the basis of his remarks in November.

Financial Times commentator Gavyn Davies said that as far as one-day shocks went the impact was "very dramatic" with the 4.5 percent reversal in the dollar-euro exchange rate the largest since 2009, and the combined drop in equities, bonds and currency movement being described as the most severe since 1999. In a subsequent speech, Davies noted, Draghi had sought to upgrade the significance of the new round of QE, reflecting concern about the "extreme market reaction."

Focusing on the "clear tension" between the market's behaviour and underlying conditions, Borio said at the conclusion of his remarks that at some point it would have to be resolved, and suddenly. "Markets can remain calm for much longer than we think. Until they no longer can," he said.

Perhaps he had in mind Marx's remark in *Capital* that economic laws assert themselves in the same way gravity does when a house falls about our ears.

In any event, there are growing signs that the house of finance is looking increasingly unstable and a relatively small tremor, in the form of a 0.25 percent increase in the Fed's base rate, could cause major problems.

Reporting on the rate fears in corporate bond markets, the *Financial Times* noted that concerns over the impact of a possible US rate rise increase on more vulnerable borrowers had been "exacerbated by rising indebtedness and shrinking revenues among companies," fuelling concerns that "the profitable 'credit cycle' that has reigned since the financial crisis is coming to an end."

"People are going to be carried out on stretchers," a senior bond manager at a California-based asset management firm told the newspaper. It was "not good," he said, "when earnings are coming down, leverage is high and interest rates are going up."

The Swiss bank UBS has estimated that as much as $1 trillion of US junk bonds and loans could be in the danger zone as borrowing conditions tighten. Many of the problems were in the energy sector—due to falling prices—but the bank said the problems extended more widely.

In a UBS note, strategist Matthew Mush wrote: "It is our humble belief that the consensus at the Fed does not fully understand the magnitude of the problems in corporate credit markets and the unintended consequences of their policy actions."

So far this year there have been 102 global defaults, the highest since 2009, with 63 of these in the United States.

The financial agency Moody's has reported that the number of companies on its "distressed list" rose by 5 percent in November to 239, representing a 37 percent jump over last year.