Tug of war on global financial markets

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Financial markets are embroiled in a kind of tug of war amid rising uncertainty over the effect of the interest rate hikes by the US Federal Reserve and other central banks and how long they will continue in the face of growing signs of a recession.

One view is that the inflationary surge, which has already seen the fastest increase in prices for four decades—8.6 percent in the US and heading towards double digits in the UK and the euro zone—will continue and lead to further significant interest rate increases as central banks seek to suppress wage demands.

The other is that the interest rate rises so far have brought about a slowdown in the economy and even set in motion a recession and the Fed and other central banks will not lift rates as much as previously thought.

This appears to be the prevailing sentiment on Wall Street at the present with the major indexes recording rises over the past days following the worst opening half-year for stocks for 50 years. However, this view could rapidly change.

The Fed minutes of its June meeting, at which it decided to lift interest rates by 75 basis points (a 0.75 percentage point increase), with indications of more to come at its next meeting to the held at the end of this month, pointed to a tightening of monetary policy.

According to the minutes, members of the Fed's monetary policy making body "concurred that the economic outlook warranted moving to a restrictive stance of policy, and they recognised the possibility that an even more restrictive stance could be appropriate if elevated inflation pressures were to persist."

They recognised that interest rate hikes could "slow the pace of economic growth for a time" but insisted that the return of inflation to 2 percent was "critical."

The minutes also made clear the key question in determining policy was whether inflation would lead to a further development of the movement by workers for wage rises.

"Many participants judged that a significant risk now facing the Committee was that elevated inflation could become entrenched if the public began to question the resolve of the Committee to adjust the stance of policy as warranted."

The word "entrenched" is part of the coded language used by the Fed. It refers to a situation where workers believe price hikes that have already inflicted major cuts in their living standards are going to continue and advance wage demands.

Since the June meeting at least two Fed officials have been pushing the view that restrictive policies must continue.

Speaking at a webinar on Thursday, Fed governor Christopher Waller said: "Inflation is just too high and doesn't seem to be coming down. We need to move to a much more restrictive setting in terms of interest rates and policy, and we need to do that as quickly as possible."

Referring to the issue of wages, again in coded language, he said: "The whole thing we know about expectations [is] once they become unanchored, you've lost." The Fed was "dead set" on bringing inflation under control. This means ensuring that price rises do not lead to increased wage demands.

His views were echoed by another Fed governor, James Bullard, who supports a rate rise of another 75 basis points at the end of the month. Speaking at an event in Arkansas on Thursday, he said the economic situation was "already straining the Fed's credibility with respect to its inflation target" of 2 percent.

These views continue the thrust of the June Fed meeting. But since then, there has been a shift in global economic conditions, indicating the degree of turbulence both in the real economy and in financial markets.

As a result of economic slowdown and recession fears, prices in oil, metals and basic food commodities have fallen from their highs earlier this year and there are indications of slowing industrial activity both in the US and Europe.

US GDP fell at an annualised rate of 1.6 percent in the first quarter. Initially this was dismissed as a kind of blip, or statistical aberration, in the face of what was claimed to be a “strong” US economy.

But a closely watched index compiled by the Atlanta Fed has forecast an annualised contraction of 2.1 percent for the second quarter. And in a sign of a developing contraction in the labour market, it was reported on Thursday that the number of new applicants for unemployment benefits had risen to a six-month high.

Another recession indicator has emerged in the bond market where the yield curve has inverted. That is the yield, or interest rate, on the 10-year Treasury bond has fallen below that on two-year debt, contrary to what is considered to a be a normal situation where the yield on longer-term debt is higher than that on shorter-term bonds. Yield curve inversion has occurred prior to all the recessions of the past 50 years.

The recessionary tendencies have led to the view in financial markets that the Fed will be forced to pull back on its interest hikes. In other words, after taking away the punchbowl of cheap money, the Fed will soon be forced to return it and the financial party, based on speculation, can resume after a brief hiatus.

Stocks on Wall Street have been rising with the S&P 500 recording its largest increase this week since March and the interest-rate sensitive NASDAQ enjoying the same result. The uplift has also been reflected in highly speculative stocks such as GameStop which jumped by 15 percent on Thursday.

The sentiment driving the rises was summed up in a comment by Tatjana Greil Castro, the head of public markets at a British investment firm, to the *Financial Times*.

“Over the last few weeks, recession fears have been so strong that markets are expressing that whatever central banks say, they won’t have the runway to raise rates to the extent that they have indicated that they will,” she said.

The central bankers, who present themselves as the guardians of the interests of the economy and the mass of the population, have no idea where it is heading.

But one thing is certain: whatever the outcome of the present turbulence as the enforcers of the interests of financial capital, in collaboration with all governments that serve the same interests, they will strive to make the working class pay through the suppression of wage demands as inflation rises, the imposition of recession, or a combination of both.