Growing fears over what interest rate hike will produce

Nick Beams
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As the date approaches for the US Federal Reserve to start lifting interest rates, expected to be at the meeting of its Federal Open Market Committee next month, there are continuing indications of nervousness about the effect of monetary policy tightening on financial markets.

The Fed is treading a very fine line. On the one hand, it is being pushed to lift interest rates, possibly by as many as seven times this year, because of the inflation surge it had previously designated as "transitory." Inflation is now running at more than 7 percent with predictions it will go even higher.

The chief concern is that workers will undertake a concerted push for higher wages, with independent action, and break free of the drive by the trade unions, backed by the Biden administration, to shackle them.

On the other hand, there are fears that a too rapid increase in interest rates, combined with a rundown of the Fed's asset holdings, which have blown out to almost $9 trillion, will trigger major turbulence on Wall Street and even provoke a financial crisis.

It is a sign of the fragility of the financial markets and their total dependence on the flow of ultra-cheap money from the Fed that what were once regarded as relatively small incremental rises in the base interest rate—0.25 percent, 0.5 percent or even 1 percent—are now viewed with some trepidation.

As Joseph Amato, chief investment officer for equities at Neuberger Berman told the *Wall Street Journal*: "We haven't seen a single rate hike yet and the market is whipping itself into a bit of a frenzy."

The state of the financial markets was the subject of the lead article in this week's edition of the *Economist* magazine and headlined "What would happen if the financial markets crashed?"

"Today America's financial system looks nothing like it did before the crashes of 2001 and 2008, yet lately there have been some familiar signs of froth and fear on Wall Street; wild trading days on no real news," the article began.

It declared that it was "tempting" to think of the sell-off in January as exactly what was needed to purge the stock market of speculative excesses but "America's new-look financial system is still loaded with risks." The last time asset prices were so high relative to earning "was before the slumps of 2001 and 1929."

"The mix of sky-high valuations and rising interest rates could easily result in large losses, as the rate used to discount future income rises," it said.

This refers to the calculation that the present value of a share or financial asset is determined by the expected flow of income, discounted at the rate of interest. The higher the interest rate, the lower the present value.

"If big losses do materialise, the important question, for investors, central bankers and for the world economy is whether the financial system will safely absorb them."

The article did not make the point, but that question has already been answered. In March 2020, at the start of the pandemic, the plunge in the stock market led to a crisis in the market for US Treasury bonds. This $22 trillion market, the basis for the operation of the global financial system, froze such that at one point no buyers could be found for US government debt, supposedly the safest financial asset in the world.

The Fed had to intervene as the backstop for all areas of the financial system, including stocks and corporate debt, virtually doubling its asset holdings in a matter of days.

The *Economist* noted that while banks were better capitalised and held fewer risky assets, debt had been transferred to so-called shadow banks and investment funds. The total borrowings and deposit-like liabilities of hedge funds, property trust and money market funds had risen to 43 percent of GDP compared to 32 percent a decade ago.

On Monday a report prepared by the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency pointed to growing vulnerabilities in areas of the economy hit by the pandemic.

As the *Financial Times* noted in its article on the report, companies rushed to borrow cash, initially to provide a buffer against the pandemic and then to refinance their loans at lower rates of interest.

"That has resulted in a swelling of corporate debt piles, with credit even extended to the lowest rated companies, fuelled by investor demand for higher-yielding assets and bolstered by the Fed's historic intervention in financial markets," it said.

The official report said that while "some leveraged borrowers" had adjusted to the economic impact of COVID-19 and showed signs of recovery, others with elevated leverage "remain especially vulnerable."

It said rising interest rates may "negatively impact" both the "financial performance and repayment capacity of borrowers in a wide variety of industries."

The expectation of a rise in interest rates has already seen a tightening of monetary conditions with bond prices falling in both the short- and long-term segments of the market, leading to a rise in yields—the two have an inverse relationship.

After the release of inflation data last week, the yield on the 10-year Treasury bonds rose above 2 percent for the first time since the middle of 2019. At the end of last year, the 10-year Treasury yield was 1.496 percent.

The yield on two-year Treasury bonds, which are very sensitive to Fed policy moves, rose to 1.6 percent at the start of this week compared to 0.5 percent a year ago. The numbers may be small, but they are of major significance.

The key concern of the Fed and other central banks is the question of wages as the Bank of England made clear in its recent decision to lift its interest rates to enforce a further wage cut on British workers.

Speaking to the *Wall Street Journal* (WSJ) last week, John Briggs, head of strategy for Americas as NatWest Markets, said: "If consumers and workers start believing that inflation is not going to be transitory they're going to start demanding higher wages and higher inflation becomes embedded in the system."

The WSJ cited comments by Thanos Bardas a senior portfolio manager at Neuberger Berman, who said the yield on the 10-year bond could go as high as 2.5 percent. This reflected a major shift in the economy and meant central banks around the world would need to "change course, very, very soon, very aggressively to align themselves with the new reality" and this would bring "lots of volatility across all asset classes."

Fed chair Jerome Powell has insisted the Fed will use all its tools to bring down inflation. But, as the WSJ noted, the historical record shows that inflation has only been reduced by pushing the economy into a recession.

This means that, on top of the devastation produced by the pandemic, workers face the prospect of a major job losses as the result of a recession that will be further intensified if the house of cards, which is the financial system, undergoes another collapse, as seen in 2008 and March 2020.