The Two Faces of Dislocation: Liquidity and Solvency

April 2020

From The Desk Of The CIO – Fixed Income

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The economic impact of the COVID-19 health crisis and the response of policymakers can be viewed through the lens of liquidity and solvency. For investors with a longer time horizon, market selloffs such as these provide investment opportunities for active managers. Assets are cheaper; valuations are favorable.

Our lives — and the financial markets — are often shaped by crises. The personal and financial disruption we are living through at present is no exception. The global economy has not experienced a complete standstill like this in modern history. There is no playbook for the health crisis caused by COVID-19 — the quintessence of this debacle — nor for the economic dislocation following closely in its shadow.

It is helpful to recognize that this is primarily a health crisis, unlike the 2008/2009 global financial crisis (GFC) that was caused by risks and leverage in the financial system. Until we know more about the virus, its transmission and the timeline for efficacious treatments and a vaccine, we cannot reliably project when businesses will begin operating and generating revenue again.

The current dislocation in the economy and markets might best be seen through the lens of liquidity and solvency, two related requirements for a functioning market economy. Liquidity is a short-term concept, referring to the ability of a company to pay off short-term liabilities with current assets. Solvency, on the other hand, is the ability of a company to meet its long-term debts and financial obligations. Solvency is essential to *staying* in business as it demonstrates a firm's ability to continue operations into the foreseeable future.

Liquidity also refers to the functioning of the financial system, the plumbing, if you like. In the current crisis, both liquidity and solvency concerns have emerged, and both need to be addressed: the short-term cash flow needs of enterprises and employees, and the effectiveness of market operations. Liquidity and solvency considerations are key when examining the investment opportunities in the present context of large swaths of the economy under lockdown.

Economy on pause

The magnitude of the uncertainty regarding the virus and its transmission has led to enormous variability in the inputs and outputs of the economic models that power forecasts. The usual data and sentiment surveys are unreliable, not least because there are currently fewer respondents and irregular activity. There are a couple of data points that illustrate the scope and size of the economic standstill. Ten million people filed unemployment claims in the United States in the past two weeks, a number not seen since the Great Depression in the 1930s. Jobless claims in Europe have been at similarly elevated levels during the same period.

Precipitous declines in credit and debit card spending also highlight the anemic economic activity. In the last week of March, in industries most affected by the shutdown, such as airlines, lodging and cruises, year-over-year revenue declined by more than 100% due to refunds, while consumer outlays for restaurants, department stores and clothing dropped between 50% and 65%. Only grocery store and online electronic sales rose in March.[1] Apparently, people are consuming food and logging onto the Internet for work or pleasure — and doing little else!

Fiscal and monetary cavalry to the rescue

Not only is there a protracted pause in activity, it is also happening in the context of a levered economy. Corporate debt has risen markedly since the GFC, as falling interest rates have paved the way for cheap credit. Half of the investment-grade bond universe now comprises BBB-rated debt, the lowest rating permitted for investment-grade debt. Needless to say, it is challenging for companies to service high levels of debt when revenues are falling precipitously, as is the case with many enterprises.

The rapid decline in economic pursuits led to a market crisis beginning in mid-March. The US Federal Reserve (Fed) and the European Central bank (ECB), along with other central banks, responded swiftly with "bazooka" firepower to ease the liquidity pressures that threatened market functioning. Liquidity suffered from investors looking to raise cash and reduce risk and the unwillingness of traditional counterparties to take market risks. The crisis was further compounded by trading glitches caused by traders at home or in dispersed locations using untested systems.

Against this backdrop, Fed liquidity actions included another round of quantitative easing, dollar swap lines, repo facilities and other measures that addressed the Treasury, corporate, and mortgage debt markets. Central banks essentially signaled they were willing to do *whatever it takes* to restore market stability. The result is liquidity has begun to return to the markets; we are seeing hints of normal market activity return, as well as a reopening of the new issue market. It is clearly too early to sound the "all clear" signal, but early April feels better than early March.

Markets have also improved, as policymakers have addressed solvency challenges with vast quantities of fiscal stimulus. A $2.3 trillion fiscal package amounting to 10% of GDP will be disbursed in the United States, while even more prodigious fiscal measures have been announced in some European countries: Germany (22% of GDP), the United Kingdom (16%) and France (14%). In many cases, these measures are likely only the first in a series of aggressive attempts by policymakers to ease the burden of the current macro backdrop.

The scale and swiftness of the monetary and fiscal response reflects lessons learned from the GFC and the Great Depression. Policymakers have been quick to try to alleviate some of the pressure points, in terms of both liquidity and medium-term solvency. However, the size of the policy measures and the speed with which they are being rolled out is creating undue complications with disbursements and potentially other unintended consequences.

Finally, it is important to note the need for cooperation among policymakers and the risk that entails. The US fiscal package, for instance, includes additional funding for the Treasury's Exchange Stabilization Fund. In essence, this fund is the capital base for much of the Fed's market operations. Clear coordination between the Fed and the Treasury is required for effective policymaking. At the same time, obvious questions exist about the ongoing role of fiscal policy in the US economy, as well as the potential for politicizing monetary policy and the independence of the Fed.

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Banks on surer footing

A positive in the current crisis is that the banking system is in a better position today than it was during the GFC. Increased capital requirements and liquidity provisions implemented in the aftermath of the GFC have placed the banking sector on much firmer footing, enabling banks to provide both short-term and longer-term credit facilities. Regulators have in fact been able to relax bank capital requirements in the past few weeks with the aim of keeping credit flowing to businesses and households to mitigate the economic turmoil. About US$500 billion has been freed up because of reduced capital requirements, providing lenders with the capacity to make approximately US$5 trillion of additional loans globally.[2]

The ready provision of credit is a crucial pillar in the recovery architecture of the global economy. Hemingway, in his novel *The Sun Also Rises*, brings this to life. Asked how he went bankrupt, the character Mike responds, "Two ways…Gradually and then suddenly."[3] Credit is indeed the lifeblood of the economy under duress. For this reason, loans to small businesses to ensure they survive this crisis is an important component of the US fiscal package.

Crises creates opportunities

While we have seen very significant drawdowns in a short space of time in fixed income as well as equities, with correlations between major asset classes moving to one, similar to what happened during the GFC, we are harvesting the fruits of the learning gained in past crises. Many market participants survived a near-death experience during the GFC and understand the recovery process as a result. In addition, central banks will be loath to take liquidity out of the system prematurely, as some did following the financial crisis.

All of this said, the virus remains at the core of the problem; monetary and fiscal stimulus is not able to fully alleviate the downside pressure; it can only help us bridge the gap between shutdown and recovery.

Another key learning is a recognition of the opportunities born of crisis. For investors with a longer time horizon, market selloffs provide investment opportunities. Assets are cheaper; valuations are favorable. An investment period of three to five years allows investment managers to evaluate solvency over the longer term rather than make judgments based on short-term liquidity. Moreover, active managers are in a position to sift the wheat from the chaff, to select companies that are more likely to weather the storm and harvest the commensurate returns.

Endnotes

[1] Bank of America Global Research, "COVID-19 and the consumer: Data through March 24," 30 March, 2020.

[2] *Financial Times*, April 5, 2020, "Regulators free up $500bn in capital for lenders to fight virus storm."

[3] 1954 (Copyright 1926), *The Sun Also Rises by Ernest Hemingway*, Book II, Chapter 13, page 136, Charles Scribner's Sons, New York.

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