

Another downward swing on Wall Street

Nick Beams
6 March 2020

Wall Street had another turbulent session yesterday with market indexes down by more than 3 percent after a surge on Wednesday, fuelled in large measure by the market's appreciation of the victory of former US Vice-President Joe Biden in the Super Tuesday Democratic primary elections.

The market fall was accompanied by a further decline in bond market interest rates. The yield on the 10-year US Treasury bond fell to a new record low of 0.9 percent, while the yield on the 30-year Treasury bond dropped to 1.55 percent, also a record low.

The move of investors into bonds, sending their prices higher and their yields lower, is an indication that markets are not just expecting, but demanding a further interest rate cut by the Federal Reserve, following its emergency rate reduction of 0.5 percentage points on Tuesday.

The Dow finished down by 970 points yesterday, a fall of 3.6 percent, with the S&P 500 dropping 3.4 percent and the Nasdaq finishing lower by 3.1 percent. So far this week, the Dow has had two days in which it has risen by more than 1,000 points, a one-day drop of more than 800 points and yesterday's fall of almost 1,000.

The immediate cause of the swings is the conflict between two opposed outlooks.

On the one hand, there is the belief in some quarters that still more money will be made available by the Fed and other central banks, ensuring that the financial elites can continue to rake in money hand over fist—whatever the impact of the coronavirus on the real economy and the lives of millions of people. On the other, some investors fear that the spread of the virus is going to lead to a major economic downturn in the US and around world.

The gyrations in global stock markets have also focused attention on underlying trends in the financial system that are creating the conditions for another crisis

on the scale of 2008 or even larger.

A major article, entitled “The seeds of the next debt crisis,” by long-time financial journalist John Plender, published in the *Financial Times* this week, brought together some of the most significant developments.

Plender began by noting that the shock the coronavirus has wrought on markets “coincides with a dangerous financial backdrop marked by spiralling global debt.”

The Institute of International Finance has calculated that the ratio of global debt to world gross domestic product has reached an all-time high of more than 332 percent, with total debt now at \$235 trillion.

“The implication, if the virus continues to spread, is that any fragilities in the financial system have the potential to trigger a new debt crisis,” Plender wrote.

He noted that, despite lower interest rates, financial conditions have tightened for weaker corporate borrowers because their access to bond markets has become more difficult. This is because, as the fall in Treasury bond yields shows, major investors are seeking a safe haven.

This was significant, Plender continued, because the debt build-up since 2008 has been concentrated in the non-bank corporate sector “where the current disruption to supply chains and reduced global growth imply lower earnings and greater difficulty in serving debt,” raising the “extraordinary possibility of a credit crunch in a world of ultra-low and negative interest rates.”

Plender drew attention to the dangerous implications of moves by the Fed and other central banks to make still more money available to financial markets. This “policy activism carries a longer-term risk of entrenching the dysfunctional monetary policy that contributed to the original financial crisis, as well as exacerbating the dangerous debt overhang that the global economy now faces.”

The risks have been continuing to build since the late 1980s when central banks, above all the Fed, pursued an “asymmetric monetary policy” of supporting markets when they plunge but failing to dampen down the formation of bubbles, leading to “excessive risk taking” by banks

The quantitative easing policy pursued since the crisis was a continuation of the asymmetric approach and the resulting safety net under the banking system, Plender commented, is “unprecedented in scale and duration.”

The threat to the stability to the global financial system is not the same as the crisis in 2008, which had its origins in property and mortgage lending markets. Today, it is concentrated in loans to the corporate sector.

A recent report by the Organisation for Economic Co-operation and Development said that at the end of December last year the global stock of non-financial corporate bonds had reached an all-time high of \$13.5 trillion, double the December 2008 level in real terms. The rise has been most marked in the US, where the Fed has estimated that corporate debt has risen from \$3.3 trillion before the financial crisis to \$6.5 trillion last year.

The rise in corporate debt has been accompanied by a decrease in its quality. There has been a disproportionate increase in the issuance of BBB bonds—the lowest investment grade rating one notch above junk status—that could be downgraded in the event of an economic downturn.

Plender wrote: “That would lead to big increases in borrowing costs because many investors are constrained by regulation or self-imposed restrictions from investing in non-investment grade bonds.”

In other words, any major downgrade, either as a result of financial market turbulence or recessionary trends, would have a cascading effect as major investors would be forced to sell into a falling market.

As Plender noted, the deterioration in debt quality is “particularly striking in the \$1.3 trillion market for leveraged loans.” These are loans arranged by syndicates of banks to companies that are already heavily indebted or have weak credit ratings, and whose ratio of debt to assets or earnings is above industry norms. The issuance of such bonds hit a record high of \$788 billion in 2017, with the US accounting for \$564 billion of the total.

Another factor adding to the potential for a crisis is that much of this debt has not been used to finance new plant and equipment to increase production and sales revenue but to finance mergers and acquisitions, as well as share buybacks to boost stock market valuations—a process that provides very handsome rewards for corporate executives and major finance houses.

Plender warned that the huge accumulation of corporate debt “of increasingly poor quality” was “likely to exacerbate the next recession,” under conditions where the ultra-loose monetary policy had encouraged complacency. This, he added, “is a prerequisite of financial crises.”

While the dangers are most pronounced in the corporate sector, banks would not be immune and could not “escape the consequences of a wider collapse in markets in the event of a continued loss of investor confidence and or a rise in interest rates from today’s extraordinary low levels. Such an outcome would lead to increased defaults on banks’ loans together with a shrinkage in the value of collateral in the banking system.”

And such dangers would persist even if the coronavirus shock passes—and as yet there is no indication of that taking place—because the policies of the central banks have driven investors to search for yield “regardless of the dangers.”



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