As Wall Street finishes worst quarter since 2008

Financial turbulence continues to grow

By Nick Beams
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When trading on Wall Street closed yesterday, with the Dow down by more than 400 points, it was the end of the worst quarter for stocks since the financial crisis of 2008. The market has fallen 20 percent since the start of the year.

What is most significant is not the size of the fall but the speed at which it has taken place. The quarter divides in two parts.

The beginning of the year was marked by a surge in the market. There was confidence that the Fed would continue to provide ultra-cheap money to finance its speculation and parasitism. At the same time, trade tensions with China had eased somewhat with the signing of a “phase one” deal on January 15.

The market was propelled to new record highs on February 12. It has undergone a precipitous fall in the seven weeks since then.

While the coronavirus was the trigger it was not the underlying cause. Markets had been set up for a crash by the rise and rise of financial assets, above all stocks, completely divorced from the process of production in the real economy.

It took just 16 days for stocks to fall 20 percent from their record high, compared to the previous record for a 20 percent fall set in 1929.

The Vix index, which measures volatility and is often referred to as Wall Street’s “fear gauge,” went to a record high in mid-March. It was one of the factors that led to Fed initiate a massive intervention in financial markets across the board.

This intervention helped prevent an even larger fall that would have seen Wall Street record its worst quarter since the Great Depression.

The Fed has now emerged as the chief backstop for all areas of the financial system.

It has cut interest rates to zero, resumed its multi-billion dollar purchases of Treasury bonds and mortgage-backed securities, bought debt in the commercial paper market, entered the municipal bond market, resumed purchases of securities backed by credit card and student loan debt and, for the first time in its history, undertaken to buy newly issued corporate bonds.

In addition, it has intervened in the overnight repo market to the tune of trillions of dollars in order to try to prevent interest rates spiking, and setting off a freeze in credit markets as took place in the financial crisis of 2008.

The Fed first intervened in the mortgage-backed securities (MBS) market in middle of last month with purchases of $68 billion. However, this was not enough to halt the wave of selling and it had to make an additional $168 billion worth of purchases last week.

This intervention, going well beyond that of 2008, has had unintended consequences because of its impact on hedges taken out by mortgage-backed securities traders.

On Sunday the Mortgage Bankers Association (MBA), whose members underpin the mortgage market, issued a letter warning that the housing market was “in danger of large-scale disruption” because of the Fed intervention.

The hedges involve the practice of shorting in which traders sell a security they do not have—borrowing it from brokers—on the expectation that its price will fall at which point they then buy it.

Such action is aimed to cover any potential losses that might occur between the time the security is initially bought and then sold off to the government-sponsored agencies Fannie Mae and Freddie Mac.

However, the intervention of the Fed has increased
the price of mortgage-backed securities, meaning that those who engaged in the hedge operations face potential losses. This has led to an increase in margin calls by brokers, forcing those engaged in the hedge either to sell their holdings at a loss or put more money into their trading accounts.

The MBA letter said that at the end of last week broker-dealer margin calls on mortgage lenders “reached staggering and unprecedented levels.” For a “significant number,” this was “eroding their working capital and threatening their ability to operate.”

The MBS market is not the only area of financial markets facing increased turbulence.

The Financial Times (FT) has reported that “big banks that helped asset managers package risky loans into investment products are sitting on billions of dollars of debt linked to companies most exposed in an economic downturn.”

Banks, including such major firms as Citigroup and Credit Suisse, have become involved in providing credit to the market in collateralised loan obligations (CLOs). This market operates in a similar way to the sub-prime housing market that helped trigger the financial crisis of 2008.

Highly risky loans are made to companies that because of their financial situation do not have high credit ratings.

These loans are then packaged together in securities that are sold off. The assumption behind these operations is that, while there may be defaults by some companies, there will not be a downturn across the board. This was the same kind of assumption made in 2008 that house prices would not fall across the US simultaneously.

The foundations of the CLO market have been blown apart.

The FT reported that between March 1 and March 20 the credit ratings of about 140 issuers with loans held in American CLOs had either been downgraded or put on notice for possible downgrades, about 10 percent of the total.

The value of these financial assets has plummeted as a result of doubts about the ability of heavily indebted companies to withstand big hits to the economy. One executive of a company involved in the CLO investments, cited in the FT report, described the situation as a “disaster.”

The corporate bond market is also being heavily impacted. Yesterday Moody’s cut its outlook on corporate debt to negative, warning that as a result of recession default rates will rise with sectors “most sensitive to consumer demand and sentiment the hardest hit.”

Among its bailout measures, the Fed said that for the first time in its history it would buy corporate debt. Moody’s said, however, that some highly indebted sectors would be still vulnerable because the Fed’s operations will be limited to investment-grade companies with high credit quality. The Fed’s actions were “unlikely to prevent distress at businesses with less certain long-term viability,” it said.

Those companies will be hammered by what is predicted to be the most serious downturn in the American economy since the Great Depression.

Goldman Sachs further downgraded its forecast for the US GDP for the second quarter of this year. Little more than a week ago it forecast the economy would shrink at annualised rate of 24 percent from April to June.

Yesterday it forecast the annualised rate of contraction would be 34 percent with the US unemployment rate rising to 15 percent by the middle of the year.

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