

# 2023: A year of financial turbulence

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The year is set to close with the US stock market at, or very close to, record highs after what has been a turbulent year for the financial system.

The rise on Wall Street, which has been boosted by the “dovish” turn by the US Federal Reserve at its December 13 meeting, is being fuelled by market expectations of at least three and possibly as many as six interest rate cuts in 2024.

The surge is extending across the board. The Dow has hit seven record highs for the month and the S&P 500 is fractionally below its record high reached in January 2022 after posting a 34 percent rise from its low last year. And in what has been described as a “bond carnival” the world biggest debt market, that for US Treasuries, is on track to make its biggest two-month gain on record.

The tech-heavy NASDAQ 100 index is set to record its largest rise since 1999, at the height of the dot.com bubble. It is up 55 percent this year, fuelled by the prospects of profits from artificial intelligence.

But the market frenzy is being accompanied by expressions of concern that the extreme volatility in the financial system, evident throughout the year, can spark major problems, if not a crisis.

“We have an ‘everything rally’ at the year’s end. The magnitude is breathtaking,” Sonja Laud, the chief investment officer at the UK’s largest asset manager Legal & General Investment, told the *Financial Times* (FT). “I’m worried about that. There’s no room for error.”

And, notwithstanding the euphoria in markets over the prospect of rate cuts, the effects of the steep rise in rates over the past 18 months—the Fed rate is now more than 5 percent after being near zero for more than a decade—are still flowing through the system and can cause sudden shocks.

No one, for example, predicted that the rises would lead to three of the four largest banking failures in US

history in March, marked by the fastest run on deposits seen in history, and would require a major intervention by the Fed and government authorities to prevent a financial meltdown.

It is significant that one of the areas of greatest concern is the US Treasury market, where government debt is bought and sold. Now approaching \$27 trillion it is the bedrock of the US and global financial system.

It is showing signs of increased volatility. In the middle portion of the year yields on 10-year bonds were rising as they were sold off—yields and bond prices move in opposite directions—in the expectation that the Fed was going to maintain its monetary policy tightening stance.

But as inflation numbers started to come down and wage demands continued to be suppressed by the trade union apparatuses, there was a rising clamour in the markets for rate cuts. At first the Fed appeared to resist these demands. But at the December meeting Fed chair Jerome Powell threw in the towel and made a pivot, just two weeks after insisting that the previous orientation would be maintained.

The result has been that the yield on the 10-year bond, which touched just over 5 percent in October is now down to around 4 percent and set to go even lower. Such rapid movements in a market where shifts of fractions of a percentage point can be significant, is indicative of instability.

Another cause of concern which has emerged this year is the so-called basis trade where big bets are made exploiting the slight difference between bond prices and what they will fetch in futures markets. Because the differences are so small traders need to borrow large amounts of money to make the operation profitable.

In a recent post on his Chartbook site, economic historian Adam Tooze noted that regulators were “particularly concerned” about the speculative character of the trade in which a hedge fund employs a

minimum of its own money and a maximum of borrowed money.

The amounts involved are large, more than half a trillion dollars.

“According to one set of estimates,” Tooze wrote, “in December 2022 the hedge funds owed \$553 billion on basis trade borrowing and were leveraged at a ratio of 56 to 1. This creates the potential either for widespread losses in the credit system or major hedge fund failure.”

The numbers involved have almost certainly gone up this year, creating the risk that the failure of even one fund can set off a “dash for cash” and the kind of “doom loop” that developed in the UK in October 2022 when falling bond prices forced pension funds to sell bonds to raise cash, sending prices even lower.

But as Tooze noted, even as regulators seek to intervene, they are to a great extent operating in the dark because “we don’t know all that we might about how the Treasury market and its working.”

Even if they start to come down, interest rates are likely to remain well above the near zero level to which they fell after the financial crash of 2008 and the Fed’s policy of quantitative easing involving the outlay of trillions of dollars as it bought government debt.

US government debt, boosted by increased government spending on war and the military is reaching new record highs—it now stands at more than \$33 trillion. But the interest bill on this debt is rising rapidly and is now the third largest item of government spending after Medicare and Social Security.

As military spending continues to rise this has led to heightened calls for cuts in key areas of social spending. In other words, the attacks on the social position of the working class must be deepened so the ever-increasing war expenditure is financed, and the holders of Treasury debt are paid.

The latest rise in the stock market and the prospect that it could climb even further has created an atmosphere of euphoria. But closer analysis reveals it is highly unstable.

Back in the 1960s and 1970s Wall Street was driven by what was known as the “nifty fifty”—the cohort of high value stocks which brought good returns.

Those days have long gone, and the market is now dominated by the so-called “magnificent seven.” These comprise the big tech names, Apple, Microsoft, Alphabet (the owner of Google), Amazon, Telsa, Meta

(the owner of Facebook) and Nvidia.

So top heavy has the market become that at the midpoint of the year the price of these stocks had risen by between 40 percent and 180 percent and were responsible for all the increase in the S&P 500 index in the year to that point as all the others remained flat. Since then, others have joined the “everything rally” but the Mag7 continue to dominate and account for 64 percent of the rise in the S&P.

As the FT recently noted: “Their size is now so pronounced that they do not dominate just US stocks, but a large slice of the performance of global equity markets too.”

This high degree of concentration of financial power, which has accelerated this year, is reflected in the banking sector as well. In the first nine months of the year, according to analysis carried out by the FT, based on figures compiled by an industry tracker, JPMorgan Chase took in almost 20 percent of US bank profits. This was up from around 12 percent a year earlier.

Its earnings have exceeded those of its rivals Bank of America and Citigroup combined and in the words of one Wells Fargo analyst “JPMorgan is the Goliath of Goliaths.”

However, as Wall Street and finance capital in general, salivate on the prospect of cheaper money there are signs of weakness in the underlying economy. Commercial real estate is starting to feel the effects of higher interest rates, consumer spending is being hit by inflation as wages continue to lag, corporate bankruptcies are on the increase, rising by 30 percent in the 12 months to September compared to a year earlier, and mass layoffs are taking place, particularly in high-tech.

Beneath the surface of the present celebrations in financial markets all the conditions which led to the turbulence of 2023 have not gone away but are continuing to intensify.



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