Too much too soon, too little too late? Markets not in a mood to wait and see

As gauges of value, financial markets look broken in the current turmoil, where pointless comparisons with 9/11, the global financial crisis, or worse than the two combined are being made. Off-beam and disjointed policy responses are a hindrance not a help.

Active managers gingerly stepping in to buy across asset classes over the past two weeks thinking a bottom might be in sight have gotten crushed on the wild volatility. Crushed at the macro level by market anxiety about contagion and near-term impacts on economic activity and risks to the outlook.

Crushed at the micro level by a combination of short selling, forced selling, machine selling, ETF unwinds and an urgent need for cash to finance possible future fund redemptions. It's too early to put the contagion into perspective when populations are increasingly being put into lockdown.

In the credit market, wide bid-offer spreads are reported in many cases to bear no relation to where traders can get in or out on the big swing days (which is most days). Dealers (who carry little or no inventory) are reported to be posting prices to lose flow and there has been anecdotal evidence of trades getting executed several big figures away from screen prices.

Credit markets are transfixed by the mesmerising effects of higher potential sub-investment-grade defaults and the fallen-angel syndrome. This is a lot closer, especially in the energy complex with oil prices sporting a three handle or lower.

One would have thought the continued sharp market sell-off had put paid to any notion that stand-alone monetary responses are adequate. But the lack of very specific fiscal measures targeted at the places they are most needed (badly-affected industry sectors such as airlines, tourism, hospitality, small businesses; households) and put into effect as part of a co-ordinated response suggests not.

The policy response so far is making the situation worse not better. Fiscal actions by individual governments are starting to be slowly drip-fed, but this is not what the market has been looking for. In morning trading on 17 March, all eyes in Europe were on the European Council's video conference for signs of Covid-19 actions at the regional level.

Questions abound about whether the Fed deployed its monetary arsenal and is using up its firepower too early. The market's so-so reaction to more Fed QE (just like the reaction to more ECB QE) was similar to the market's reaction to the Fed's expansion of repo operations (i.e. massive but ineffective). What the US market hasn't yet got is a second iteration of the Fed's Commercial Paper Funding Facility. Given where the CP market is, CPFF 2.0 is presumably near the top of the agenda, along with other targeted direct lending programmes.

Dierk Brandenburg, head of Scope's financial institutions team, doesn't mince his words in describing the policy response. "The Fed and EU packages have been disappointing. In fact, one struggles to see whose policy makers are more incompetent: the US or Europe. Markets are quite reasonably voting with their feet faced with such levels of policy senselessness. It's clear that the economic damage will be massive and mostly self-inflicted."

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"The one reasonable policy response has come from the UK which announced a well-co-ordinated pack of fiscal, regulatory and monetary measures. Unlike European neighbours, the UK is not shutting down its economy," Brandenburg added. "That will cost lives, due to the UK's weak healthcare system; a difficult trade-off to manage. But putting people out of work comes at a huge economic cost that is hard to ignore."

On the issue of self-inflicted damage, Scope had already said last week that government action to protect public-health capacity by putting economies into lockdown will make the impacts on businesses and workers worse. And run counter to any monetary actions to soften the blow. "As the virus spreads, the risk that European governments respond with draconian measures that undermine economic growth – at least for the short-term – has increased significantly," Marco Troiano, Scope's deputy head of financial institutions noted in a Scope research note last week (Covid-19 impacts on European banks: pre-existing financial health matters).

Keeping the system liquid and encouraging banks to use their capital and liquidity buffers to support customers may help at the edges but are unlikely to have a material impact. Keeping businesses and households solvent through the crisis and beyond calls for solutions beyond (failing) monetary measures designed to calm financial markets and keep them orderly.

The market has indeed become disorderly at times; its hyper-sensitivity nowhere more evident than in odd reactions (i.e. a sharp widening of the Bund-BTP spread) to Christine Lagarde's comment that the ECB is not here to close spreads of euro area sovereign bonds as having had political intent.

The ECB sets interest rates, manages euro area foreign currency reserves, oversees financial market and bank supervision, ensures the safety and soundness of the European banking system, authorises production of euro banknotes, and monitors price trends and assesses risks to price stability. Nowhere does it say anything about determining sovereign bond yield differentials, which is patently not its job. That's for the market to decide. But in markets driven by fear, the episode acted as a sign that officials need to exercise extreme care in what they say.

The health of the banks will be paramount through the unfolding crisis. In last week's bank research note, Troiano said Covid-19 is adding considerably to the challenges of European banks and that asset-quality deterioration seems likely. The impact on bank credit quality will depend on the length and depth of any economic contraction and of course where banks started out in terms of asset quality, profitability and capital. On the plus side, the sector as a whole has a stronger balance sheet and much higher levels of capital.

Oliver Wyman noted in a 16 March report that poorly organised, knee-jerk reactions "could lead inadvertently to banks amplifying the impact of the outbreak. Well structured, considered and organised approaches will serve to dampen it". The consulting firm is forecasting at a European level that falling interest rates, reduced economic activity and increases in loan provisions could lead to a 3%-5% revenue decline; higher as the outbreak escalates.

Banks have already been inundated with requests from corporate clients to draw on contingent funding facilities; there are reports some banks may need to tap the market to fund credit lines. That could be a test. The new-issue market is basically shut. Syndicate professionals do report, however, that on up days, the market could be open to drive-by financings from well-regarded names.

The bond market did see some very limited deal flow last week during moments of calm, including SSA names (EFSF, IFC, CADES, KfW) as well as corporate flow from the likes of Zimmer Biomet, Ohio Power, Entergy Arkansas, Duke Energy, Textron, Starbucks, and Danone. All-in supply was a tad below USD 16bn equivalent.

This week, three Canadian banks have so far been the only game in town in the primary bond market across any issuer segment and were all marketing covered bonds. Toronto-Dominion Bank (three-year GBP covered FRN at SONIA+80bp), CIBC (GBP 500m due Oct 2022 covered FRN tap at SONIA+82bp) and RBC (five-year benchmark euro covered guided to MS+40bp) were out in the morning of 17 March. They follow Bank of Nova Scotia, which priced a EUR 1.25bn five-year covered bond on 11 March at MS+20bp.

(Source for raw bond data: Bond Radar (www.bondradar.com); bank and media sources

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