Biden threats over Ukraine roil markets

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The continuous ramping up of threats against Russia by the Biden administration, combined with the prospect of rising interest rates and a tightening monetary policy under the impact of rising inflation, is bringing ongoing turbulence to Wall Street.

Stocks fell for the second day in a row yesterday. The S&P 500 dropped by 0.7 percent, losing 1.6 percent for the week. The Dow dropped by 200 points after losing 600 points the previous day, its largest one-day fall so far this year. The tech-heavy NASDAQ index ended down nearly 2 percent for the week.

The S&P 500 is down 8.5 percent for the year while the NASDAQ has fallen by 13 percent. The larger fall in the NASDAQ is the result of the greater sensitivity of tech stocks to the prospect of higher interest rates.

The combined effect of rising war dangers and tightening monetary policy has been highlighted by numerous financial analysts and commentators.

As Peter Essele, the head of portfolio management at Commonwealth Financial Network, told the business channel CNBC: "A further escalation of tensions in the near term could roil markets due to the potential impact on a tenuous global supply chain, particularly as the Fed prepares for its first rate hike in years. A perfect storm may be on the horizon if calmer heads don't prevail."

Similar views were expressed by the senior market analyst at the brokerage firm Oanda, Edward Moya, in a recent note. "Wall Street is feeling very jittery as it looks to the left and sees intensifying geopolitical risks with the Ukraine and then it looks to the right and sees the potential for aggressive Fed tightening," he wrote.

In the lead up to the next Fed meeting, to be held in mid-March, there are disagreements about what exactly should be done, regarding the level of the initial interest rate increase, the pace of rises for the rest of the year and, if and when the Fed, should start to reduce its $9 trillion balance sheet.

The minutes of the January meeting of the Federal Open Market Committee (FOMC) revealed there was agreement that interest rates should be increased "soon," but what happens after that has yet to be determined.

Blerina Uruci, US economist at T Rowe Price, told the *Financial Times* (FT): "It is very telling that there is a lot of debate going on across the committee and there is no consensus about the appropriate pace of tightening. It seems very much still up in the air."

Fed chair Jerome Powell is using the time before the March meeting to try to forge a consensus on monetary policy as members of the governing body air their views on its direction.

St Louis Federal Reserve president James Bullard is among those advocating significant action by the Fed because of the rapid rise in inflation, now running at more than 7 percent with predictions that it could go even higher.

"We're at more risk now than we've been in a generation that this could get out of control," he said during a panel discussion at Columbia University on Thursday.

What is meant by "out of control" is a situation where price rises force workers to take action to reverse the continuous cuts in their living standards—one of the main fears of the Fed and other central banks.

And other "risk" factors abound.

"One scenario would be… a new surprise that hits us that we can't anticipate right now, but we would have even more inflation. That's the kind of situation that we want to… make sure it doesn't occur," Bullard said.

He has called for interest rate increases to be front loaded and that there should be a full percentage point rise by July, saying such a move was not tight policy.

"Don't let anyone tell you it's tight policy. It's removal of accommodation that will signal that we take our responsibility seriously."

Interest rate hikes of the kind being advocated by Bullard are small when compared to the historical record. But such is the dependence of financial markets on the flow of ultra-cheap money from the Fed that even small increases in rates are viewed with trepidation lest they spark a crisis.

While Bullard has indicated that he will defer to Powell on the interest rate decision his remarks have provoked comments from other members of the Fed's governing body who want a more gradual approach.

Minneapolis Fed president Neel Kashkari has said the Fed should not "overdo it" and has warned that if the Fed raised rates "really aggressively, we run the risks of slamming the brakes on the economy."

New York Fed president John Williams, who is close to Powell, said yesterday the central bank should "steadily" raise interest rates from their current levels of near zero next month, but he did not see compelling reason for a "big step."

Other officials, including Mary Daly, the president of the San Francisco Fed who is regarded as "dovish," have called for a "measured" approach to lifting interest rates.

A potentially bigger question than the speed and size of interest rate increases is the issue of a reduction in the size of the Fed's balance sheet. The last time the Fed tried to reduce its asset holdings it led to a plunge on Wall Street at the end of 2018, forcing Powell to beat a hasty retreat.

Since then, the Fed's holdings of financial assets—Treasury bonds and mortgage-backed securities—have more than doubled because of its massive intervention, starting in March 2020 when the crucial $22 trillion bond market froze at the onset of the pandemic.

The FOMC has begun discussing how to reduce its balance sheet but there is no agreement on how and when or even if this should be done.

But the turn from quantitative easing (QE) to quantitative tightening (QT) is already causing concern because central banks have no previous experience and no clear idea about what will happen once they start selling off some of the assets they have bought.

Fears have been voiced that the holders of long-term bonds have been too complacent about the effects of a balance sheet reduction by central banks.

The head of rates at Royal London Asset Management, Craig Inches, told the FT: "Long-term bonds are effectively living in cloud cuckoo land. Has the market priced QT in? No. People seem totally focused on interest rate hikes and aren't thinking about balance sheets."

Concern over the effect of rate rises is not confined to Wall Street. This week the chair of supervision at the European Central Bank, Andrea Enria, warned that the regulator may lift capital requirements for major banks because some of them were breaching guidelines on so-called leveraged loans that finance companies with high debt levels and poor credit ratings.

Since 2017, the proportion of so-called "covenant lite" loans that have reduced protection for lenders has almost doubled, largely because of ultra-low interest rates.

According to the FT: "Regulators are worried that if economic growth disappoints, or borrowing costs rise sharply, large debt loads could become unmanageable, accelerating the decline of heavily indebted companies and potentially exposing banks to losses."

Those risks are being exacerbated by the geo-political tensions and the threat of war resulting from the ever-more bellicose actions of the Biden administration against Russia.