Australian central bank action and Wall Street gyrations indicate a coming storm

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It is not often that the actions of the Reserve Bank of Australia are regarded as a significant indication of future moves by other central banks because its policies are generally in response to initiatives taken elsewhere.

But its decision on Monday to double its daily purchases of government bonds from $2 billion a day to $4 billion was an exception. The RBA made the intervention in order to try and push down the yield on government debt—which sets the baseline for interest rates—following a rapid rise over the previous few days.

Last week saw a spike in the 10-year Australian government bond yield from 1.61 percent to 1.71 percent after it had reached as high as 1.95 percent on Thursday amid a bond sell-off. The absolute numbers are small but the speed of the movement is significant for the operation of the financial system.

The dumping of bonds in Australia was part of a global sell-off last Thursday that saw yields rise. It prompted a significant fall on Wall Street amid rising concern that a rise in interest rates could spark another crisis in the global financial system.

The actions of the RBA may well be the forerunner of further increases in bond purchases by other central banks, including the US Fed and the European Central Bank.

The RBA began quantitative easing last month when it announced it would purchase $100 billion worth of government bonds. It decided to lift its purchases by a further $100 billion last month and Monday's announcement was a further escalation.

RBA governor Philip Lowe has stated that the central bank is not directly financing government debt, but this is something of a semantic quibble.

While the RBA is not directly buying new government debt, the two tranches of $100 billion purchases mean that the RBA holds around 20 percent of government debt. It is now buying more bonds in the secondary market than the government is issuing in new bonds to finance its increasing debt—estimated to be heading for the $1 trillion mark.

The RBA has a program which targets the yield on certain government bonds to keep them within a fixed range close to its base interest rate. Yield curve targeting has not been adopted by the Fed in the US but it is studying the Australian experience.

The RBA's stepped-up intervention highlights the growing concerns in financial markets that increased government debt, above all in the US as a result of the Biden administration's proposed $1.9 trillion stimulus package now going before the Senate, could spark a rise in interest rates and end the Wall Street stock market bubble.

Since the major intervention by the Fed, amounting to more than $3 trillion following the freezing up of financial markets last March, Wall Street has risen to new record highs. This is on the back of the assumption that the issuing of essentially free money will remain for the indefinite future and, moreover, if there is a market crisis the Fed will again intervene.

However, if investors withdraw from the government debt market, then bond prices will fall and interest rates will rise (the two move in the opposite direction).

The global bond sell-off last Thursday sparked a significant fall on Wall Street because, as the *Wall Street Journal* noted, it "rattled one of the foundations of the past year's powerful stock-market rally: investor certainty that ultra-low long-term interest rates are here to stay."

The sell-off appears to have been sparked by what the WSJ said were "concerning dynamics" in a Treasury auction for new government debt. Heading into the auction, demand for five and seven-year Treasury bonds was weak and "nearly evaporated" in the minutes following it, making it "one of the most poorly received that analysts could remember."

The weak demand has raised concerns because the US government will need to sell vast quantities of debt in order to finance the Biden stimulus package. If buyers cannot be found the Fed may have to increase its purchases of financial assets—currently running at $120 billion a month—and possibly take the road of the RBA and begin targeting the yield curve in order to keep interest rates down.

So far investors and speculators have been gratified by the assurances from Fed chairman Jerome Powell. He has indicated that interest rates are going to remain at virtually zero for the indefinite future and the central bank will not respond to an increase in inflation by lifting its base rate.

Notwithstanding these assurances, there remains the fear that the crisis that erupted in mid-March, when there was a rush for cash and an exit out of even the most secure government debt, could return.

There have been numerous warnings that the stock market is at unsustainable levels and is a bubble about to burst. The speculative rise of stocks such as GameStop, the significant involvement of so-called retail traders and the rise of the crypto currency bitcoin are signs of this.

Ruchir Sharma, the chief global strategist at Morgan Stanley, warned in the *Financial Times* that "higher long-term interest rates could end the extraordinary bull run for giant tech stocks." The transition to a post-COVID economy "may be more disruptive than imagined for financial markets," which had become "hooked" on low long-term interest rates.

Another indication of the market mania produced by low rates is the increased use of special purpose acquisition companies (SPACs) to launch new companies on the stock market. A SPAC is a company comprised entirely of cash which facilitates the launching of a company onto the stock market, bypassing the procedures for an initial public offering.

According to a report in the *Financial Times*, SPACs were involved in 50 deals for the month of February alone, demonstrating "the intensifying race to snap up promising young companies, often with little in the way of revenue, at ever-increasing valuations."

So far this year, 188 SPACs have raised $58 billion compared to 244 in 2020 when a total of $78 billion was raised for the entire year.

Following last week's Wall Street sell-off, markets bounced back on Monday. After its worst fall since last October, the S&P 500 had its biggest rise in nine months. The tech-heavy NASDAQ index rose by 3 percent and the Dow climbed more than 600 points, or 1.9 percent.

Yesterday the market fell, with the S&P 500 down by 0.8 percent with NASDAQ dropping by 1.7 percent. The dependence of the markets on the Fed was highlighted in comments to the *Wall Street Journal* by Fahad Kamal, chief investment officer at Kleinwort Hambros.

"The state of the bond market is driving everything," he said. "The central banks continue to be the real pivot in markets right now; as long as they continue to buy enormous amounts of bonds in the market, the upside move [in yields] is capped."

That may be the case in the short term but the gyrations themselves—the biggest fall in months followed in a matter of days by the biggest rise in months—are indications of a coming storm.