

# Financial Meltdown: The Impending Credit Crunch; The Next Shoe to Drop?

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*Last week's violent gyrations in the stock market are the result of a tug-of-war between two well-represented groups of investors. One group thinks the Coronavirus will severely impact the global economy pushing stocks further into the red, while the other group believes the Fed will intervene in the market once more and save the day. The matter is likely to be settled as soon as next week as the drip, drip, drip of bad news continues to dampen investor expectations further intensifying the selloff.*

Investors perception of the Fed's role in fueling rallies, micromanaging the markets and providing a safety-net whenever stocks fall, has reached a critical tipping point. For the last decade, the Central Bank's low rates, endless liquidity and frequent interventions have conditioned investors to ignore fundamentals and, instead, base their decisions on the Fed's accommodative policy. Thus, when the Fed trims its balance sheet to reduce its cache of Mortgage-Backed Securities (MBS), investors "sell" and when the Fed provides \$400 billion in low interest loans to borrowers in the repo market, investors "buy". Coronavirus's impact on stocks has eroded confidence in the Fed and is gradually reversing years of Pavlovian conditioning that fostered a belief in the Fed's omnipotence. This is no small matter. When investors finally realize that the Fed has lost control of the system, stock prices are likely to fall sharply. And, with all three main indices having tripled in the last decade, there's no telling how low prices will go.

Despite the fireworks in equities, the real action is in the bond market. It's the bond market that is signaling no inflation, no growth, and endless economic stagnation for as far as the eye can see. That is the unwavering verdict of the benchmark 10-year US Treasury whose yields sunk to an all-time low of 0.709% just last week. What this means is that investors are so terrified, they're willing to lend money to the government below the rate of inflation. In other words, they would rather lose money and feel like their investment is safe, than take a chance on any other bond or security. This is an expression of the unalloyed fear that is presently gripping Wall Street.

The 10-year at its current price is the equivalent of a 5-alarm fire at the heart of the global economy. It is a wailing siren warning the public that the bombs have already been dropped but not yet hit their targets. It's also a sign of desperation regarding the country's economic future as well as an indictment of the Fed's abyssal mismanagement of the financial system. Bond traders have basically abandoned all hope, sold their risk-assets, and stampeded into a shelter that they hope will protect them from the approaching storm. Do I exaggerate?

Not at all. US Treasuries are now priced for an event that dwarfs 9-11 and makes the 2008 Financial Crisis look like a walk in the park. In both cases, bond traders were more optimistic than they are today. This isn't a theory I'm spouting here, it is the reality of the pervasive

pessimism that manifests itself in the 10-year yield, a yield that is lower than anytime in its history. What it tells us, is that bond traders think they know something that stock buyers don't. Stock investors are still looking for a light in the tunnel while bond traders shrieking "The world is coming to an end."

Last week, oil prices dropped nearly 10 percent in one day. The airlines are all 30 percent down or more. The tourism industry has been hammered as have the tech companies, manufacturing, durable goods, etc etc. All the big name industries; Intel, Boeing, Dupont, Apple, 3M, Nike, Cisco have been hurt by the selloff. The same goes for Bezos, Zuckerberg, Gates, Buffett, Ellison, Musk all wracking up billions in losses from a vastly-contagious virus that is just now taking root in America. The current price of the 10-year simply reflects the carnage that investors see around them as well as the trouble they anticipate in the future. Here's an excerpt from an article at the Wall Street Journal that helps to underscore this point:

"A dramatic decline in long-term bond yields this week is scrambling the Federal Reserve's recently updated playbook for counteracting a downturn....Investors have rushed to buy long-term U.S. Treasury securities this week, reflecting rising fears that the novel coronavirus will deliver a sharp blow to economic activity and a credit crunch for businesses that risks recession.

If a recession were to hit in this low-interest-rate environment, the Fed could confront challenges it "did not face even during the Great Recession," said Boston Fed President Eric Rosengren at a conference Friday in New York....with long-term rates tumbling to new lows, the Fed "may not be able to use the tools that it used 10 years ago. This is an elephant in the room."...

Mr. Rosengren said that, without a stronger fiscal response, the Fed would need to ask Congress for new tools to spur growth, such as allowing the central bank to purchase a broader range of securities or assets than the government-guaranteed bonds currently allowed under law. Central banks in other countries have purchased corporate bonds and other private-sector assets. Separately, Mr. Rosengren said the Fed could consider a lending facility to purchase riskier bonds, but only if the Treasury agreed to absorb credit losses....

What does it mean?

It means the Fed is already planning its next big bailout. The Fed wants Congress to grant it the power to buy stocks to keep the market artificially high and to abandon any pretense that prices are set in a free market according to supply-demand dynamics. It means the Fed wants to buy the junk debt from over-extended corporations that have been hawking their garbage bonds to gullible investors who didn't realize the money was being used to goose stock prices so CEOs could cream off more executive compensation. It means the Fed wants a green light to lavish trillions of dollars on its crooked friends on Wall Street who rigged the system so it blows up every 10 years pushing more families out of the middle class, widening the gaping chasm of inequality, and further enriching the parasites at the top of the distribution heap.

More importantly, it means that we are at the brink of another financial crisis whose epicenter will be corporate debt and leveraged loans, both of which the Fed has known about for over 4 years but chose to ignore so its chiseling friends could continue to rip off credulous investors. Take a look at this article titled "Credit Market Endures Worst Day in a

Decade on Virus Rout”:

“U.S. credit markets are suffering their worst day in a decade as fears intensify that the spreading coronavirus will hurt corporate income and some companies’ ability to repay debt. While stocks have sold off over the past two weeks in dramatic fashion, the drop in credit had largely been orderly until now, market participants say. They’re bidding securities even lower to get trades done, making transaction costs that much higher. For some, it’s the first time they’ve experienced such volatility in their careers...

It feels very tenuous,” said Jerry Cudzil, head of U.S. credit trading at TCW Group. The market is illiquid, and buyers are naming their price, he said...It’s also been difficult to bring new debt offerings, for those brave enough to tap the markets...

In other markets like leveraged loans, borrowers aren’t even trying to bring new deals, or are rethinking plans to do so. Alkermes Plc, Thryv Holdings and Lakeview Loan Servicing yanked planned offerings on Friday, bringing the total to seven deals pulled this week. Just one deal launched this week for \$380 million, the lowest volume of 2020 so far.” ([“Credit Market Endures Worst Day in a Decade on Virus Rout”](#), Bloomberg)

What does it mean?

It means the problems in the credit markets are getting very bad, very fast. It means that companies that need money, can’t get it and, thus, will not be able to roll over their debts. It means that the Fed’s easy money policy has created a new “subprime” phenom in the multi-trillion dollar corporate bond and leveraged loan market that will trigger a number of defaults that will tighten lending, push down stock prices, and wreak havoc on the credit markets. Here’s more from an article by the Telegraph’s Ambrose Evans Pritchard:

“There are mounting risks of a credit crunch in vulnerable sectors of the corporate bond market \$3.4 trillion of US debt is perched precariously above junk grade, risking a fire-sales in a financial crisis. A swath of highly indebted companies face an incipient funding shock and risk being shut out of the capital markets as the COVID-19 epidemic mushrooms into global crisis, Standard & Poor’s has warned....

While the headline drama for markets is in equities, veterans of past recessions are playing closer attention to the plumbing of the credit system. Trouble in loan funding and credit derivatives is where metastasis invariably occurs at the onset of financial crises....

But what they are even more worried about is a fat tranche of BBB rated securities that has mushroom fivefold since 2008 to \$3.4 trillion and is precariously perched on the cliff-edge. The slightest shock could lead to a cascade of downgrades.

The OFR also warned that most of the \$2.4 trillion leveraged loan market is being packaged into collateralised loan obligations on “cov-lite” terms with scant protection for creditors and is now an accident waiting to happen. “CLOs may perform worse in the next downturn than they did in the (Lehman) crisis,” it said.

On top of this the Bank for International Settlements warns that the proportion of “zombie” companies with insufficient earnings to cover debt payments has risen to 12pc. Negative

interest rates in Europe have put off the day of reckoning for these “walking dead” but once revenues start to evaporate the end is nigh....” ([“Coronavirus threatens a global credit crunch and a cascade of bond downgrade”](#), The Telegraph)

So while the stock market is attracting all the attention, the real danger lies further below the surface in corporate bonds and leveraged loans, two IEDs that could explode at any time precipitating a wave of defaults that increase deflationary pressures and clear the way for another financial crisis. This is why the Fed wants Congress to once again expand its tool kit so it can implement radical policies that save its constituents while the real economy tanks, the unemployment roles grow, and ordinary working people are thrown under the bus.

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