

US Federal Reserve report points to financial risks

Nick Beams**10 November 2021**

Amid growing uncertainty about the direction of the American and global economy, the US Federal Reserve has identified a series of risk factors in its semi-annual Financial Stability Report released on Monday.

It began by noting that, since the last report in May, prices of risky assets had risen further, despite concerns over the spread of the Delta variant of the coronavirus. This was the result of increased earnings and low interest rates as banks continued to remain profitable and strongly capitalised.

However, structural vulnerabilities persisted “in some types of money market funds and other cash-management vehicles as well as in bond and bank loan mutual funds and could again amplify shocks to the financial system in times of stress.”

One of the new risk factors was the financial turmoil in China that has cast doubt over the future of the real estate giant Evergrande and other property developers, which have either defaulted on their debts or struggled to make payments on them.

“Given the size of China’s economy and financial system, as well as its extensive trade links with the rest of the world, financial stresses in China could strain global financial markets through a deterioration of risk sentiment, pose risks to global growth, and affect the United States,” the report said.

This assessment is somewhat at variance with that of Fed chair Jerome Powell who said when the Evergrande crisis erupted two months ago that it was “very particular” to China.

In addition, a sharp tightening of global financial conditions, especially in highly indebted emerging market economies, could also pose “some risks to the US financial system.” A rise in bond yields and a “deterioration in global risk sentiment” could push up debt servicing costs for EMEs and stress their financial

systems.

The regional head of research for the Americas at the financial firm ING, Padhraic Garvey, told the *Financial Times*: “There was a notion of correlation [in the report]. The fear is that if one thing goes, the rest could go.”

On the domestic front, the report said key measures of vulnerability had returned to pre-pandemic levels as business balance sheets had benefited from continued earnings growth, low interest rates and government support.

While this was intended to provide reassurance, it should be recalled that the high degree of indebtedness in the pre-pandemic financial system and the rise of ever-more risky operations meant it went into virtual freefall when the pandemic struck. It had to be bailed out by the Fed to the tune of more than \$4 trillion—on top of the \$4 trillion that had already been pumped in under the quantitative easing program that followed the 2008 crisis.

The report pointed to the sensitivity of financial markets and equity valuations to interest rates. Across most asset classes valuations were high relative to historical norms and this was in part due to improved earnings expectations. But the ratio of stock prices to forecasts of corporate earnings stood “at the upper end of its historical distribution.”

Treasury yields were low relative to their historical norms meaning that “an increase in Treasury yields, if unaccompanied by a commensurate strengthening of the economic outlook, could put downward pressure on valuations in a variety of markets.”

The report described corporate borrowing as “robust” due to low interest rates. Bonds with the lowest investment grade ratings, those just above high-risk junk bonds, remained at “historically elevated levels”

and “the composition of newly-issued bonds has become riskier.”

On the impact of the Delta variant, the report warned that a deterioration in the public health situation would slow the recent economic recovery if business closures return and supply chains were further disrupted.

“An economic slowdown could weaken business and household balance sheets, leading to an increase in delinquencies, bankruptcies and other forms of financial distress. These rising losses on non-financial debt could put strains on banks and other lenders.”

This assessment underscores the reason for the homicidal drive by the US ruling class to scrap virtually all public health measures. The health and lives of the population must be sacrificed to ensure the health of the financial system and corporate profit.

The report also underscored why the question of interest rates has assumed such importance in financial assessments. “A steep rise in interest rates,” it said, “could lead to a large correction in prices of risky assets” because the valuation of many assets would be susceptible to a spike in yields.

Powell has been particularly conscious of this relationship. He has continually reassured Wall Street that, despite the decision to taper its purchases of Treasury bonds and mortgage-backed securities at the rate of \$15 billion a month, this does not imply an immediate increase in the Fed’s base interest rate.

The report also drew attention to the trading of so-called meme stocks, such as GameStop, which have drawn younger people into stock trading. It said the development of social media apps had made stock trading seem like a game for younger and less experienced investors.

Social media apps could create an “echo chamber” effect in which retail investors find themselves communicating most frequently with those who held similar views, reinforcing their views, even if they are biased or speculative.

It said that to date the effects of such trading on the broader market had been limited, but it noted that younger investors had a larger debt burden than the average and this vulnerability was being amplified by the use of options.

The Fed report also returned to the issue of the March 2020 freeze of the US Treasury market which, as has been noted, continues to haunt it and other financial

regulators.

In somewhat anodyne language it said the market, which forms the base of the US and global financial system, had experienced “severe dislocations.” In fact, it was an historically unprecedented situation.

As the report acknowledged, the typical response to severe global financial stress is the purchase of US Treasuries. But on this occasion, there was mass selling pressure in what has been dubbed a “dash for cash.”

Foreign investors, which held \$7.2 trillion of US Treasuries as of the second quarter 2021, played a significant role in the March 2020 events. They sold \$287 billion worth of Treasuries in the first quarter of 2020, with more than half of net foreign sales accounted for by official investors, that is, governments and central banks.

The Fed has since set up a repo system, whereby foreign monetary authorities can use their holdings of Treasuries as collateral for short-term borrowing of dollars and so do not have to sell off their bonds to obtain cash. The report said this had helped stabilise the market.

However, US financial authorities have yet to produce a full analysis of what happened or to develop mechanisms to prevent its recurrence.



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