Christmas crunch portends 2019 financial disaster

By *Elisa Barwick*

In the closing days of 2018 no less than three current and former US Federal Reserve officials warned of an oncoming financial crisis. Former Fed Chairman Janet Yellen, who only six months prior had declared there would be no new financial crises in her lifetime, in mid-December warned that high levels of corporate debt were creating similar conditions as did the snowballing housing debt in the lead-up to the 2007-08 global financial crisis (GFC): "any kind of negative shock [can lead to] … a lot of corporate bankruptcies, a lot of distressed credit crunch [*sic*], a lot of downgrading of loans, a lot of investor losses", she worried, adding that today's regulation is inadequate.

Current Fed Board of Governors member Lael Brainard, in a 7 December Peterson Institute speech, noted the "sizeable growth in leveraged [risky] lending, accompanied by a notable deterioration in underwriting standards", and warned that most of this debt is packaged into high-risk collateralised loan obligations (CLOs), in the same way the mortgage-backed securities (MBS) that triggered the last crisis were. In the first half of 2018 the pace of CLO issuance increased by one third compared with the previous year. Some 80 per cent of the underlying leveraged debt is "cov-lite" (having little in the way of protective covenants regarding collateral, income checks, etc.), meaning it is as dodgy as subprime mortgages.

Has the pin already been pulled on this grenade? Source: Real Investment Advice

In an 18 December CNN interview, former Fed Chairman Alan Greenspan warned that the bull market is coming to an end, and investors will need to "run for cover" soon. And from an economic forum in Atlanta, First Deputy Managing Director of the International Monetary Fund (IMF) David Lipton told the *Financial Times* on 7 January that with a new recession "somewhere over the horizon" and fiscal and monetary options lacking, we are "less prepared than in the last [crisis in 2008]".

The *New York Times* of 10 December echoed the sentiment, blaring, "Are You Ready for the Financial Crisis of 2019?" It declared that "the anxiety that we could be in for a replay of 1929—or 1987, or 2000, or 2008—has become palpable not just for the Aspen set, but for any American".

Mnuchin intervenes

So fragile are conditions at the moment that the slightest hiccup can spook the markets, and the Christmas period provided no shortage of excitement. In early December, current Fed Chair Jerome Powell had been hinting at halting rate rises when the Federal Reserve's quarterly *Financial Stability Report* warned of "near-term risks to the US financial system", largely from deteriorating masses of debt, both domestically and overseas; but the Fed raised interest rates by a quarter of a per cent on 19 December. Adding to market jitters, hysteria erupted with rumours that Trump might sack Powell to stop him lifting rates any further.

As markets plummeted, Treasury Secretary Steve Mnuchin took two significant actions: He spoke with the heads of the big six US banks (Bank of America, Citi, Goldman Sachs, JPMorgan Chase, Morgan Stanley and Wells Fargo), and reported back that they had "ample liquidity" and have not "experienced any clearance or margin issues and that the markets continue to function properly". The following day, Christmas Eve (with trading closing at 1:00 pm), the Dow lost over 2.9 per cent (653 points). Mnuchin also announced he was convening the "Plunge Protection Team"—officially the President's Working Group on Financial Markets—which was formed after the 1987 crash to intervene to prop up stock markets and last convened in 2009. It includes the Fed Board of Governors and representatives from the Securities and Exchange Commission and Commodity Futures Trading Commission; representatives of the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) were also to attend. No report of the meeting was released but markets suddenly changed direction, rising by over 1,000 points—the biggest one-day gain ever—on the next trading day, 26 December.

Lending freeze

Less well reported was a December freeze in junk-bond markets and loan issuance, reminiscent of late 2008. Signs were already present in October when Wells Fargo and Barclays kept a US$415million leveraged loan on their books after it failed to sell, a highly unusual occurrence in a world where money is routinely made from buying and selling debt. In December, several large companies withdrew loan issues which were being advanced to fund expansions or to refinance. Even with generous incentives and substantial discounts offered, several deals had to be cancelled or postponed, with banks eating the losses.

The 16 December *Financial Times* reported that the junk market (for both loans and bonds) had frozen up and the US credit market had "ground to a halt". As Zero Hedge reported, fund managers were "refusing to fund buyouts

and investors [were] shunning high-yield bond sales".

As of the 17 December not a single company had borrowed money through the US high-yield corporate bond market. The last time that happened over a full month was November 2008. Even high-quality, investment grade bonds experienced problems, with several deals pulled.

Bloomberg News on 20 December reported on investor activity feeding the dangerous cycle: "Besieged by investor withdrawals, mutual funds that invest in risky corporate loans have been unloading big chunks of loans in recent days. The selling is driving down prices to levels not seen in more than two years and forcing banks to keep some of the unwanted debt on their balance sheets. … In just the past four trading days, investors have pulled US$2.2 billion from all loan mutual funds and exchange-traded funds. That brings withdrawals from the asset class to almost US$9 billion since mid-November."

Corporate blowout

Turbulence in the market for buying and selling risky loans threatens the massive US corporate debt bubble. The IMF warned in April 2017 that at least 20 per cent of this debt would be unpayable under a scenario of rising rates. US corporate debt exceeds US$9 trillion, nearly double that of 2007. This year US$540 billion of that needs to be refinanced; US$760 billion in 2020; and some US$2 trillion the following year. In June 2007, pre-financial crash, less than US$500 billion was up for refinancing *within the coming three years*. Large US companies like General Motors and General Electric that have been borrowing to buy back their own shares are now seeing stock prices plummet, and their losses are dwarfing their net income. Some of the biggest US banks saw their shares plummet by up to 30 per cent over 2018, despite buying their own shares to the tune of tens of billions of dollars.

The London *Telegraph* reported on the credit crunch 16 December in "BIS Fears Financial Seizure at the Heart of the World's Clearing System", which was reprinted in the *Australian Financial Review*. Author Ambrose Evans-Pritchard cited the latest Bank for International Settlements Quarterly Report, which warned that Central Counterparties (CCPs), set up after the GFC as middle men to clear derivatives trades, could cause "a destabilising feedback loop, amplifying stress". In September a Scandinavian clearing house nearly melted down. Evans-Pritchard noted that "The notional value of the derivatives cleared worldwide is 4.4 times world GDP, up from 2.8 times in 2008." The BIS says this market "could unravel with 'potentially system-wide effects'".

The IMF also warned in 2018, said Evans-Pritchard, that "CCPs 'increase the risk of a failure of the infrastructure itself' and could lead to a 'catastrophe' if the all layers of defence were overrun by a big default".

Quarantining such speculation from commercial banking associated with vital economic functions, by restoring the US 1933 *Glass-Steagall Act*, is urgent if we are to prevent it taking the entire global economy down with it when it goes.