City of London by Stephen Lewis

New threat to market stability

The securities houses are carrying huge amounts of U.S. Treasury securities on their own books.

Between last October's stock market crash and the end of the year, Wall Street commentators became increasingly confident that the economy would come through unscathed.

That confidence is now being severely tested.

United States retail sales are slipping back and the auto industry is cutting down production schedules.

January's employment report set the seal on the change of mood, showing fresh signs of weakness in the economy.

It was facile to expect that the collapse in stock prices would impact on the economy within so short a period as a few weeks.

The conventional Wall Street view that a decline in financial market prices from the overblown levels of last October should, in itself, have little bearing on the performance of the productive economy, contains some truth.

After all, the 50% rise in stock prices which preceded the crash, in the first nine months of 1987, was far from signaling strength in U.S. economic activity.

The stock market's rise had been fueled by the United States Federal Reserve's credit policies and fueled by securities dealers' encouragement of speculation in the options and futures markets.

This has now been admitted—even in the Brady Commission Report to the White House and the independent Securities and Exchange Commission report on the October crash.

Nevertheless, there is likely to be an indirect effect on the economy from the generally weak state of the financial structure.

The losses incurred on October 19 and in its aftermath added to the strains already felt in the securities trading sector of the markets.

These strains stemmed from the securities companies' holdings of junk bonds when the bond market turned sour last spring.

Heavy losses were also inflicted on government securities dealers as a result of the volatile behavior of bond markets around the U.S. Treasury auctions last year.

The shaky state of Wall Street finances not only shows up in layoffs at the securities companies; it is also inducing a mood of caution among investors.

More damaging than the decline in the level of the Dow Jones Industrial Index is the shrinkage in market turnover to well under one-half of what it was pre-crash.

This indicates the low level of confidence among investors about the future and compounds the effect of the stock market crash on securities companies' revenues.

A new threat to the stability of the market has emerged with the most recent United States Treasury auction.

Between February 2 and February 4, the U.S. Treasury sold at auction, in all, $27 billion of notes and bonds.

There had been rumors ahead of the auction that the Bank of Japan and perhaps other central banks would take most of the bonds offered by the Treasury.

Although the Bank of Japan issued an official denial of these reports, the securities houses felt that they could not afford to be short of bonds going in to the auction and bid aggressively for paper in the open market.

Long-dated U.S. Treasury bond yields fell from 9.0% to 8.3%, a level so low as to give little hope that yield-conscious end-investors would bail out the securities houses if their calculations went awry.

In the event, Japanese participation in the auction seems to have been no stronger than is usual.

The central banks appear not to have taken bonds on any appreciable scale.

The consequences of this is that the securities houses are carrying huge amounts of Treasury securities on their own books.

They are unlikely to be able to sustain this position for long since the borrowing costs associated with these positions are eating into their profits.

At the same time, if they unload bonds onto the market, they risk taking prices much lower than those at which they originally bid for the bonds, thereby incurring substantial dealing losses.

Only if indications of recession multiply are the securities houses likely to be able to avoid losses on their bonds, since recession would encourage expectations of lower interest rates.

If these indications are not forthcoming, the parlous condition of the securities houses and the dislocation of financial markets which this is likely to trigger could itself strengthen recessionary forces in the economy.

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