Major fall on Wall Street as interest rates rise

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Wall Street experienced its biggest fall in eight months yesterday, as major indexes dropped by more than 3 percent in the wake of the upward movement of interest rates in the recent period.

The biggest falls were in tech stocks, with the Nasdaq Composite index down by more than 4 percent in its biggest drop since June 2016, following the Brexit referendum in the UK. The Standard & Poor's 500 index was down by 3.3 percent, its biggest decline since February. It has now fallen for five days in a row—its longest losing streak since Donald Trump became president.

The Dow fell 832 points, a drop of 3.2 percent, and the Chloe Volatility Index rose to over 20, its highest level since April, an indication that further volatility is expected.

The main factor behind the fall appears to be the spike in yields (interest rates) on US Treasury bonds, which have risen sharply in recent days to above 3 percent. The sell-off in the bond market and the rise in interest rates (bond prices and interest rates have an inverse relationship) imply a fall in the value of shares, as the Treasury yield is used to discount expected future income flows.

The yield on the 10-year US Treasury bond hit a seven-year high of 3.26 percent earlier this week, reflecting the belief that the US Federal Reserve will continue to lift its base rate on expectations of higher US economic growth. While it is not explicitly stated, a key factor in the move by the Fed for higher interest rates is the growing push by workers in the United States for wage rises, with stagnant and falling wages a key factor in promoting the stock market boom over the past nine years.

In its report on the plunge, the *Wall Street Journal* pointed to the fact that major corporations that have fueled the rise of the market with share buybacks are at present on the sidelines, reluctant to engage in further purchases in advance of the release of third quarter earnings results.

The newspaper reported that S&P 500 companies "have spent a staggering $380 billion on stock repurchases through the first half of this year, with Apple, Cisco and Facebook among the most active buyers of stock."

The fall on Wall Street prompted a comment from Trump on the Fed's tightening of interest rates. Trump has continually pointed to the rise of the stock market as indicating the strength of his economic policies.

"I think the Fed is making a mistake," he said. "They are so tight. I think the Fed has gone crazy."

A statement from the White House issued by press secretary Sarah Huckabee Sanders also indicated the concern of the administration over the market sell-off. "The fundamentals and future of the US economy remain incredibly strong," she said. "President Trump's economic policies are the reasons for these historic successes and they have created a solid base for continued economic growth."

But as numbers of commentators have pointed out, if that is the case, and the US economy is sound and growing, then the Fed should be increasing interest rates more rapidly in order to lift them from the historic lows of the period following the 2008 crisis to more normal levels.

In announcing the latest increase in September, Fed chairman Jerome Powell said interest rates were still "accommodative" and the central bank was moving to a position where they would be neutral, but they were probably "a long way from neutral" at present—an indication that the Fed expects further tightening.

The comments by Trump and the statement from the White House on the market fall point to concerns within the administration that, far from a reflecting the strength of the US economy, the surging stock market may be a house of cards extremely vulnerable to a tightening of financial conditions.

While the immediate outcome of the latest sell-off is unclear, numerous reports on the state of the global financial system ten years after the 2008 crash have pointed to the creation of conditions for another disaster produced by the very measures—ultra-low interest rates and the injection of trillions of dollars—that were used to prop up the global financial system.

In its latest *Global Financial Stability Report*, produced for its semi-annual meeting being held this week in Bali, Indonesia, the International Monetary Fund said that while regulatory frameworks had been enhanced and the banking system had been made stronger, "new vulnerabilities had emerged, and the reliance of the global financial system has yet to be tested."

It said medium-term risks to global financial stability remain elevated:

"A number of vulnerabilities that have built up over the years could be exposed by a sudden sharp tightening of financial conditions. In advanced economies, key financial vulnerabilities include high and rising leverage levels in the nonfinancial sector, continued deterioration in underwriting standards, and stretched asset valuations in some major markets."

One of the key expressions of "stretched asset valuations" is the record rise of the US stock market, prompted by low interest rates and the increasing use of share buybacks.

The IMF said that while banks had increased their capital and liquidity buffers since the crisis, they remained exposed to highly indebted companies, households and governments and to what it called their "holdings of opaque and illiquid assets."

The IMF report warned that, as central banks withdraw monetary accommodation, financial conditions would tighten and this could "expose fragilities in the financial system" that have emerged since the global finance crisis.

One of those "fragilities" is the build-up of dollar-denominated debt in emerging market economies.

In a speech delivered earlier this month, IMF Managing Director Christine Lagarde noted that global debt, both public and private, has now reached an all-time high of $182 trillion—some 60 percent greater than in 2007. This left governments and companies "more vulnerable to a tightening of financial conditions."

If such tightening were to rapidly accelerate, it could lead to "market corrections," sharp exchange rate movements and a weakening of capital flows. The IMF has estimated that under such conditions, emerging markets, excluding China, could face a "debt portfolio outflow" of up to $100 billion, an amount equivalent to that in the financial crisis ten years ago.

That alone, she said, should serve as a "wake-up call." Yesterday's fall on Wall Street and the somewhat frantic response of the White House may be another indication of the underlying instability of the financial system.