

VIRALLY INDUCED MARKET CONVULSIONS.

The upward gentle slope of the markets evident since the beginning of 2019, has now fissured. This week has seen the market whipped between alternating one thousand-point falls followed by one thousand-point rises. Seems investors have more to fear from whiplash than from the virus.

Despite these violent movements the S&P 500 ended the week up 3.5% compared to the closing bell on Friday the 28th February. This was thanks to an unexpected recovery towards the close yesterday which is unexplained. Either there was panic buying because of VIX exposures or more likely, key market players had news that central banks and governments were discussing injecting liquidity into the markets. Additionally, markets were comforted by the Biden come-back and the extraordinary jump in employment data on Friday.

What really needs to be explained is the lack of choppiness prior to February 19th when global fears of the virus tripped up the market. There are a number of distinctive elements. The first is the rapid growth of passive investing known by the acronym ETFs. These funds have a self-reinforcing role keeping momentum going and are amenable to algorithm induced investment. The second is the algorithms themselves. The third is the concentrated, even centralised, power of the dominant money managers or asset managers. In March 2019 the total assets held by these corporations such as Black Rock amounted to \$28.4 trillion, a sum exceeding the March market cap of the Wilshire 5000 of \$25.5 trillion. In this respect, the weight of managed asset firms ensures an orderly market if not a manipulated market. <https://www.advratings.com/top-asset-management-firms>

All these inhibitors broke down two weeks ago. Algorithms could not cope with the unpredictable swings. The self-reinforcing role of ETFs broke down as redemptions soared. However, it must be said that to date, these passive funds have coped with the redemptions and the liquidity of these funds has not yet been drained. The real crash will occur when this is no longer the case. Finally, despite their size and weight in the market, price movements escaped the grasp of the dominant asset funds.

As of the close on Friday, the FTSE All-World Index is down 14%. This size of fall, prices only a three-month disruption to the world economy. That is why we can expect a second leg or step to this crash, once it is recognised that this virus has not only led to disruption but that it has acted as a multiplier, accelerating the downward movement in the global economy occurring over the last half a decade.

The structural effect of the viral hysteria has not only been to quarantine whole cities but the world economy itself. It has amplified structural processes already in train, namely the reversal of globalisation. Just in time chains may reduce working capital and therefore improve the rate of profit, but they are brittle. The knock-on effects of disruption to supply chains due to the lock downs in China and South Korea has convinced many corporations to start sourcing products closer to home. Replacing existing supply chains that exist because they are the cheapest solution, is costly in the near term, and a drag on profit margins in the longer term.

This costly restructuring of the world economy is coming at a time when the rate of profit in most countries has already been falling for a minimum of five years. This is not a counter-vailing response to falling profitability but one driven by considerations of economic hegemony. Because it aggravates the fall in the rate of profit, therefore deepening the crisis of capitalism, it makes a military resolution of this crisis more probable, rather, than the peaceful division of the world economy into two discrete spheres of interest, one dominated by the USA and the other by China.

FactSet has just issued its final report on S&P profits for Q4 2019. It estimated a 0.9% rise in earnings per share, which when adjusted for inflation and share buybacks translates into a decline of 3.5%. We

can thus expect an annual >5% fall for total non-financial corporate profits. The cumulative estimate is for a real 29% fall in the mass of profits from its peak in 2014. Furthermore, FactSet, having begun with an estimate of a rise of 7.1% in profits for Q1 2020, now sees a fall in profits.

If this materialises and extends into the whole of 2020, this will be an unprecedented and unbroken annual decline of seven years, almost the length of a typical business cycle. This is not because profits were abnormally high in 2014 making 2019 is the new normal, it speaks to profound structural and class impediments to the realisation of profits. Instead, this seven years of famine is due to the absence of the global recession needed to purge the metabolism of capitalism of its surplus capital and debt, creating the conditions for the resumption of profitable production. For Marx boom and bust were the opposite sides of the same coin of capitalism, indispensable, one preparing the other.

Central Banks.

The bookends of the capitalist cycle of boom and bust are a joint venture between the rate of profit and the rate of interest. The fall in the rate of profit, which makes the completion of the circuit of capital impossible unless supported by extra credit, drives up interest rates as corporations scramble for funds. The spike in interest rates scythes through insolvent capitals. The weakest fail and the strongest emerge stronger.

However, since 2008 central banks have been interfering with these mechanisms. Each time interest rates spike, particularly in the vulnerable short-term market, they intervene to put a lid on these interest rates. This was the background to the New York FED intervening in the REPO market in September 2019.

Last week the FED dramatically mistimed its rate cut on Tuesday. The markets did not buy it and instead of rising, declined sharply. Some analysts saw the hand of Trump in it, political pressure from the Trumpet. The more likely reason for this, was the behaviour of the 10-year treasury bond. The interest rate on this bond is the benchmark for all kinds of financial transactions including mortgage rates. It was threatening to fall below 1% at a time when the FED's overnight rate was 1.5 – 1.75% an inversion with serious consequences for financial stability.

Graph 1.

Uncharted territory

10-year Treasury bond yields have fallen to levels last seen in 1945. (Monthly average yields)



SOURCE: European Central Bank, Federal Reserve



Aided by the FED's actions, the 10-year rate fell a further 0.5% down to 0.77% by the end of the week or by the same amount as the FED's cut of its overnight rate, maintaining the divergence, and, heralding imminent further cuts by the FED. This 0.77% is the lowest rate ever for this bond and the first time it fell below 1%. For a longer perspective on the 10-year bond going back to 1870, follow this link <https://www.multpl.com/10-year-treasury-rate>

It is also important to note that adjusted for inflation, the yields on all treasuries including 30-year bonds is now negative. This only occurs in recessions and even depressions. Michael Hartnett, chief investment strategist at Bank of America concurs: "the working assumption is that as of March 2020 we are in a global recession".

The problem for the FED is that the collapse in the 10-year rate is the equivalent of multiple rate cuts. Already, 30-year mortgage rates, which normally trend about 1.8% above treasuries are falling towards 3%. These falls in mortgage rates have, according to the latest data, driven up January sales of new single-family homes at an annual rate of 18% to their highest level since July 2007. Housing appears to be the only sector currently strengthening.

Graph 2. New single-family house sales in 000 units.



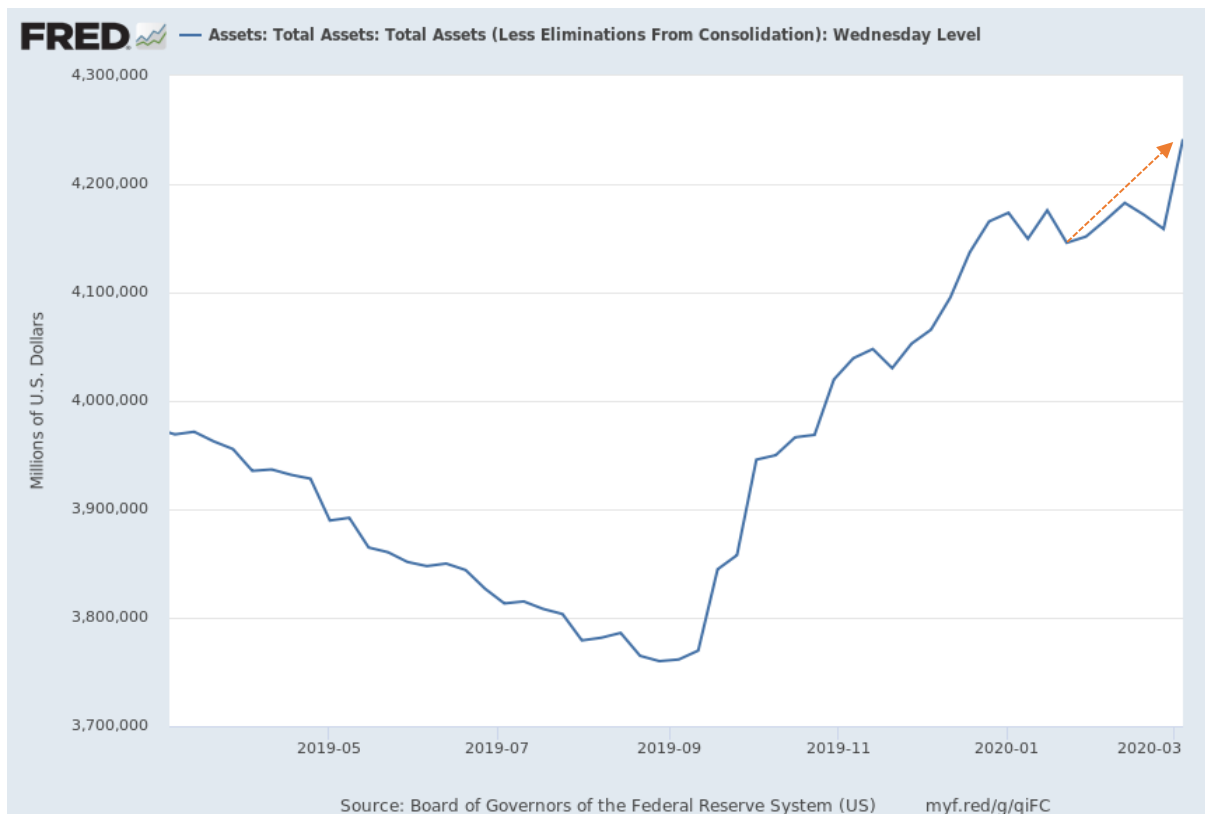
This collapse in interest rates will also help temper the burgeoning Federal budget deficit which will grow by anything between \$350 and \$500 billion this financial year depending on market conditions.

What interest rate cuts will not do is prevent a liquidity crisis, only delay it. What economies around the world are experiencing, is the collapse in turnover of a special kind. On the input side the disruption to supply chains due to worker absences in Asia is delaying the sourcing of vital materials and components needed to complete production. On the other side the stay at home or self-confinement by customers is delaying the purchases of final goods. For example, the extraordinary 80% plunge this February in Chinese auto sales or the already 200,000 cancelled flights around the world which will result in the single biggest fall in air travel since the propeller was invented.

What is needed, is for government treasuries, not central banks to create draw down facilities available to non-financial businesses. Call it MMT if you like. Cash strapped industrial and commercial corporations, especially small and medium sized firms, could use these funds to remain solvent until the viral crisis has run its course. Of course, there is precedent for this: the New York Fed's REPO facility which has been used to bank roll cash strapped speculators.

Since the markets have plunged this facility has expanded and been over-subscribed most days last week. The result, a sharp rise in FED assets to over \$4.24 trillion by March 4th.

Graph 3.



By mid-April, at this rate, FED assets are likely to top their previous highs last found in March 2015. These assets are likely to include shares once the stock markets fall into bear territory, according to the Boston Fed Governor who has floated the idea. It all is starting to look a bit Japanese although most governors have set their face against negative interest rates. Well, let us see how far the US economy subsidizes first.

To ask the question, will Japanese counter-crisis policies work, is the wrong question. The right question to ask is: will Japanese style policies work when all the drivers in the world economy are exhausted? And by that we mean China. Japanese policies from the mid-90s must be set against the dramatic growth in the Chinese market which provided a growing market for Japanese goods and capital.

The answer, therefore, is that in the absence of a dynamic world economy, Japanese reflationary policies will fail. Interest rates and economic activity will engage in a race to the bottom.

Corporate bonds.

Shale oil is the modern Klondike. An exercise in national hubris and hype. These miners and there reckless financiers should not have been put in charge of digging pit toilets never mind oil wells. All that this half-a-trillion+ Dollar loss will amount to in the end, is a ten-year subsidy to industry and car owners through its negative effect on global oil prices. When Russia said no to the OPEC cuts last week oil prices fell a total 9% on the news. It was the financial equivalent of a hypersonic missile aimed at Texas. Oil production is bound to plummet because there are no more prolific tight oil fields in the

USA to exploit. A collapse in tight oil will rob the economy of between 0.25% and 0.5% of GDP growth. There will be no repeat of the bounce from 2014.

On Sunday, the stock markets in the Gulf all cratered. Saudi Arabia now accepts as well that salvation lies via the route of crippling US oil and taking out at least 4 million barrels of production there per day. This is equal to a loss of at least \$100 billion to the US economy. It is also worth adding that the share price of Saudi Aramco has fallen below its IPO price.

Thus far, despite the collapse in Government Bond yields around the world contagion has not yet spread to corporate bonds. As the Jefferies Group put it succinctly, roll-over risk “will ultimately determine whether global equities escape from Covid-19 with a mild slowdown...” In other words, if debt ridden non-financial corporations cannot roll over the debt this is not a three-month phenomenon. This is what I have implied by the perspective that this financial crash has two steps.

Despite seizing up for five working days at the beginning of the share tumble, corporate bond issuance resumed on Tuesday in Europe and Wednesday in the USA. However, the bond market is not out of the woods. Net issuance, that is new loans minus redemptions remains negative, and until that reverses, bond markets remain precarious.

The stress in bond markets was more noticeable in Europe with the I Traxx Crossover index jumping 100 points to 380 compared to around 220 before the markets popped. Some analysts expect it to jump to 550 over the next few weeks which is a level associated with extreme stress in the sub-grade bond market. In the USA, the Ice Data yield index covering high yield bonds, ticked down to a still elevated 5.88%. More importantly, the fall in government and prime rates meant that the gap between these rates and investment grade rates actually widened.

The next few weeks will be critical. The futures market for the S&P 500, one of the deepest speculative markets in the world has lost 90% of its liquidity. This loss of depth means share prices are more prone to sharp oscillations. In addition, the collapse suffered by bourses in the Gulf means that share prices in the West remain vulnerable on opening next week despite the tick up in the last few hours on Friday.

The failure to mount a response to the virus in the USA.

It was always going to be the case that any serious medical challenge in the USA would expose how dysfunctional its financialised medical system is. Neo-liberalism stripped naked for the world to see. Dirty, obsolete and scarce testing kits. Hospital charging over \$3,000 for a test. Even with health insurance most co-payments exceed \$1,000 for the test. Surely an inducement to obtain a test when 70% of Americans (North) do not have \$500 to rub together. A CDC (Centre for Disease Control) hollowed out by the Trump cuts unable to prepare for the eventual arrival of the virus.

And what does Trump say about this looming disaster. To cover up for the absence of testing kits (at one stage California only had 200) he promises a million testing kits. To cover up for the incompetence of his administration he blames the Obama administration. Trump may not catch the virus, but when all of this is done, his reputation will be in intensive care on a political respirator paid for by his billionaire chums trying for the November elections.

Finally, to the libertarian right and their racist hued attack on the Chinese authorities, the best advice is to turn your wrath on your own authorities. You wanted a small state and freed up markets, now eat the consequences. The Chinese government may have been slow to act at first because this was a new virus, but the Trump administration has no such excuse. Once the virus was identified, the Chinese state sprang into action creating the capacity to orchestrate a major intervention to contain the virus, building large hospitals, for example, in two weeks. Conversely, the “small state” in the USA

has no such capacity and it will show. It is only a question of time before Americans (North) ask why the USA cannot emulate China. The USA has the capacity to drone kill anyone on the planet, but they do not have the means to protect their own population at home. Such is the vista presented by a rising economic power compared to a declining decadent economic power.

It is difficult to explain the over-reaction to this novel virus except that this is consistent with the thirty-year use by governments of the fear factor. The ruling class knows that fear is a means of control. The ruling class knows that as long as workers are fearful, they will not seek change. And they know that fear promotes the narrative - everyone for themselves - especially when it comes to toilet rolls and antiseptic wipes.

Populists like Trump and Johnson like to brag about how “strong and resilient” their economies are. The virus will show that these economies are about as strong and resilient as an infected 70-year-old suffering from COPD.

Addendum:

In both South Korea and Iran, two of the worst hit countries outside of China, the viral epicentres had a religious dimension. In the case of South Korea, it was an obscure Christian Sect based in Daegu whose concentrated community accelerated the infection rate and in Iran it was the holy city of Qom where it is customary for pilgrims to lick shrines. It appears that viruses thrive on superstition.

It is reminiscent of the scandal of Lourdes where the Vatican maximised the number of pilgrims taking the waters at the expense of contaminating the water by their numbers. Contaminated water and immuno-suppressed people are a bad mix, which no amount of “miracles” can cover up.

Brian Green 6th March 2020.