Thursday, 26 March 2020

Cash is King

- **The recent escalation of COVID-19 cases around the world and subsequent containment measures have had a profound impact on financial markets.**
- **The dislocations in financial markets have been reminiscent of the GFC, including the wild swings in share markets and currency markets. In addition, short-term funding premiums and credit spreads have spiked.**
- **Part of the stresses in financial markets reflects a liquidity issue, as large flows move from one asset class to another. Cash is being sought to meet leverage requirements, as asset values have fallen sharply. Big demand also comes from businesses, which are also likely looking to preserve cash to weather the sharp declines in revenue over coming months.**
- **In addition to the lack of liquidity, there is also likely some degree of concern over revenue streams and cash flows as economies shutdown. The risk of debts going bad is higher.**
- **While there are similarities in the behaviour of financial markets, the underlying cause is quite different to the GFC. In this current crisis, the impact to the financial system is more indirect as the key risk comes from the flow-on effect from a higher risk of businesses defaulting, which in turn impacts the banking sector. Meanwhile, the GFC was characterized by a concern about the solvency of banks themselves.**
- **Indeed, spreads on credit default swaps (CDS), which reflect the sentiment of default risk of corporates have risen significantly, but most of the perceived default risk appears to lie outside of banks.**
- **Strains in credit markets eased somewhat ever since the announcement by the US Federal Reserve earlier this week. It included an unlimited amount of bond purchases and the establishment new programs, which support lending through the corporate bond market and lending to small and medium-sized businesses. But signs of stresses remain. There are large corporates which are vulnerable, particularly companies which are highly leveraged. Further, not all companies meet the criteria for support from central banks and governments at this stage.**
- **Central banks have indicated that they will be giving as much support as needed for funding and liquidity. In a speech last Thursday, the RBA Governor Lowe said that "nothing was off the table" in response to the question of what the RBA could do next. These stresses suggest that more support may be needed from central banks.**

Introduction

The recent escalation of COVID-19 cases around the world and subsequent containment measures have had a profound impact on financial markets over the past few weeks and the risk of a deep recession in Australia has greatly increased.

The dislocations in financial markets have been reminiscent of the global financial crisis (GFC), including the wild swings in share markets and currency markets. In addition, short-term funding premiums have spiked and credit spreads have widened.

Why is there dislocation in financial markets?

In times of extreme moves in markets like we've seen over the past few weeks, there can be huge flows from one asset class to another. In this current episode, the movement of flows has largely been into cash. Before central banks stepped in, sell-offs were occurring across a range of asset classes; in equities, currencies that move in line with risk and even assets which are normally seen as safe havens, such as government bonds and gold. Cash is required to meet leverage requirements as asset values have fallen sharply. Companies and businesses are also likely looking to build up cash to weather the sharp declines in revenue over coming months. In particular, there has been a big drive to obtain US dollars, which is the world's reserve currency.

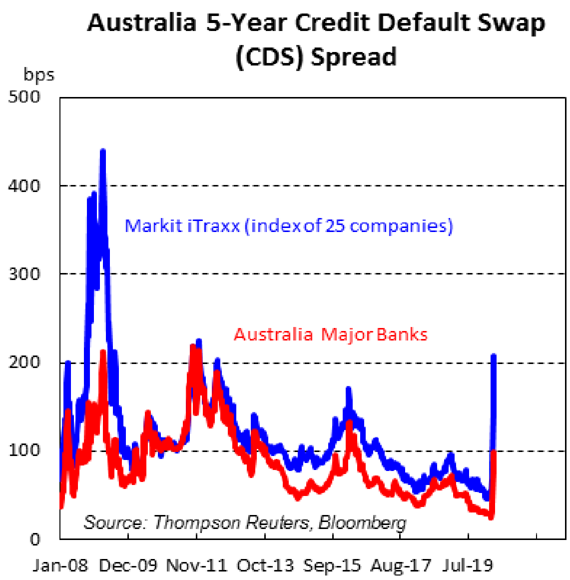
The rush to cash has led to liquidity strains in many asset markets, in particular the money market for short-term borrowing.

In addition to the lack of liquidity, there is also likely some degree of concern over revenue streams and cash flows as the movement of society shuts down and economies slow sharply. The risk of debts going bad is higher, particularly in industries within the consumer and energy sectors which have been hardest hit by the coronavirus and the associated containment measures.

Moreover, when investors are highly risk averse as they are now, they may also demand a higher risk premium overall than otherwise.

Is this Different to the GFC?

Market dislocations and the widening of money market and credit spreads were key features of the GFC. However, the main cause of this turmoil was heightened counterparty risk among financial institutions after the failure or near-failure of certain financial institutions in Europe and the US. Banks were unwilling to lend to each other as a result.



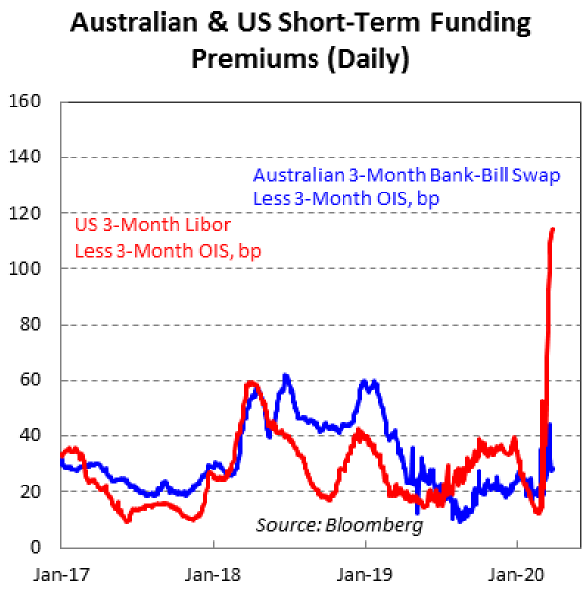
In the current crisis, sparked by the novel coronavirus, the underlying cause is quite different as a shock external from the financial system.

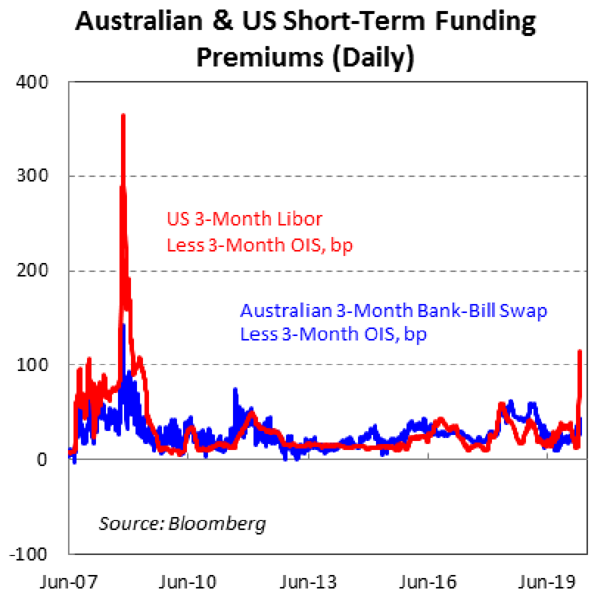
The impact to the financial system is more indirect as the key risk comes from the flow-on effect from an increased risk that businesses could default, which in turn impacts the banking sector. It differs from the GFC which was characterised by a concern about the solvency of banks themselves.

Indeed, while spreads on credit default swaps (CDS), which reflect the sentiment of default risk of corporates have risen significantly, most of the perceived default risk appears to lie outside of banks. Spreads have widened much more for non-banks. Nonetheless, spreads on credit default swaps for banks have also risen.

The spread between bank bill swap rates (BBSW) and overnight-index swaps (OIS) in Australia, or LIBOR and OIS in the US, provide a good indication of the short-term funding premium for banks.

The 3-month LIBOR-OIS spread has widened to its largest since 2008 at the height of the GFC. The equivalent in Australia, BBSW-OIS has also lifted, but not to the same extent as the equivalent US spread (see charts below). While this widening spread is partly reflecting liquidity strains amidst the search for cash, the lift in CDS spreads also suggests some degree of concern about counterparty risk, although not to the extent during the GFC.





What have central banks done?

The message given by central banks around the world is that they will do whatever is necessary to maintain orderly function in financial markets. Further, given that this current crisis is seen as a temporary shock, authorities are unwilling to let otherwise viable businesses go under during this period.

Over the past couple of weeks, measures taken by central banks have been extraordinary. Importantly, they are providing direct support for lending to businesses. The announcement by the US Federal Reserve earlier in the week had a notable impact in easing some of the strains in credit markets. The measures announced included an unlimited amount of government bond purchases, but also the establishment new programs which would support lending through the corporate bond market and lending to small businesses.

The Reserve Bank (RBA) has set up a term funding facility for banks. Authorised deposit-taking institutions (ADIs) will have the ability to borrow 3% of their existing outstanding credit to Australian businesses and households. For every extra dollar lent to large business, lenders will have access to $1 of funding from the RBA. For every extra dollar of loans to small and medium-sized businesses they will have access to an extra $5. In conjunction with the Australian Office of Financial Management (AOFM), lending support has also been announced for non-ADIs to support lending to consumers and businesses, particularly to small and medium-sized businesses.

The US Federal Reserve has also established swap arrangements with the RBA and other central banks to support US dollar liquidity and ease funding strains.

Nonetheless, there are large corporates which are vulnerable, particularly companies which are highly leveraged. There are also businesses that may not meet the criteria for direct support from central banks and governments at this stage. Currently, the US Federal Reserve will buy only investment grade securities.

It is important to note, that banks are much better capitalised than during the GFC, and central banks have indicated that they will be giving as much support as needed for funding and liquidity. In a speech last Thursday, the RBA Governor Lowe said that “nothing was off the table” in response to the question of what the RBA could do next. These stresses suggest that more support may be needed from central banks.

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