Half year of financial turbulence set to worsen

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Warning lights in the global financial system are starting to flash red as a result of the persistence of rising inflation and the drive by central banks to sharply lift interest rates, even as this provokes a recession.

Wall Street has recorded its worst opening six months of a year since 1970, when the US economy was in recession. On Thursday, the S&P 500 index dropped 0.9 percent leaving it down by 20.6 percent for the year. The fall in the tech-heavy NASDAQ index was even larger, with losses for the year approaching 30 percent.

According to calculations by Bloomberg, around $9 trillion has been wiped off the share market, with the total value of the broad-based S&P 1500 index falling from $45.8 trillion, at the end of 2021, to just over $36 trillion.

Summing up the situation, *Wall Street Journal* financial columnist James Mackintosh noted that halfway through the year “markets are beginning to fear we’re not even halfway through the bad news 2022 has in store,” as he pointed to the “surprises” of the first six months.

These included, inflation, the biggest sell off in bonds in four decades, “a plunge in tech stocks rarely matched in history,” and the “implosion” of crypto.

There are indications that the turmoil is spreading from high-risk areas to supposedly more secure areas of the market. According to a report in the *Journal*, bonds rated as investment-grade posted a fall of 11 percent in the first six months, “their worst start to a year in history.”

The prospect of a recession is rising, with the US economy recording an annualised contraction of 1.6 percent in the first quarter, amid predictions the result for the second quarter will be little better. Economists polled by the *Journal* said they saw a 44 percent probability of recession in the next 12 months, compared with 18 percent in January.

As it began its rate tightening, Federal Reserve chair Jerome Powell and other central bank officials maintained it was possible to engineer a “soft landing” for the US economy without bringing about a recession. But that scenario has gone by the board with Powell stating that interest hikes—aimed at ending what he has repeatedly called a “very tight” labour market—will cause some “pain.”

Research by the Federal Reserve Bank of St Louis on monetary tightening cycles over the past four decades concluded that the US economy went into recession four out of the last six times it began raising rates.

It has been reported that major investment banks, including Bank of America, Credit Suisse and Goldman Sachs, as well as others, could collectively lose billions of dollars on leveraged buyout operations, in which they provide loans for takeover operations that they then sell off.

But according to a *Journal* report, as of June 23, they were receiving an average of 94.8 cents on the dollar for newly-issued buyout debt, as compared to 99.2 cents at the end of January.

It is expected that losses on the $15 billion private-equity-backed leveraged buyout of the cloud-computing company Citrix, the largest such operation this year, could total as much as $1 billion.

Financial conditions in Europe are also rapidly worsening. A *Financial Times* (FT) report published at the weekend drew attention to the situation in the corporate bond market where €40 billion worth of debt is now trading at “distressed” levels, compared to $6 billion at the end of last year. And the slide appears to be accelerating.

“The stock of distressed corporate debt more than doubled from May 31 to June 30 alone, underscoring how quickly concerns are mounting that central banks’ decisions to tighten monetary policy could tilt major economies into recession,” the article said.

Last week, the ratings agency S&P Global warned of the "increasingly murky outlook for credit quality" in Europe.

"Credit ratings are likely to come under pressure into 2023 as supply constraints keep food and energy prices elevated, households increasingly struggle with falling real incomes, and central banks prioritise inflation over growth," it said.

According to calculations by Ice Data Services, reported by the FT, in the euro-denominated junk bond market—those with less than an investment grade rating—8.8 percent were now trading at "distressed" levels. That is, they were more than 10 percentage points above government bonds, compared to 1.3 percent at the end of last year.

But it is not only the riskier portions of the market that are being impacted by the growing fears that higher interest rates will bring about a recession. A note issued by JPMorgan European credit analysts on Friday said, there was an "alarming freeze in capital market lending conditions, which has gradually spread up the quality curve."

One of the sharpest expressions of the results of higher central bank interest rates and tightening credit is the meltdown in the crypto currency markets—a kind of "canary in the coal mine" for the financial system as a whole.

Three weeks after the crypto lender Celsius Network halted customer withdrawals, investors are faced with prospect that they will never get their money back. On Thursday it issued a blog post saying it was continuing to "take important steps to preserve and protect assets and explore options available to us."

Celsius is reported to have hired attorneys and consultants for a possible bankruptcy filing under which customers may not be able to recover crypto currencies in their accounts or collateral they put up for loans. Many individuals, lured in by the crypto hype and the promise of 20 percent returns, will be affected, with the possibility that major financial players could also be involved.

On Friday, the crypto hedge fund Three Arrows filed for bankruptcy in the US after it was pushed into liquidation in the Virgin Islands when it failed to pay $80 million to the digital asset exchange Deribit.

Major crypto firms stand to lose hundreds of millions of dollars. The Toronto-based crypto lender Voyager Digital said late last month it could lose more than $650 million and has suspended withdrawals and halted trading as it examines "strategic alternatives."

The FT said the failure of Three Arrows was the latest example of the how crypto turmoil had wrong-footed some of the industry's biggest players and how "trouble at one firm can ricochet across the sector due to opaque links between investors, crypto exchanges and lending firms."

Since reaching its high of $3 trillion last November, the market value of crypto has fallen to under $1 trillion. The question is how much of this loss has been incurred by major hedge funds that moved into the crypto market over the past two years.

The significance of the collapse of crypto is that while it was regarded as something of an outlier, its modus operandi was the same as the rest of the financial system. It used the essentially free money provided by the Fed to finance ever-riskier financial bets.

It is worth recalling that when the problems in the sub-prime mortgage market first emerged in 2007, the then chairman of the Fed, Ben Bernanke, insisted that because it was only a small segment of the financial system it would not have broader effects. But as the financial crisis of 2008 revealed, it was the trigger for a collapse because the practices developed in sub-prime, some of them of a criminal character, were rife throughout the system.