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STREETWISE

The Markets Are Awful, But at Least They Work—for Now

Selloff has triggered stress in financial plumbing, but measures of market disruption suggest this hasn't yet become anything like 2008

A man watched stock action in the viewing gallery at the Australian Stock Exchange in Sydney on Monday.

PHOTO: RICK RYCROFT/ASSOCIATED PRESS

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You know things are bad when the good news in markets is that the financial system seems to be working well enough that people can dump their stocks in a reasonably orderly way.

With oil prices falling by the most in three decades, circuit-breakers triggered to pause the decline in U.S. stocks, and northern Italy, one of Europe's major manufacturing regions, in quarantine, there's no shortage of disastrous news for investors.

The oil shock of 2015-16 showed that even the silver lining of lower oil prices—cheaper fuel helping U.S. consumers—no longer supports the economy, as it was offset by sharply reduced shale-oil investment.

Worse, those leveraged shale companies are now in the front line of what could be another wave of defaults on junk bonds, where yields have jumped. In 2016, a swath of junk-rated energy companies filed for bankruptcy, with a default rate of 21% globally for the energy and commodities sector, according to S&P Global.

Back then the troubles were isolated to energy, with a junk default rate excluding energy and commodities of just 2.3%. This time the stress on the oil sector comes on top of a global supply and demand shock from coronavirus that threatens recession and serious financial consequences.

Here's where we get what passes for good news: Banks are in decent shape, especially in the U.S., and the plumbing of the markets has been functioning pretty well so far. There's more stress, but crisis measures such as spreads in foreign-exchange swaps, the onshore versus offshore dollar markets and bank creditworthiness suggest this is nothing like 2008—so far. Markets are harder to trade than they were, but even junk bond trading hasn't dried up entirely.

Regulators are also more alert to the dangers now than in past crises, and likely to act more quickly. The New York Federal Reserve added $50 billion to its overnight lending on Monday.

Yet, market moves of this scale usually flush out the weakest and most highly leveraged. The danger is that the prospect of defaults and possible recession scares investors and banks enough to stop them lending even to better-quality companies. Such financial contagion multiplies the impact on the real economy as decent businesses fail because they can't refinance debt, as in 2008 and 2009.

In the post-Lehman financial crisis, the credit crunch froze even the money markets, leading to a global shortage of dollars and accelerating bank failures. There is no sign of such problems today. Indeed, the dollar fell on Monday in spite of a widespread rush to buy havens such as Treasury bonds and the yen. In part, the dollar's decline was because panicked traders are paying back cheap loans in euros they had used to buy higher-yielding currencies. This was helped by the expectation that the Federal Reserve will slash rates again at its meeting next week, perhaps to zero.

The stress point in the U.S. this time isn't an overleveraged financial system—although some traders are sure to be in trouble—but overleveraged companies. If they can't refinance debt when it matures, they will fail.

Even if they can refinance, they will have to pay more, as junk bond yields have risen sharply. Luckily, they tend to be much less reliant than banks on short-term financing, so can wait until their bonds mature. In the next six months, only $98 billion of junk bonds mature globally, according to Refinitiv data; rating agency Fitch Group says just $10 billion of U.S. junk is due to mature by the end of June.

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The stress points are different in other parts of the world. Italian bond yields leapt on Monday and Spanish and Portuguese yields were up even as German yields fell. Divergences within the euro region remain a worry.

India's rupee and Turkey's lira both fell against the dollar, in spite of the benefit that cheap oil should bring to the import-reliant countries. Currencies of countries that depend on commodity exports fell hard, while there was a flash crash in the Australian dollar.

Meanwhile, oil exporters will support their budgets by dipping into their sovereign-wealth funds, which could add to the downward pressure on global asset prices.

It is far too early to say that financial failures won't multiply the troubles investors face, and the market plumbing requires close monitoring. But for now its continued functioning is one of the few bright spots in the gloom.

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