# Wall Street volatile as global economy becomes “fragile”

**Nick Beams**
**19 October 2018**

Volatility has continued on Wall Street following two days of major falls last week. The Dow Jones index shot up by more than 500 points on Tuesday, followed by a more than 300-point decline during Wednesday before recovering to finish 80 points down.

Yesterday, after a global sell-off, the Dow finished down by 327 points, after dropping 470 points during the course of the day. In what was described as a “jittery session,” the S&P 500 was down 1.4 percent, its largest fall in a week, and has now experienced a decline in 10 out of the 14 trading sessions this month.

The immediate volatility is being driven by two conflicting tendencies. On the one hand, US markets are being pushed down by the further expected increases in the Federal Reserve’s base interest rate and the general tightening of monetary conditions expressed in the rise of the rate on the benchmark 10-year US Treasury bond, which is now hovering around 3.2 percent. Monetary conditions are also being made more restrictive by the Fed’s reduction of its assets holdings by $50 billion per month as part of its program to reduce its balance sheet. Its previous quantitative easing program saw Fed assets expand from less than $1 trillion to $4.5 trillion.

On the other hand, share prices are being boosted by the rise in profits being reported by banks and major companies. There is also an expectation that US growth will continue and that, while asset valuations may be “stretched,” there is still some way for the market to run and gains to be reaped.

The underlying instability and fears of a major sell-off were underscored by further comments by US President Donald Trump following his denunciation of the Fed’s interest rate rises as “crazy” and “loco” during last week’s sell-off. In an interview with the Fox Business News Network, he repeated his assertion that the Fed was raising interest rates too fast and described the central bank’s actions as “my biggest threat.”

Nominally adhering to the independence of the Fed, Trump said he had not spoken to its chairman Jerome Powell, whom he appointed last year. But he was “not happy” with what Powell was doing, “because it’s going too fast.” Powell, he asserted, was “being extremely conservative, to use a nice term.”

Former Fed chairwoman Janet Yellen weighed into the debate, saying she agreed with the Fed’s present policies and that there was a danger of the economy overheating. She said the present growth rate of 3 percent was “terrific” but cast doubt on whether it was sustainable in the longer term. The Fed would need to be “skilful and lucky” to achieve a soft landing after 2019.

It is a significant observation when a former Fed chief remarks that US growth needs “luck” to continue.

The minutes from the Fed’s interest-rate setting Open Market Committee of September 25-26, released on Wednesday, indicated that the central bank is still on course for another interest rate rise in December, with some participants wanting to tighten policy still further.

The minutes noted that some members thought it would be necessary to “temporarily raise the federal funds rate above their assessments of its longer-run level in order to reduce the risk of a sustained overshooting of the Committee’s two percent inflation objective or the risk posed by significant financial imbalances.”

The chief concern is not with inflation per se but whether the lowering of the unemployment rate and labour shortages lead to a significant push for increased wages, which the Fed is determined to suppress.

Market volatility is also being fuelled by the worsening global economic outlook resulting from the rise in US interest rates, the increasing value of the dollar, and the escalation of trade tensions between the US, China and other countries.

The dollar’s rising value has a major impact on emerging markets because it increases the real level of dollar-denominated loans, making the repayment of the interest and principal more expensive. The *Financial Times* has described the situation facing emerging markets as “ugly,” noting that the JPMorgan Chase EM currency index has fallen by 12 percent since April. Stock markets have also been hit, with the MSCI Emerging Markets Index down by more than 16 percent in the same period.

The elevated stock market values in the US stand in contrast to the rest of the world. While the S&P 500 index is up more than 4 percent for the year, the Stoxx Europe 600 index has experienced a 6.2 percent decline, Japan's Nikkei 225 is down by 0.9 percent and the Shanghai Composite has fallen by 23 percent.

Trade tensions are continuing to rise. There was a sharp exchange at a World Trade Organisation (WTO) meeting on Tuesday between the US representative Dennis Shea and his Chinese counterpart Zhang Xiangchen.

Shea demanded that the WTO confront China's alleged trade abuses and remove its rights as a developing economy. Zhang countered that "no one can be singled out" and that efforts to undermine the basic principles of the organisation had to be opposed. But Shea insisted that the world body target China.

"Adequately responding to the challenges of non-market economies is nothing less than an existential matter for this institution," Shea said.

This is a thinly-veiled threat that unless the WTO takes action over what the US calls China's "market-distorting" policies, including subsidies for state-backed industries and its alleged acquisition of high-tech knowledge through forced technology transfers or outright theft, it will withdraw from the body.

The US has already significantly undermined the WTO by blocking the appointment of members to its appellate body, which has the final say on trade disputes. The Trump administration has refused for more than a year to consider new appointments because it says former members went beyond their mandate and took an "activist approach" detrimental to the US. The administration's actions have reduced the normally seven-member body to just three and if the present stand-off continues it will not be able to function past December next year.

As part of its trade war against China, the US has been seeking to bring its "strategic allies" into its camp by opening up negotiations with them on bilateral trade deals. These moves, including the recently-concluded US Mexico Canada Agreement (USMCA) and agreements with the European Union and Japan for one-on-one negotiations, have been accompanied by threats of auto tariffs of up to 25 percent.

In addition, the USMCA contained what the US side characterised as a "poison pill." If either of the other partners entered a free trade agreement with a "non-market" economy, namely China, the US could withdraw. US trade officials have made it clear they want to see this provision included in other bilateral deals.

Negotiations with Europe, agreed on at a meeting between Trump and European Commission President Jean-Claude Junker in July, have already produced conflict.

In talks on Wednesday each side accused the other of undermining the July agreement. Commerce Secretary Wilbur Ross said of his EU counterpart Cecilia Malmstrom that it was "as though she was at a different meeting from the one that we attended."

Ross said the purpose of the meeting was to get "near-term deliverables including both tariff relief and standards." Trump's "patience was not unlimited."

Malmstrom said the EU had asked several times for a "scoping exercise"—the prelude to a full-scale trade deal—but the US had failed to respond. "So far," she stated, "the US has not shown any big interest there, so the ball is in their court."

Ross said the contention that the US was slowing things down was "simply inaccurate." The US ambassador to the EU, Gordon Sondland, was even more blunt and implicitly raised the threat that auto tariffs could be put back on the agenda.

"If the president sees more quotes like the one that came out today his patience will come to an end," Sondland said, attacking the "complete intransigence" of the EU and warning that any attempt to "wait out" Trump's term as president was a "futile exercise."

Warning that politics was putting the "skids under the bull market," *Financial Times* economics commentator Martin Wolf wrote on Wednesday that, as the recent IMF meeting had made clear, reasons for concern "abound." Above all, the "struggle between old and new superpowers" could "change everything."

Wolf noted that the valuation of risky assets was "stretched" and just a small shift in global financial conditions could damage not only emerging markets. Wolf said the aggregate debt in countries "with systemically important financial sectors now stands at $167 trillion, or over 250 percent of aggregate gross domestic product," compared with 210 percent in 2008.

The global economy and financial systems are "fragile," Wolf concluded. "These are dangerous times—far more so than many now recognise. The IMF's warnings are timely, but predictably understated. Our world is being turned upside down. The idea that the economy will motor on regardless while this happens is a fantasy."