Opinion **Capital markets**

How coronavirus became a corporate credit run

Central bankers are going to have to keep the money taps on

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Rana Foroohar YESTERDAY

It was only hours after US president Donald Trump told us, in an address from the Oval Office last week, "this is not a financial crisis", when markets began acting very much as though it was.

Investors dumped assets resulting in the worst trading day since 1987. Bond markets seized up, putting pressure on banks, and the US Federal Reserve swooped in with yet more emergency funding for short-term borrowing markets (known as repurchasing or repo markets), a tactic which suggests we may see quantitative easing to infinity — and beyond.

So when exactly does a coronavirus-triggered corporate market meltdown officially turn into a full-blown financial crisis? That's a question many market participants, and banks in particular, must be asking themselves.

If there has been any silver lining to the current market shock and the recession that is likely to follow, it is that it hasn't been a 2008-style banking crisis — of the kind that jumps like a virus between highly leveraged global financial institutions and causes them to bleed dry. The Dodd-Frank and Basel III regulations that followed in the wake of the subprime crisis were designed to mitigate that risk. Banks, required to hold larger quantities of high-quality assets, were made to do less trading, and more traditional lending.

That worked, up to a point. The virus-induced brake on consumer activity and labour markets, which has in turn triggered a corporate credit run, is what caused the market panic this time, rather than risky trading on the part of global banks.

Today, it is not Wall Street financial institutions, but companies in a variety of industries that are stressed, as a simultaneous supply and demand shock means they need to tap credit lines to pay their bills. With flights halted, supply chains disrupted and the consumer economy gutted, companies are trying to stockpile cash, whether they need it immediately or not.

It's one thing for the aircraft manufacturer Boeing to draw down its entire $13.8bn credit line. It's another for multiple big corporations to draw theirs at the same time. Still, as a recent Credit Suisse report pointed out, "we now have a global banking system where all major banks have to pre-fund 30-day outflows" with high-quality liquid asset portfolios. This is one important reason why these corporate funding stresses haven't caused a real time banking crisis in the way that the 2008 subprime crisis did. Another reason is that the Fed is backstopping the banking system with its repo operations, as banks exchange Treasury bills for cash.

All of this underscores a fundamental truth — regulators usually tend to fight the last war. The dollar deposits that corporations are currently drawing down are one of the highest-quality types of funding for banks, the same kind that the Basel III rules stipulate they should keep on hand.

Nobody assumed that a pandemic would result in huge credit drawdowns by many companies all at once. Losing these deposits so quickly threatens the liquidity profile and regulatory compliance of banks themselves. And that is before we start to see the spike in corporate downgrades and defaults that will create even more funding pressure.

The fact is that the banking system has already been pulled into the corporate credit crisis that many people predicted would be the cause of the next big market downturn. It's all too easy to see how the problems of individual companies — technology firms, retailers, airlines and insurance companies — could be passed to individual banks and then to countrywide banking systems. Ultimately, they could spread throughout the global financial system, leaving central bankers once again the lender of last resort, standing between us and another global financial crisis.

That is pretty much what is already happening, and we haven't even seen the next phase of falling dominoes — the meltdown of passive and algorithmic investing, the unwinding of exchange traded funds, and the sale of even the highest quality assets by people who are desperate to raise cash in the midst of a liquidity crisis. All this means that central bankers will have to keep the money taps on, and probably increase the variety of assets that they are buying or backstopping.

We shouldn't mistake all that easy money for a cure. As Credit Suisse managing director Zoltan Pozsar points out, "QE isn't a vaccine for this outbreak." Even if the Fed can offset pressures within the banking system, that doesn't replace the loss of private-sector spending. What's needed is something more akin to a wartime fiscal stimulus programme, in which the government replaces lost consumer demand, ideally with a major public health spending programme. We might start by bolstering the number of available hospital beds in the US, which is woefully behind other developed countries. Sadly, the only wartime reference in Mr Trump's ill-advised speech was to the US "fighting a foreign virus".

Covid-19 is, of course, an equal opportunity pandemic. Being asymptomatic doesn't mean you aren't contagious. The corporate crisis roiling the markets has already infected the banking system.

Whether unlimited central bank injections of liquidity are enough to keep it healthy over the next few weeks and months, as both the pandemic and the market crisis plays out, remains to be seen.

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