Coronavirus and all that – credit crunch vs financial crisis

The majority of newspapers and analysts are looking for a financial crisis. In our view we are in a credit crunch, potentially heading straight for a credit crisis. A financial crisis may indeed follow, but it is not where we should look for clues right now. The locus of the drama remains in corporate debt.

The Draghi moment - whatever it takes

The impact of the coronavirus crisis in human terms has been brutal and we expect that over the next couple of weeks it will get particularly ugly as US data catch-up to reality

It has also been brutal to the global micro economy. Millions of businesses across the world see their demand dramatically curtailed, further down the supply lines it is the same and employees in large numbers are told to stay home.

Businesses lose revenue faster than anything seen in decades while being asked to keep employees on board, full time or part time, in order to avoid a complete economic breakdown.

In the anticipation that this is a short-term crisis, governments across the world are subsidising companies to keep their employees or handing out money to employees already laid off.

Companies are now forced to take a hard look at their liquidity situation and many businesses will need a credit in order to survive in the short term.

Central banks are slashing interest rates and throwing huge amounts of liquidity at the financial system with increasingly specific credit initiatives.

The governments have added seemingly huge amounts in guarantees or direct loans to companies.

That is nowhere too early as the economy is weakening exponentially by the day!

What if ?

When reading newspaper reports about the huge packages introduced by governments it is central to distinguish between direct measures aimed at stabilising demand and the measures aimed at easing credit conditions. The demand stabilising measures are considerably smaller than the credit guarantees.

What we see these days is that companies are hoarding cash. They draw down their credit facilities with the banks in order to cover for what is widely believed to be a short-term situation.

It is all fine as long as we stay within the short-term paradigm. But what if we do not? What if the virus and the economic contraction is still with us in the autumn or even well into 2021?

In that case some of the darker predictions begin to gain in importance. We do not have the overview of all bank lending to corporates in the US, Europe and the capitalistic economies of Asia.

But courtesy of IMF we have a snapshot of the global corporate bond market. It is in the vicinity of 50tn or 50,000bn USD. A substantial part of this debt (about 40%) has ratings below Investment Grade. About half of the rest are rated BBB, the lowest rating of the Investment Grade.

Now assume that the crisis lingers on and that the Q2 shows a collapse of economic activity. At that point in time we probably have a better appreciation of the depth of the recession, and we will certainly have seen the credit guarantees or direct loans offered by governments fully used up.

We will also see some, possibly many, companies who are defaulting on their bond issues. And then it will all become very serious. It is obvious that even with the substantial initiatives being put in place right now, they will not sum up to anything like size of just the HY/junk bond marketBanks will see substantial credit losses. Pension funds and other institutional investors will have begun off-loading corporate credits. Investment funds will have seen substantial redemptions. And a lot of companies will already be dead in the water. Jobs will be permanently lost. People will default on their mortgage loans and foreclosures will climb steeply.

Once the pandemic retreats, there may well have been a dismantling of productive capacity comparable to what happened after the great depression. And of course, the banks will be hit, no matter how well capitalised they may be.

Admittedly, this is a worst-case scenario. But with the unchecked growth in coronavirus cases in Europe and the US still largely in denial about how quickly the virus will spread, it is a scenario that becomes more and more likely by the day.

A voice of optimism

But let us take a look at what optimistic voices say. St. Louis Federal Reserve President James Bullard. There's little doubt he aims to be a sobering voice to the US Congres not to be petty - nor to be slow.

Bullard has just been quoted by Reuters for some quite remarkable statements:

"A potential $2.5 trillion hit coming to the economy is both necessary and manageable if officials move fast and keep it simple"

It may seem an unconventional view in a moment of global anxiety, but Bullard argues the shutdown measures now being rolled out are essential to shortening the course of the pandemic."

He argues that a 1tn US direct stimulus program is way too small.

"If economic output falls by half in the second quarter, that's a win - not a record-setting defeat. It means businesses have heeded orders to close and customers to stay home."

"We are not trying to move production and income up in the second quarter. We are trying to keep it out of the second quarter".

Bullard's ballpark estimate is that unemployment could hit 30%, higher than in the Great Depression and three times more than the 2007-2009 recession. Output in the second quarter could be half the norm, a hit of about $2.5 trillion.

He argues that this sharp drop in output is necessary in order to stop the virus and that from a macroeconomic standpoint it is a tractable problem. The federal government should just borrow and distribute some USD 2tn and distribute it to people and businesses. “You want capital to just sit in place. Switch off the factory ... Then switch it back on.”

This being the voice of a self-proclaimed optimist, we hardly need pessimists. Having some experience with the real worlds whimsy’s we have a sneaking feeling that things may not be quite as simple as Bullard claims.

Like who’s going to deliver the money?

With US postal service hit by coronavirus we’re either back to Friedman’s helicopter money drop, quite literally. Or the government will join the row of most frequent lies; “the check is in the mail”.

23 March 2020
This document is for investment professionals only