Storm clouds gather over global financial system

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Storm clouds are gathering around global financial markets as the US war on Iran enters its fifth week and oil prices continue to rise along with a range of oil- and gas-dependent commodities such as fertilisers.

Even before the war began, there were growing concerns about the stability of the financial system. This focused on the financing of the massive investments in AI data centres and the role of private credit in financing software firms which could find their business models severely impacted or even wiped out by the development of AI-based tools.

For the first couple of weeks of the war, financial markets, sustained by the claims of US President Trump that it would be over in a few weeks and the US had already achieved "victory," did not experience major movements. There was certainly nothing like the shifts which took place in April last year when Trump unveiled his sweeping "reciprocal tariffs" against the rest of the world.

In an effort to calm the markets, Trump has claimed that negotiations are underway, that Iran is desperate for a deal and the war will soon be over. But with the preparations for an intensified onslaught involving the use of ground troops becoming ever more apparent, these efforts are wearing thin.

As an article in the *Wall Street Journal* put it, "traders say they are increasingly discounting leaders' words in favour of information like troop movements." Or, as one analyst cited by the *Financial Times* (FT) remarked: "Markets may start paying less attention to the White House jawboning and more to the energy scarcity situation on the ground."

The market reaction to Trump's announcement last Thursday that he was further extending his deadline for attacks on Iran's infrastructure showed the change of direction. The S&P 500 fell a further 1.7 percent, bringing its total loss to 7 percent for the month. The NASDAQ and the Dow both fell by 10 percent from their highs, putting them in what is known as correction territory. Every sector of the S&P 500 is in the red except energy and oil.

Equally significant was the fall in bond prices, sending their yields higher. Gold also fell indicating that some investors were selling off the metal to cover losses incurred in other areas.

The traditional portfolio balance is 60/40, that is 60 percent equities and 40 percent bonds, but this combination has experienced its worst month since September 2022 when the Fed started raising interest rates from the near zero levels, to which they had been lowered with the onset of the COVID-19 pandemic.

The $30 trillion US Treasury market, which forms the foundation for the global financial system, is reported to be showing signs of stress as the war intensifies amid indications of a tightening of liquidity.

This is indicated by the size of trades that significantly move the market. In a liquid market, even large trades do not have a significant effect, which is likened to the limited effect of dropping a stone in a deep pond. But according to JP Morgan Chase, the size of trades which move prices, so-called "market depth," has fallen by nearly as much as it did following Trump's "liberation day" tariff announcements.

The sell-off and tightening of markets is a global phenomenon. The MSCI All Country World Index, which tracks both developed and so-called emerging markets, has fallen by 9 percent since the start of the war. An index of government and corporate bonds has fallen by 2 percent.

The rise in bond yields is putting pressure on the already stretched finances of European governments.

The FT reported that government bonds in the euro

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zone were "heading for one of their worst months of the past decade, pushing borrowing costs for some countries to multiyear highs as investors grow nervous about the effect of the Iran shock on the region's public finances."

In a speech last Friday, a leading member of the European Central Bank's (ECB) executive board, Isabel Schnabel, said the "spectre of inflation has returned" with the shift taking place faster than "many people" had expected. She said the ECB would not "rush into action" but would examine data for second inflationary effects. In the language of central bankers that means rates will be lifted in response to wages struggles by workers hit by the impact on their living standards of the war.

As market fragility increases, it is increasingly being asked in financial circles: what might trigger a crisis, possibly more serious than 2008? One of the candidates is the private credit market which has grown in leaps and bounds over past decade and a half. It has more than quadrupled in size since 2010 and is now estimated to be $2 trillion.

It has come into focus because of the limitations by a number of high-profile firms on redemptions to investors demanding their money back. Blue Owl, one of the private credit highfliers in recent times, set the ball in motion last November when it limited redemptions and then tightened restrictions in February.

It has since been followed by BlackRock, Apollo Global Management among others. The concerns were initially sparked by the collapse of the auto-connected firms Tricolor and First Brands which were found to have close ties with private credit firms. It prompted the comment by JP Morgan chief Jamie Dimon that where one cockroach is found it means there are more.

Concerns have been amplified by the heavy investments of private credit in software companies whose business models are under serious threat from the development of artificial intelligence. The global finance firm UBS has estimated that more than one quarter of the private credit market is exposed to firms that are vulnerable to AI displacement.

There are signs that vulture financial firms, which seek to scoop up cheap assets in a time of bankruptcy and crisis, are smelling blood.

On Monday, the FT carried a report that one of these firms, Strategic Value Partners, which manages $21 billion in assets is looking to move. The firm's founder Victor Kholsa told the newspaper it was "the biggest opportunity since 2008."

The founder of another such firm said: "This is not about a few bad loans… We're out in the market right now raising a new fund because this is the greatest opportunity I've seen in my lifetime."

Back in November, the founder of the significant investment firm DoubleLine Capital, Jeffrey Gundlach, said the equity market in the US was the "least healthy" he had seen in his entire career.

"The next big crisis in the financial markets is going to be private credit. It has the same trappings as subprime mortgage repackaging had back in 2006," he told Bloomberg.

Others are reaching the same conclusion. This month a survey of global fund managers conducted by the Bank of America found that 63 percent identified private equity and private credit as the most likely source of a systemic financial event.

In an editorial on Friday, the FT drew attention to the "very public breakdown of private credit," pointing to the pile up of redemption requests, the exposure to threatened software companies, the prospect of higher interest rates hitting asset valuations and unravelling some of the more arcane practices, problems with the robustness of lending standards and the difficulty in determining the true value of assets, and indicated that the war in the Middle East could only worsen the situation.

It said that what it called the "recent bad headlines" ought to "mark the start of a healthy reset." But given the history of finance and the fact that nothing fundamental has been done to deal with the root causes of the crises which erupted in 2008 and again in March 2020 the only conclusion to be drawn is that the chances of that are nil.

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