Investment Weekly

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Global liquidity crunch threatens to become a credit crisis

♦ Yield premium for high-yield bonds hits the highest since 2009 as bid-ask spreads widen to levels not seen since the Global Financial Crisis.

♦ Spread between Libor and overnight swaps, a measure of liquidity in interbank lending, hits the highest level since December 2008.

♦ News of large losses and wind downs among big hedge funds add to the concerns about liquidity spiral.

♦ US stock market sell-off on Friday sees the largest volume since December indicating investors have started to capitulate.

♦ Gold catches a bid after dropping for nearly two weeks as investors seek havens amid risk asset sell-off.

♦ FAB AAC remains underweight equities and overweight gold amid continued uncertainty in markets

A rush for cash across the globe is causing a liquidity crunch in bond and lending markets that risks becoming a full blown credit crisis. Measures of liquidity in the financial system tested levels not seen since the Global Financial Crisis of 2008-2009 and indicated that banks and companies were hoarding cash as they see the world slow down to try and contain the spread of the new coronavirus.

Libor rates shot up 36 basis points last week to 1.2% as banks began to charge higher rates to lend to each other even overnight. At the current level, Libor is trading nearly 95 basis points over the Fed Funds rate, the benchmark lending rate in the US.

On average, Libor has traded about 12 basis points higher than the Fed Funds rate over the past 10 years. Only in periods of liquidity stress has it traded so much wider to the US benchmark.

That shift suggests that banks are hoarding dollars and are refusing to lend even to other safe lenders unless they get significantly rewarded. Part of the reason why banks may be holding their cash dear is the fact that companies in the US have been drawing down on their lending facilities as they, themselves, try to ensure they have cash available as stores and restaurants shut down temporarily to slow down the spread of the coronavirus.

Similarly, banks across the world are also facing increased demand for cash among their clients, many of whom are facing margin calls and liquidations and are having to sell assets to cover these requirements. That has seen trading liquidity, particularly in the bond markets, dry out, exacerbating price swings.

US high-yield spreads are the highest since 2008 as investors hold on to their cash

That dynamic has been particularly felt in the US high-yield bond market, where bid-ask spreads for some names have become as wide as 10 points. Investors trying to sell their bonds are finding bids very difficult to come by, and when they exist, they usually come at levels several points below where the bonds were quoted just a couple of weeks ago.

As sellers outpace buyers, spreads have ballooned, with the Bloomberg US Corporate High-Yield index offering 1,013 basis points over Treasuries on Friday, compared to 330 basis points at the end of 2019. The Bloomberg Barclays US Liquid Corporate IG index has also suffered, offering 377 basis points over Treasuries on Friday compared to 103 basis points at the end of 2019.

Faced with the need to raise cash and with very challenging liquidity in bond markets, investors have turned to liquidating other assets, such as equities or even gold. That helps explain why the yellow metal, which normally moves higher in times of market volatility, has dropped for eight of the past 10 sessions. Gold, however, bounced on Friday, rising 1.9% to US$1,498/oz. That suggests that, perhaps, some of the forced selling for the asset has subsided.

Gold followed a very similar trajectory in the 2008 global crisis. Between the last week of July 2008, when the banking crisis in the US began to take hold of headlines, and the second week of November that year, gold prices fell 26.2%. The metal then rose 160% from that low, peaking at US$1,900 in September, 2011.

That is why the FAB Asset Allocation Committee (FAB AAC) remains overweight in gold, with the yellow metal now representing 7% of the Committee's balanced model portfolio. The Committee had an emergency meeting last week to consider whether gold holdings should be increased further but members were of the opinion that this would lead to undue concentration of portfolios, even though they recognized that the price drop offered an opportunity for clients who may not have increased their holdings of gold yet.

The AAC also discussed whether to go further underweight in its equity exposure, in light of the 31.8% drop in the MSCI World index in the past 30 days. The AAC decided, however, not to reduce further their exposure to equities, especially given that stocks are now becoming relatively cheap. The balanced portfolio holds roughly 40% of its assets in stocks, with the biggest weight being in the US market, which represents 21% of the portfolio.

While the AAC agreed not to reduce further the stock component of its portfolios, members agreed that it is not yet the time to enter the market. The impact of the coronavirus on the global economy is yet to be fully appreciated and how much further the liquidity crisis will continue remains uncertain, members agreed. And until there is certainty about these two factors, investors are probably better off not adding risk to their portfolios.

Central banks across the world have been trying to address the issues causing some of the market dislocations. The Federal Reserve last week announced a special lending facility aimed at money market funds. These cash-like investments very seldom trade below 100 cents on the dollar but they may have been at risk of doing so because of some of the dislocations in the short-term funding markets. The Fed acted quickly to avoid it.

The moves came on the back of new lending facilities for primary dealers and other extreme measures the Fed implemented over the past few days, which had not been seen since the 2008 financial crisis. The latest measure by the US central bank was to create a funding facility to support buying of municipal bonds as the spreads on these local government securities more than tripled over the past two weeks.

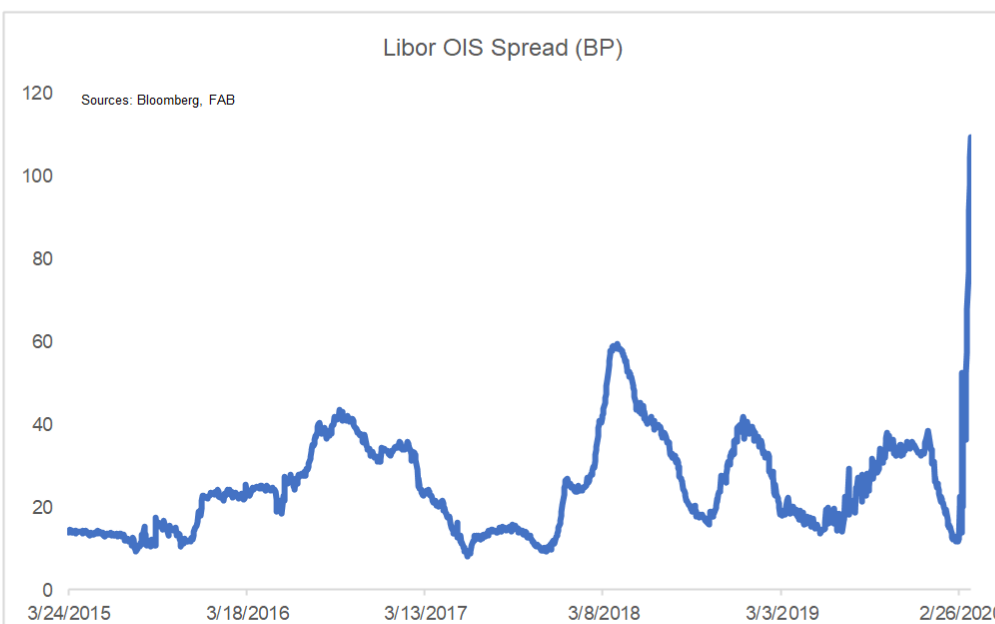
The spread of Libor over overnight swaps has reached levels not seen in a decade

The ECB has now also joined the fray, having announced 750 billion euros of additional bond buybacks, which helped reduce the spreads of Italian and Spanish sovereign bonds. Meanwhile, the Bank of Japan expanded its asset purchase program last week too, buying more ETFs among other securities.

The raft of measures have helped plug several holes in the system, but the spread between Libor and the overnight swaps shows that the market dislocation remains severe. These two measures tend to move together, but they have seen the difference between them gap in a way not seen since the Global Financial Crisis, when banks became scared of lending to each other for fear of another bankruptcy such as Lehman Brothers'.

The move this time could be driven by hedge funds which borrowed in short-term markets, such as the repurchase market, to fund highly leveraged arbitrage trades. Some of the hedge funds well known for such strategies have recently reported large losses and some smaller ones, such as Malachite Capital, announced last week that they were winding down.

Any financial institution borrowing in the short-term markets would be at risk of a similar fate now, given the dearth of



liquidity in the interbank market evidenced by the spike in Libor rates.

That has some analysts suggesting that the Fed could soon start to intervene in the corporate bond markets or to bail out some of these large funds directly, as it did in 1998, when hedge fund Long Term Capital Management (LTCM) lost US$4.6 billion in less than four months and became unable to repay its loans. The Federal Reserve Bank of New York stepped in at the time and organized a US$3.6 billion bailout funded by many of the banks which had dealings with LTCM.

Such expectations, however, may find limitations in the statutory requirements and rights of the US central bank. The Fed is unable to do many of the operations that investors may want it to without Congressional approval, something that would not come by fast enough to deal with the issue. The Fed can, however, engineer certain facilities in a similar vein to those that it used in the 2008 financial crisis, whereby it guarantees certain kinds of debts. Many of the last week's measures used such strategies.

The Fed has an incentive to do so as the current liquidity crisis in asset markets has the potential to become a full blown credit crisis. With loan and bond markets effectively closed for new borrowing, any companies in need of funding would have a hard time getting it.

Furthermore, many of the high-yield borrowers face stringent covenants that require them to keep certain levels of earnings and equity. Keeping those levels may prove challenging for companies in many of the service industries currently affected by the widespread business shutdowns. Airlines, hospitality and shale gas companies, for instance, comprise nearly a tenth of the high-yield index and face challenging times ahead.

The biggest risk to the US economy, however, lies more in the smaller companies. Mom and pop operations tend to depend on daily cashflow and often do not have enough liquidity to withstand a 30 -day stoppage of their business. They also rely on overdrafts and other short-term facilities that are going to become more expensive or outright unavailable.

That puts several millions of jobs at risk in the US alone. The Conference Board last week estimated that some 22.8 million jobs in the service sector in the US are at risk, with two thirds of those facing a high likelihood of vanishing temporarily. While many of these jobs could return once Americans return to work and leave their homes, many could disappear as shops, restaurants and bars close in the aftermath of the current crisis.

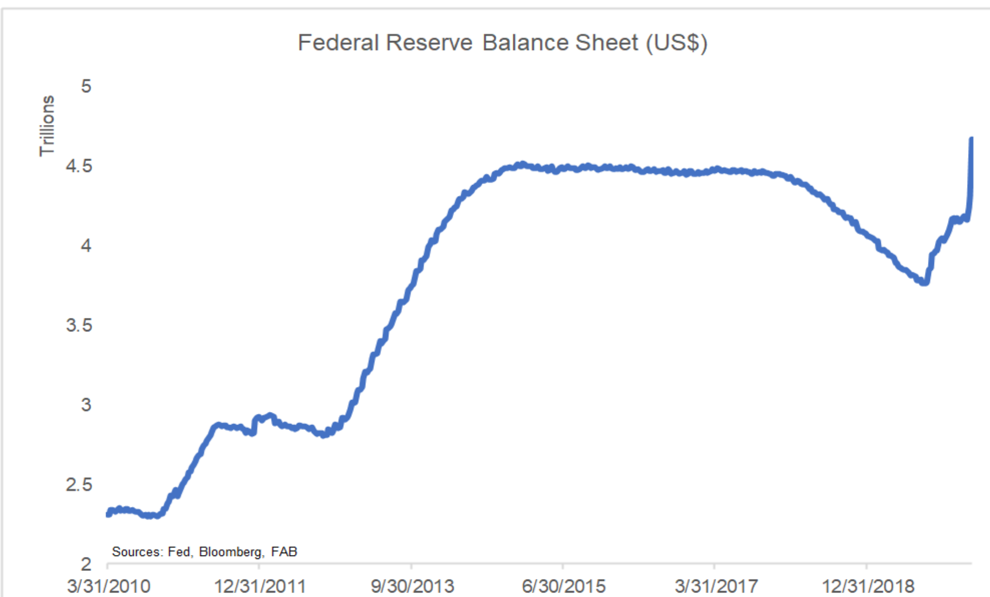
That is why the US Congress is speeding ahead with a fiscal stimulus program that adds up to nearly US$ 2 trillion, US$1.3 trillion of which would be in direct assistance to consumers and businesses, while some US$600 billion would be in the form of loans to companies impacted, including airlines. The package would be the largest in history and was rushing through Congress and could be approved as early as this week.

Lawmakers, however, may be pushed to do a lot more. Bloomberg calculates that simply to replace 80% of the revenue of businesses in all industries excluding manufacturing, healthcare, education, finance and insurance, with fewer than 500 employees for three months, it would take US$1.2 trillion, about four times the US$300 billion currently being mulled to address that part of the economy.

Similarly, even though the UK, Europe, Japan, Australia and many other countries across the world are announcing record stimulus packages, they may need to spend even more to get the economy out of the slump the coronavirus shutdown is likely to cause.

In simple terms, once the market dislocations are over, investors will be able to start to try and assess what future earnings will look like. Given the state of the world economy, it is unlikely that the picture will be very pretty. And until there is some clarity of what to really expect, those who have cash in their portfolios are best holding on to it. After all, now more than ever, cash is king.

The Fed has started to pump liquidity into the markets at a rate not seen since 2009



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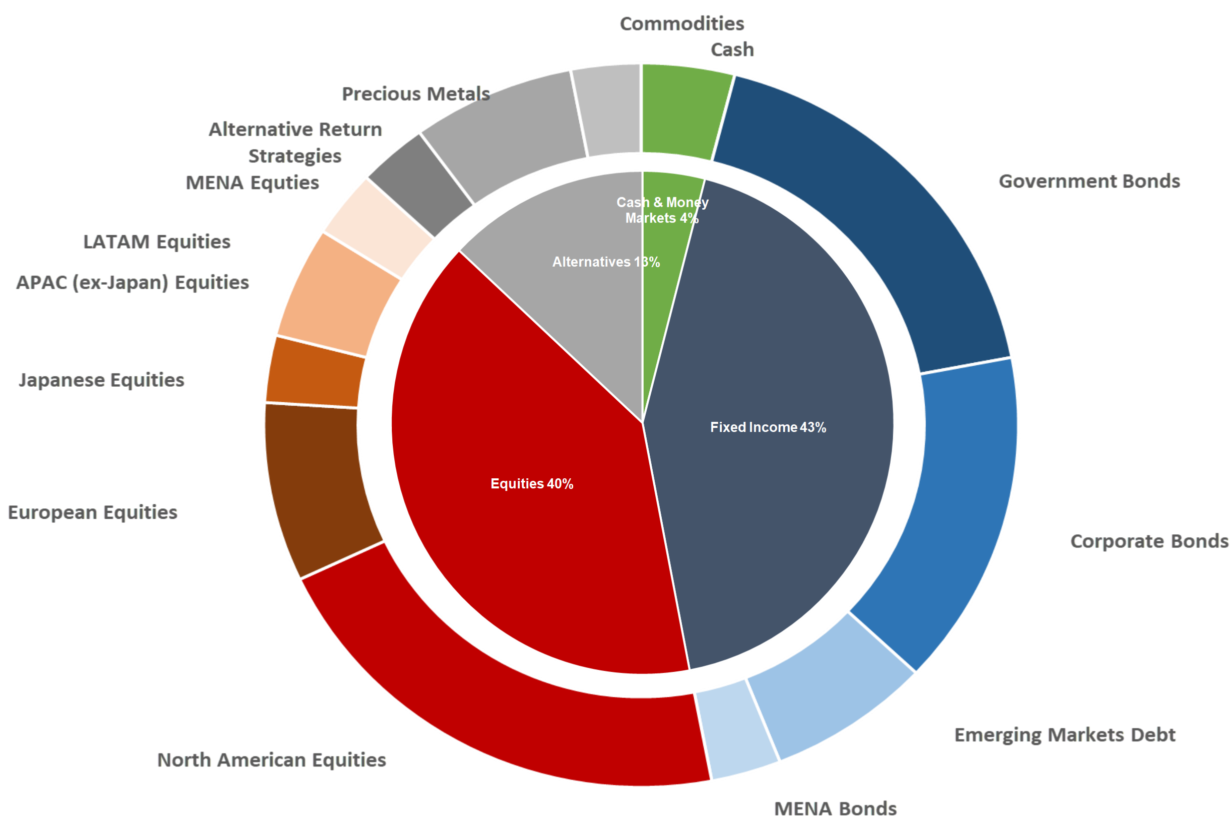
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	After allocating more cash to investment grade corporate debt
Fixed Income	Overweight	Moving to slightly overweight after adding overweight to EM dollar debt and corporate investment grade bonds
Equities	Neutral	Rotating US exposure to defensive stocks
Alternatives	Underweight	However, overweight on precious metals specifically

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