

Question mark raised over the world's most important financial market

Nick Beams

7 December 2023

The current edition of the *Economist*, one of the world's leading financial magazines, carries an extraordinary headline.

It poses the question: "Is the world's most important asset market broken?"

The article deals with significant problems in the \$25 trillion US Treasury market where government debt is bought and sold, and which forms the key foundation for the entire global financial system.

Those problems have surfaced in a series of crises in recent years. In 2019 there was turmoil in the repo market where holders of financial assets use them as collateral to obtain cash short-term, sometimes overnight, as part of their daily operations.

Interest rates in these usually routine transactions, which grease the wheels of the financial system, rose to unprecedented heights, as much as 10 percent at one point, before the Federal Reserve intervened to stabilise the situation.

Then came the market freeze in March 2020 at the start of the pandemic when, in a so-called "dash for cash," no buyers could be found for US government debt, supposedly the safest financial asset in the world, for several days.

The Fed intervened injecting \$4 trillion into the financial system—at one point it was said to be spending a million dollars a second—and became the backstop not only for US Treasury bonds but many other forms of debt.

The intervention not only stabilised the situation but created the conditions where financial oligarchs were able to rake in hundreds of billions of dollars during the worst period of the pandemic.

Since then, there have been problems with the issuing of new government debt. The Treasury modified its last issue of debt earlier this year somewhat away from the

longer end of the market in order to mitigate against turbulence.

Last month a cyber-attack on ICBC, a Chinese bank, disrupted settlements in the Treasury market for several days.

The *Economist* article describes the Treasury market as "a network of mind-bending complexity" which touches almost every financial institution.

"Short-term bills and long-term bonds... are issued by Treasury. They are sold to 'primary dealers' (banks and broker dealers) in auctions. Dealers then sell them to customers: foreign investors, hedge funds, pension funds, firms and purveyors of money-market funds. Many buyers raise money to buy Treasuries using the overnight repo market, where bonds can be swapped for cash. In secondary markets high-frequency traders often match buyers and sellers using algorithms. Participants, in particular large asset managers, often prefer to buy Treasury futures—contracts that pay the holder the value of a specific Treasury on an agreed date—since it requires less cash up front than buying a bond outright. Each link in the chain is a potential vulnerability."

As a result of the recent crises, regulators are seeking to impose new controls under conditions where the debt market has grown by leaps and bounds and the conflict in Congress over the "debt ceiling" continually threatens to push the US into a debt default.

Government debt is now equivalent to around 100 percent of GDP, up from 71 percent a decade ago. Servicing it now comes to a fifth of all government spending and is one of the fastest growing categories.

On the regulatory front some minor changes have been introduced by the Treasury, the *Economist* characterises them as "fiddles," which provide greater data, with the main push coming from the Securities

and Exchange Commission (SEC).

The SEC has directed attention to the so-called basis trade which links the market for Treasuries to the futures market. Because there is a very slight difference in price there is the opportunity for profit and it has been eagerly seized on.

Hedge funds can go short by selling a futures contract and then buying the Treasury bond in the market when the contract becomes due at a marginally lower price. They can then go to the repo market to obtain more cash to finance more basis trades. Because the price differences are so small, this requires a large amount of borrowed money to make it profitable.

As long as everything goes smoothly, there are large profits to be made. But in times of turbulence, futures exchanges will make margin call—that is demand that borrowers put up more cash. This is believed to be one of the reasons for the “dash for cash” in 2020, which led to the Treasury market freeze.

The SEC is proposing that the hedge funds that are most active in the market are designated as broker dealers meaning they are subject to stricter regulations. It is also considering rules that would limit the amount they can receive from banks to finance their operations.

As could be expected, the hedge funds are having none of it, with Ken Griffin, the head of Citadel, one of the largest and most profitable funds, saying the SEC was “searching for a problem.”

The hedge funds developed their highly profitable operations under conditions where interest rates were at an historic low and they could count on the Fed to come in as the backstop to the market if trouble developed.

But these conditions have changed with the lifting of interest rates since March 2022. On top of this, there is a question of how far the Fed can go in continually bailing out the financial markets when there is growing concern about its stability.

This is reflected in the rising price of gold in recent days as the question is increasingly raised: how long can the US go on just issuing new dollars at the press of a computer button to finance itself? This is inherently unsustainable and that being the case then, as the old saying in financial circles has it, being unsustainable means at some point it must stop.

The increase in interest rates is having an impact in the broader economy—an issue which was the subject of

analysis by Bloomberg financial columnist John Authers this week.

He began by noting that there had been a strange non-event in that the widely anticipated wave of corporate defaults because of rising interest rates had not eventuated, at least not yet.

But there have been two of major significance. The recent bankruptcy of WeWork was the largest by a US company since the global financial crisis (GFC) while the demise of the Austrian real estate group Signa was Europe’s biggest post-GFC insolvency.

Both these major developments proceeded “relatively quietly.”

However, the calm may not last as Authers cited research on the worsening debt position of US corporations in the higher interest rate environment.

According to one metric devised by New York University academic Edward Altman, in the last century more than half of all American companies were strong and healthy.

“That number had now dropped to below 10 percent for the first time on record,” Authers wrote, adding that “the number of companies that are imminent risks for bankruptcy has been rising consistently, and has reached a new high.”

In the era of low interest rates, companies had become “more and more accustomed to taking risks with their financial health and getting away with it.”

He also cited other findings on so-called “zombie firms,” that is companies that do not produce enough profits to cover their interest expenses.

The research found that over a three-year period, “slightly more than a fifth of US companies” fell into this category.

On the surface the capitalist economic engine may appear to be running smoothly as finance capital rubs its hands at the prospect of rate cuts. But lift the hood and from the Treasury market to the gold market and the corporate world, there are growing signs of a major malfunction.



To contact the WSWS and the
Socialist Equality Party visit:

wsws.org/contact