Signs of turbulence in stock markets

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2 February 2018

Volatility appears to be returning to the US and global stock markets after rapid rises over the past month, with markets experiencing their best start to a new year since 1987.

There was a sell-off at the start of the week, with the US market recording its biggest two-day decline since September 2016. Markets finished up on Wednesday after ups and downs during the course of the day, but a downward movement could resume.

The main immediate factor in the fall appears to have been the decline in bond prices and the consequent rise in interest rates (bond prices and interest rates have an inverse relationship).

The yield on the benchmark 10-year US Treasury bond is around 2.7 percent, a level which had not been expected until later in the year, with the 3 percent level seen as a significant turning point for financial markets.

The rise in the Treasury bond yield is being driven by the expectation that the US Federal Reserve will continue its policy of lifting its base interest rate and that other major central banks will start to pull back on their quantitative easing policies, which have sent interest rates to record lows, during the course of the year.

On Wednesday, the Fed's open market committee meeting, the last held under outgoing chairwoman Janet Yellen, kept its base interest rate at between 1.25 and 1.5 percent, as expected, but indicated in its statement that "further" interest rate rises lay ahead. At this point, the Fed is expected to raise rates three times during the course of the year, the first rise coming in March, with another increase possible in June.

Another factor working to push up interest rates in the longer term is the expected increase in the level of US debt, largely to pay for the massive tax cuts of the Trump administration, which could lift the annual growth in US debt from its present level of $700 billion towards the $1 trillion mark. More bonds on the market to finance the debt imply lower prices and a higher interest rate.

The major concern in financial markets is that a rise in bond yields could see an end to the rise in stock prices and even set off a major downturn.

As an article in *Bloomberg* noted: "For many, 3 percent is the breaking point at which corporate financing costs would get too expensive, the equity market would lose its luster and growth momentum would fade."

A similar view was expressed in the *Financial Times*. "Some investors and analysts are now questioning how long bond yields can continue to rise without puncturing the euphoria in global stock markets," it commented. Rising bond yield make borrowing more expensive, "potentially straining companies that have been relying on cheap money to grow."

Since the global financial crisis of 2008, financial markets have been elevated to record highs by the injection of trillions of dollars by central banks—a policy which has seen the price of assets soaring, returning vast fortunes to the corporate and financial elites.

But there is a fear that if there is a rapid increase in rates as a result of the "normalisation" of monetary policy, then this financial house of cards could come crashing down.

This week Industry Super Australia, the peak body for the country's industry superannuation funds, issued what could be described as something of a "canary in the coal mine" warning.

It said unsustainable house prices, which have been driven up by ultra-low interest rates, had put the country "at the precipice" of a once-in-a-century bust if global borrowing costs rose by more than 1.5 percentage points.

According to the ISA's chief economist Stephen

Anthony, house prices in the two main cities of Sydney and Melbourne rose to nearly seven times average weekly earnings last year from four times earnings in 2000. “In the 2000s it has gone ballistic, to a point where it looks unsustainable,” he told the *Australian Financial Review* .

Anthony noted that US long-term interest rates, as reflected in the bond markets, had risen by 40 basis points (a 0.4 percentage point increase) since Christmas and “once you start getting a 150 basis-point-plus” rate increase then “a lot of these highly-exposed households are in significant trouble.”

Such a rise would not only have a severe impact on families straining under huge mortgages—the median price for a house in Sydney is more than $1.1 million—but would hit investors who are dependent on cheap money.

Another factor which could lead to growing financial market instability is the outbreak of trade war, sparked by the aggressive “America First” policies of the Trump administration.

Trump did not say a great deal about trade in his State of the Union address delivered on Tuesday night, but what he did say was significant. Hailing a “New America Moment” he declared that the “era of economic surrender is over.”

The US had “finally turned the page on decades of unfair trade deals that sacrificed our prosperity and shipped away our companies, our jobs and our nation’s wealth.”

Much of Trump’s fire has been directed against China, but Trump used his speech to take a shot at Europe. “I’ve had a lot of problems with the European Union, and it may morph into something very big,” he said, “from a trade standpoint.”

A spokesman for the EU said on Monday it was ready to “react swiftly and appropriately in case our exports are affected by any restrictive trade measures from the United States.”

Last week, the US imposed major tariffs on the imports of solar panels and washing machines, prompting intense opposition from Chinese solar panel makers and South Korean washing machine manufacturers.

Further measures are in the pipeline, with the administration actively considering whether to impose protection for US aluminium and steel industries under national security legislation.

Currency movements may also lead to financial destabilisation. Last week European Central Bank President Mario Draghi took issue with comments by US Treasury Secretary Steven Mnuchin that a lower US dollar assisted American exporters. While not naming Mnuchin or the Trump administration, Draghi said such comments contravened agreements reached at the International Monetary Fund that countries should seek to avoid engaging in competitive devaluation of their currency.

Major global institutions, such as the IMF and the Organisation for Economic Co-operation and Development, have welcomed the upturn in global economic growth but have warned that it could be disrupted by conflicts over trade and currencies.