

Turbulence returns to financial markets

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Volatility is returning to global bond and equity markets amid growing concerns over how much longer the flood of cheap money from the US Fed and other major central banks can continue to fuel their rise.

Last Friday, the Dow Jones index fell by almost 400 points following the European Central Bank decision the previous day not to further lower its base interest rates and its silence on whether to extend its quantitative easing program, which has already seen €1 trillion injected into financial markets, beyond March 2017.

Even more significant than the slide on the share markets was the shift in bond markets as yields began to rise and bond prices fell (the two bear an inverse relationship to each other).

Over the past year the flood of cheap money into financial markets, coupled with the lowering of interest rates, has seen the creation of a massive bubble such that \$13 trillion worth of government bonds are now trading at negative yields. This means that their price is so high that an investor purchasing a bond and holding it to maturity would make a loss.

This phenomenon means that the international market has been turned into a giant casino in which bonds are purchased on the basis that their price will rise still further and speculators will be able to make capital gains. However, if prices fall and yields begin to increase, they will incur significant losses.

That was in evidence on Friday. The yield on the US 10-year treasury bonds rose to 1.67 percent compared to a low of 1.46 percent it had reached several weeks earlier. In the past few days, the yield has increased by 0.15 percentage points, a significant movement. In Europe, yields on some German bonds, which had been negative, moved into positive territory for the first time in several months.

Another factor in Friday's share market slide was remarks from members of the Fed's open market

committee that sets its base rate indicating they were in favour of an increase. Consequently all eyes on Monday were focused on a speech by Federal Reserve governor, Lael Brainard, a voting member of the open market committee. Brainard is considered to be a "dove," that is, favouring a cautious approach on lifting rates, and so a turn by her would have almost certainly have sent the markets falling.

In the event, Brainard stuck to her previous line and the markets got the comment they wanted to hear, with the Dow Jones up by 239 points and recovering more than half of its losses on Friday. After reviewing the economic and financial situation and deflationary pressures in Europe and Asia Brainard said: "Today's new normal counsels prudence in the removal of policy accommodation."

Immediately after her comment, the futures market priced in a 15 percent chance of a rate rise when the Fed next meets on September 21, down from 24 percent two days earlier.

Significantly, the yield on bonds did not fall. One reason may have been a prediction by Goldman Sachs, one of the world's largest bond market traders, that prices could fall further, with yields rising to 2 percent by the beginning of 2017. A rapid increase implies major losses for speculators who have gambled on their continuing decline as a result of central banks' policies.

Apart from its immediate impact on the share market, Brainard's speech was significant because of the picture it painted of the US and global economy and the growing perplexity at the top levels of the financial establishment over what to do next in view of the evident failure of the policies adopted since the financial crash of 2008 to end what is being recognised as ongoing stagnation.

Dealing with a series of interrelated phenomena, dubbed the "new normal"—other observers, such as former US treasury secretary Lawrence Summers, point

to “secular stagnation”—she began by noting that a “sustained period” of undershooting the Fed’s inflation target of 2 percent could not be ruled out “along with global deflationary pressures that are weighing on inflation expectations.”

Labor market slack on the US had been greater than anticipated, she said, pointing to the lower participation rate in the labour force, which could be an expression of the “very slow recovery in job opportunities and wages.”

Financial transmission from foreign markets was strong and the disinflationary pressures and weak demand from abroad “will likely weigh on the US outlook for some time to come,” with “fragility” in global markets posing risks for the American economy.

Japan remained “greatly challenged” by weak growth and low inflation as is Europe and the experience from these economies highlighted the risk of becoming trapped in a “low-growth, low-inflation” environment. “Downside risks” were also present in emerging markets and growth in China was slowing.

Turning to the US economy, Brainard said it has been becoming increasingly clear that the so-called neutral rate of interest—the rate which neither stimulates the economy nor depresses it—remained “considerably and persistently lower than it was before the crisis.”

Highlighting the shift that has taken place, she said given the underlying relationships that prevailed at the time it would have seemed inconceivable ten years ago that with the Fed rate at or near zero, growth and inflation could have remained as low as they have.

One of the factors contributing to lower growth, and hence a fall in the neutral rate, is the sharp fall in productivity growth. In the years from 1950 to 2000 productivity, Brainard noted, had risen at an annual average rate of 2.5 percent. In the past five years it had only increased on average at a rate of 0.5 percent.

Brainard concluded her remarks with a discussion of policy options. Under the “new normal,” with interest rates near zero and likely to return there because of the lower neutral rate, the measures available to the Fed, were asymmetric. In other words, while the Fed can use interest rates to lower demand, they cannot be employed to lift it.

Neither Brainard nor any other members of the financial establishment have any alternative economic

or financial measures to counter the present situation and so are continuing to fuel financial markets with cheap money, even as they know that this will create the conditions for ever greater turbulence and potentially another crisis.



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