Wall Street rises as economic and financial problems mount

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If one were to take the movement of stock prices on Wall Street as a guide, then the problems for the financial system and the broader economy arising from inflation and interest rate hikes by the US Fed and other central banks are on the wane.

Since its low point in mid-June, the interest-rate-sensitive, tech-heavy NASDAQ index has risen by more than 20 percent. Over the same period the broad-based S&P 500 index has risen by 17 percent while remaining down by 10 percent for the year. The Dow is also up from its June lows.

The rise in the market has been driven by the belief that inflation is starting to come down—official figures for July saw no increase, bringing the US annual rate of inflation down from 9.1 percent to 8.5 percent—and the Fed will start to ease off on its rate increases after two consecutive hikes of 75 basis points each.

The view is that if this does take place, then the orgy of profit-making based on cheap money will be able to resume.

But looking beyond Wall Street, it becomes clear that, far from being alleviated, problems in the financial system and the global economy are growing.

In the first instance, the Fed may pull back on the interest rate hikes at its meeting in September—the expectation is that there will be a rise of 50 basis points rather than 75. However, Fed officials have made it clear the central bank is far from finished in its drive to ensure that a wages movement by the working class in response to price hikes is suppressed.

The Fed's program is part of an international strategy by the world's central banks to drive down the living standards and social conditions of the working class in the name of "fighting inflation." At this point, this social counter-revolution is most sharply expressed in the UK where the Bank of England has lifted interest rates with the aim of driving the economy into a recession to counter wage demands.

In an interview with the *Financial Times* last week, Mary Daly, president of the San Francisco Fed, indicated that 0.75 percentage point rise was not off the table in September, while her "baseline" was a 0.5 percentage point increase.

While there was some "good news" in the monthly data, inflation "remains far too high and not near our price stability goal." It was too early to declare victory over inflation, she said, and "we're not near done yet."

Minneapolis Fed president Neel Kashkari has said he still anticipated the Fed would need to raise its base rate by another 1.5 percentage points by next year, lifting it to around 4.4 percent.

In an interview last week, St Louis Fed president James Bullard, regarded as one of the more hawkish members of the Fed's governing body, pointed to the essential driving force of the rate increases. "We've got a long ways to go on the labour market," he said.

Bullard was pointing to what is regarded as a "tight" labour market, saying there would need to be tangible and widespread evidence of disinflation occurring "before we can be really confident." That evidence will be indications that even the limited wage increases, below the inflation rate, which workers have so far been able to secure, have ceased.

As prices in basic items continue to rise—grocery items, for example, are up by more than 13 percent—there are clear signs of recessionary trends. The rise in US gross domestic product has been negative for each of the past two quarters, a situation sometimes described as a "technical recession," with indications the contraction is continuing.

On Monday, a New York Federal Reserve survey of manufacturers registered minus 31.3 for August compared to 11 the previous month. The forecast was for a reading of 5 and the slump in the so-called Empire State gauge was the second-largest monthly fall on record.

Recession signs are also flashing in financial markets as so-called yield curve inversion—a situation in which the interest rate on short-term government debt is above that on 10-year Treasury bonds—persists. Over the past 50 years, this inversion, which is contrary to the normal situation, has been a reliable indicator of recession.

There are also clear warning signs of a marked slowdown in the world's second-largest economy, China.

On Monday, the People's Bank of China (PBoC) unexpectedly cut its medium-term lending rate by 10 basis points in a bid to boost the economy, amid signs of slowing consumer demand, lower industrial demand and a worsening housing and real estate market.

In the second quarter, the economy narrowly avoided a contraction, expanding by only 0.4 percent, and the problems appear to be worsening.

July data show that retail sales rose by only 2.7 percent for the year, compared to forecasts of a 5 percent rise, while industrial production was up by 3.8 percent, compared to the forecast of a 4.6 percent increase.

Chinese financial authorities have been reluctant to ease financial conditions because of concerns over rising debt. But Julian Evans-Pritchard, senior China economist with Capital Economics, told the FT that the PBoC seemed to have decided that it faced a more pressing problem.

"The latest data show lacklustre economic momentum in July and a slowdown in credit growth, which has been less responsive to policy easing than during previous economic downturns," he said.

Real estate and housing, which account for more than a quarter of the Chinese economy when flow-on effects are considered, are at the centre of the slide in economic growth. This threatens to render the official target of 5.5 percent growth for this year—itself the lowest target in more than three decades—a dead letter.

Data released on Monday show that new home prices recorded their steepest year-on-year decline in more than six years in July.

In comments to the *Wall Street Journal* last week, Logan Wright, the director at Rhodium Group, a New York research firm that closely follows China, said: "We've never seen a property market slowdown of this size and severity." There was little financial authorities could do to turn it around, he added.

There are significant financial effects. More than 30 property developers have now joined the real estate giant Evergrande in defaulting on their international debts.

The issue of debt defaults is by no means confined to China. The rise in interest rates internationally has created the conditions where a number of less developed countries will be unable to pay back loans.

Sri Lanka is already in this situation and others, including Kenya, Egypt, Bangladesh, and Pakistan, could follow. According to Leland Goss, general counsel at the International Capital Markets Association, borrowing in emerging markets, even before COVID hit, grew from $3.3 trillion, a quarter of economic output, to $5.6 trillion, around one third, in a decade.

Goss told the FT the prospect of "possibly systemic debt crisis" was real. "Creditors with exposures to not one, or a few, but many sovereign borrowers could have large aggregate exposures" with "potential systemic implications" if they were large financial institutions, he said.

A report issued at the end of last month revealed that emerging markets are already being hit by withdrawals of money. The Institute of International Finance reported that outflows from emerging markets in July were $10.5 billion, taking the total to $38 billion over the past five months—the longest period of outflows since records began in 2005.

The gyrations on Wall Street are driven by the shortest of short-term considerations. Interest rate rises by the Fed may ease somewhat and so the market goes up. But the longer-term implications of the rises so far have yet to take full effect. They will begin to impact when debt, taken out when interest rates were near zero, must be refinanced.

According to the rating agency Fitch, defaults on high-yield US debt could double this year to 1 percent and also double in Europe to 1.5 percent. Other estimates put the rate even higher, as much as 4 percent per year.