Stock market falls point to mounting problems in financial system

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Wall Street, together with other stock markets around the world, has continued to fall under the impact of rising interest rates, inflation, and a slowing global economy amid warnings the conditions are being created for instability in financial markets.

The *Financial Times* reported that its All-Worlds barometer of global equities dropped on Monday by 3 percent, its sharpest fall since June 2020 as markets were hit by the onset of the pandemic, reaching its lowest level since December of that year.

The sharp declines on Wall Street last week continued Monday with the S&P 500 down by 3.2 percent with the tech-focused NASDAQ dropping a further 4.3 percent. The S&P is down more than 16 percent for the year while the NASDAQ has fallen more than 25 percent and is now down 27 percent from its record high last November.

After a significant selloff in Asian markets yesterday, Wall Street rose slightly on the day.

Summing broad sentiments, Seema Shah of Principal Global Investors told the *Wall Street Journal*: “By 2023 you are very likely to see growth slowing very significantly, and the spectre of recessions is really starting to loom.”

The world economy is pointing in the same direction. There are fears of a significant slowdown in China as it grapples to bring the spread of the latest COVID-19 outbreak under control with exports falling to their lowest levels in two years last month. There are indications of a slowdown in German and French manufacturing industries. The price of oil has also fallen as fears grow of a weakening global economy.

The latest phase in what the WSJ described as a “rout” began last Thursday. Prices had risen sharply the previous day on the back of assurances by Federal Reserve chairman Jerome Powell that the central bank was not considering an increase of 0.75 percent points in the bank’s interest rate.

But then the reality of continued Fed rate rises—Powell indicated rises each of 0.5 percentage points were on the table for at least the next two meetings of the Fed—sank in and markets fell sharply.

Beneath the immediate fluctuations of the share markets, there are indications of mounting problems in the financial system. It is haunted by the meltdown in March 2020 at the start of the pandemic which saw the Fed intervene to the tune of around $4 trillion, becoming the backstop for all areas of finance.

These fears were highlighted in the Fed’s semi-annual Financial Stability report issued on Monday. It said there was a “higher than normal” chance that conditions in US financial markets could suddenly worsen.

“Further adverse surprises in inflation and interest rates, particularly if accompanied by a decline in economic activity, could negatively affect the financial system,” the report stated.

A sharp rise in rates “could lead to higher volatility, stresses to market liquidity, and a large correction in prices of risky assets, potentially causing losses at a range of financial intermediaries” which could reduce “their ability to raise capital and retain the confidence of their counterparties.”

The Fed report said banks remain well capitalised “but some money market and bond funds are still exposed to sizable liquidity risks.” It warned that some types of money market funds remained prone to runs and “many bond and bank loan mutual funds continue to be vulnerable to redemption risks.” That is, they can experience liquidity problems when large numbers of investors decide to pull their money out.

It noted that elevated inflation and rising interest rates could have far-reaching effects, negatively impacting on “domestic economic activity, asset prices, credit quality, and financial conditions.”

If any near terms risks were realised, it continued, “and especially should such events precipitate a marked worsening of the economic outlook, their effects could be amplified through the financial vulnerabilities” within the system.

The Fed report noted that since late 2021 there had been a tightening in the market for US Treasury securities. Markets are regarded as liquid if traders can make transactions without affecting the market as a whole. Low liquidity, by contrast, can amplify volatility and result in unexpected financial tightening.

“In extreme cases, such as the market turmoil at the onset of the pandemic in March 2020, low liquidity can impair the ability of the financial system to respond to a large shock because investors may not be able to adjust their holdings of assets to raise cash or hedge risks, or they may be able to do so only at a substantial cost.”

While the deterioration in liquidity had not been as extreme as in past cases, “the risk of a sudden deterioration appears higher than normal.”

The low depth of liquidity, it said, could indicate that liquidity providers were being particularly cautious. “Declining depth at times of rising uncertainty and volatility could result in a negative feedback loop, as lower liquidity in turn may cause prices to be more volatile.”

The report also drew attention to the situation now developing in the corporate bond market noting that heightened uncertainty weighed on the risk appetite for this form of debt. The share of new speculative-grade bonds with the lowest ratings from financial agencies was low by historical standards but it pointed to the build-up of problems in other areas.

“[The] share of outstanding bonds with the lowest investment-grade ratings—the so-called triple-B cliff—reached its highest level in two decades, suggesting that many investment-grade bonds remain vulnerable to being downgraded to speculative-grade in the event of a negative economic shock.”

The rise in bank interest rates has sparked a selloff in Treasury bonds with the yield on the 10-year Treasury now around 3 percent, compared to less than 1 percent only a few months ago. [Bond prices and their yield or interest rate move in opposite directions.]

The shift in Treasury yields is having an effect in the corporate bond market. The *Financial Times* reported on Monday that the Bank of America estimated that the average price of investment-grade US corporate bonds has fallen to just above 93 cents on the dollar.

This was below the level reached during the market crash of March 2020 and at a level not seen since May 2009 when markets were still reeling from the effects of the global financial crisis of 2008. Now there are clear indications the conditions which produced these crises are building up once again.