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EIR Economics

World financial crisis: the fear barometer is rising

by Lothar Komp

When the Russian government declared a debt moratorium last August, collective panic broke out among international investors. Possessing the presence of mind and clarity characteristic of a herd of buffaloes under buckshot fire, they moved international capital out of all second-class debtor countries in the world and moved it toward the supposedly "safe havens": American, British, German, and Swiss government bonds. Under such strong demand, the yields on other bonds, whether government or corporate, shot up. This produced a sudden liquidity crunch in large parts of the world financial system, while other markets at the same time were flooded with liquidity, which provoked more distortions and caused the panic only to increase. Had the central banks not intervened at the last moment with injections of liquidity, while at the same time bailing out the speculative Long Term Capital Management (LTCM) hedge fund, the financial system would have collapsed.

Now, one of the most important barometers of fear on the markets—the interest rate difference or spread between corporate bonds and government bonds—has reached the level of last year once again. In just a few weeks, this yield spread on U.S. ten-year bonds moved from 80 to 110 basis points, which is even higher than in autumn 1998, and higher than after the outbreak of the Asia phase of the world financial crisis in summer/autumn 1997. In Europe, too, the risk premiums, which investors demand for corporate bonds (which have no state guarantees), are also at a record level. For countries like Brazil, Indonesia, or Russia, the conditions for receiving supplies of urgently needed funds have dramatically deteriorated in the recent period.

In addition, in the expectation of increasing central bank interest rates, the yield on U.S. and European government bonds has shot up sharply since the beginning of the year: In the United States, the yield on 30-year bonds went from 5.15% to 6.25%, and for ten-year Euro-denominated government bonds, it went from 3.75% to over 5%. This increase caused a sharp drop in the value of all circulating current bonds with lower interest rates.

Both a cause and an effect of the growing fears on financial markets, is a new round of news items and rumors, about market participants in trouble.

On Aug. 7, the London *Independent* reported that the explosive increase of bond yield spreads in the last days was related to the difficulties of some big hedge fund. This created fears of a repetition of the crisis of last year, it reported. In this connection, there were reports that Goldman Sachs and Chase Manhattan had blocked their credit lines to the Tiger Fund, with $12 billion under management. Even LTCM was again being talked about. According to market rumors picked up by the *Independent,* one big American or Swiss bank was in an emergency situation, as a result of speculative losses. In any case, the London stock and currency markets were spun around on Aug. 6 and 7, by a series of unusually large transactions. The U.S. investment bank Goldman Sachs was said to have registered losses of £200 million, on European options transactions.

On Aug. 10, rumors shocked the Zurich stock market, that the two biggest Swiss banks, UBS and Crédit Suisse, had suffered speculative losses in the billions. The transaction had reportedly been carried out on the unregulated offshore paradise of the Cayman Islands. Despite the denial by UBS—while Crédit Suisse declined to comment—the rumors persisted. And the values of the stocks of both banks plunged into the cellar.

On Aug. 11, it became known that mega-speculator George Soros had replaced his beseiged Quantum Fund chief strategist Stanley Druckenmiller with a former top manager from Bankers Trust, Duncan Hennes. In this year, the Quantum Fund has already sustained losses of 11.2%, or $700 million, especially with wrong bets that the euro would rise

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and the U.S. Internet stocks would collapse in spring of 1999. Unfortunately for Soros, the Internet stocks maintained their steady rise through April, before being cut in half by August. The value of the entire portfolio managed by the Soros group, has dropped in the last 12 months from $22 billion to $13.2 billion.

On Aug. 12, the Zurich financial market expert Heinz Brestel reported on the consequences of the abrupt drops on the world wide bond markets: "Apparently, it has come to the first forced sales by institutional investors, which have further burdened the overall market, which would explain the sudden collapse in values on the bond markets."

Internet stocks started it

The rapid fall of the Internet stocks in the United States from May to the end of July, caused a sudden loss of value which hit numerous small and large investors. The entire market value of the 50 leading Internet stocks in the United States, reached its high-point on April 12, with a value of $613.4 billion. On Aug. 9, they were worth only $374.2 billion, which corresponds to a loss of $239.2 billion. Similar "corrections" are on the horizon for the other bubbles on Wall Street.

Even the International Monetary Fund, which had been chided for its cheerful forecasts of the Asian financial situation just before the outbreak of the Asia crisis in 1998, did not want to sit back any longer, but wanted to document for posterity, that it, too, belonged at least once to those who warned of a Wall Street crash.

On July 30, the IMF, in its annual report on the U.S. economy, warned of "significant risks," especially the "danger of a substantial and abrupt fall of the U.S. stocks values." The economic activity in the United States, the report said, rested largely on the "high level of the stock market, a level that is difficult to explain." Thus, a "sharp collapse" on the stock market could cause considerable consequences for the U.S. and world economy. The longer the Federal Reserve waited to move against this, the worse the danger would become, that it would be finally forced to effect a radical interest rate increase, and thus provoke a correspondingly rapid crash on the stock market.

International Commentaries

John Plender, "The Wobbliest Month," lead editorial, London *Financial Times,* Aug. 13.

"A full-blown stock market collapse" could soon hit Wall Street, writes Plender. "For the third year in succession August is proving to be a month of extreme financial turbulence. The U.S. equity and bond markets have been nervous. The dollar looks distinctly tired after its long bull run. Meanwhile, rumors are rife that at least one investment bank has incurred big losses on its proprietary trading activities. The trouble is thought to have arisen in the interest rate swaps market, which is going through unprecedented and stressful contortions."

Plender points to one of the most alarming signs of market nervousness: "Last weekend William McDonough, the head of the New York Federal Reserve, felt the need to tell Dow Jones Newswires that he knew of no situation that posed a systemic risk. It was the kind of central banker's denial that offers mixed comfort to nervous investors and traders."

After going through "potential horror stories," such as a sudden dollar crisis, Plender notes: "Of course, when the U.S. equity market finally collapsed in October 1987, it was none other than Alan Greenspan, the Fed chairman, who came to the rescue. Confronted with a shock that threatened the financial system, he opened the monetary sluice gates, as he did in the crisis last autumn. Can the markets rely on Greenspan coming to the rescue yet again if the collapse of a big institution poses a systemic threat or the markets take a severe tumble? It would certainly be harder for him to do so."

Plender concludes: "Stephen Lewis, chief economist of London-based Monument Derivatives, argues powerfully that the Fed cannot allow historically high swap rates to deter it from tightening credit. Otherwise, it would undermine confidence in the anti-inflationary thrust of Fed policy. Yet a full-blown stock market collapse might be another matter. Mr. Lewis also forecasts a very interesting month. He could well be right."

Felix Zulauf, head of the Switzerland-based Zulauf Asset Management, interview with the *Frankfurter Allgemeine Zeitung,* Aug. 5.

A "stock market thunder storm" is about to hit the international markets, warns Zulauf, who speaks of a sharp correction in late summer or autumn. He draws a comparison to what happened last year: "We stood at the abyss. The stability of the international financial system was in extreme danger." There was not only the near-collapse of LTCM, but also the huge mountains of bad loans in the Japanese banking system, the shattering of the foreign exchange markets, in particular between the dollar and the yen, and the threat of a massive withdrawal of Japanese capital from the United States.

Such circumstances, says Zulauf, could easily have caused the collapse of some of the most prominent banks internationally. Only the massive liquidity creation by the leading central banks moved the global financial system back from the abyss. But now, the situation on international markets has again dramatically worsened, says Zulauf. The record high U.S. current account deficit and the extremely low U.S. savings rate could trigger a stock market crash, with U.S. stocks plunging by 20% and more, in combination with a crashing U.S. bond market, driving yields of 30-year Treasuries above the 7% level, and, further, the outbreak of a "big dollar crisis." Fed Chairman Alan Greenspan is reluctant to act, because he fears renewed global financial disasters as soon as he increases interest rates. The leading stock market indices will have to face the biggest plunge. And among other things, the boom in Internet stocks will just fall apart.