Market Liquidity Drought

While it is important to keep a long-term perspective amid market volatility, it is also appropriate to reflect on the historical event we are all experiencing. In 2008, we saw how the financial uncertainty spreading from the downturn in real estate—by way of subprime to funding markets and from there to the balance sheets of major banks—could threaten the economy. It was this massive financial shock, piled on top of the losses to households from a downturn in the real estate sector, that caused economic activity to contract. In the worst of times, over the winter of 2008-2009, more than 750,000 job losses were recorded every month—a total of 8.7 million over the course of the recession. Major industrial companies like GM and Chrysler stumbled toward bankruptcy. For the global economy, it unleashed the largest contraction in international trade ever seen. Thanks to massive intervention of both monetary and fiscal policy, it did not become a deep and prolonged recession. After a contraction of 4.2 percent in gross domestic product, a recovery began in the second half of 2009. Unemployment peaked at 10 percent in October 2009.

The effects of the current disruption seem far too familiar. A lack of liquidity (check), a breakdown of fund markets (check), and in some cases forced selling of assets (check). Many investors, including us at TD Capital, thought the market moves in 2008 were so extreme that we would likely not see anything like them again in our lifetimes – yet twelve years later, here we are.

Remember that in 2008, financing was a big problem. The banks had taken large hits and were unwilling to lend to each other or anyone else. In 2020, while financing is also a problem, it is less structural. While capital markets have again become frozen, banks are still willing and able to lend – they are just receiving an extremely high demand.

It is too early to confidently predict the course of the economic downturn facing us due to the coronavirus. But, a recession is inevitable. The global manufacturing industry was already shaky in 2019. Now we are deliberately shutting down the world's major economies for at least several months. Factories are closing, shops, gyms, bars, schools, colleges, and restaurants shuttering. Early indicators suggest job losses in the United States could top 1 million per month between now and June. That would be a sharper downturn than in 2008-2009. For sectors like the airline industry, the impact will be far worse. In the oil industry, the prospect of market contraction has unleashed a ruthless price war among OPEC, Russia, and shale producers. This will stress the heavily indebted energy sector.

Rather than rehash the news headlines – we have all seen the statistics - let's focus on a few areas of the financial markets that may not have received as much attention – fixed income liquidity (or lack thereof).

1. Treasury Bonds – The risk in the current environment is that sustained illiquidity of the U.S. Treasury market could cause leveraged investors to reduce their Treasury positions on a large scale. This would essentially result in a Treasury 'supply shock' as these funds reduce their positions & force dealers to sell those positions in a very illiquid market. Significant position reduction from one large leveraged UST investor would likely lead to a cascading effect whereby U.S. Treasury yields rise sharply and force liquidations from other similar investors. This would worsen conditions for dealers to intermediate risk in the U.S. Treasury market, exacerbate the rise in U.S. Treasury yields, and further cheapen Treasuries. It didn't take long for word of the liquidity crunch to reach the Fed's ears. They unveiled a series of actions to address temporary disruptions in Treasury financing markets that are tantamount to a return to full-blown quantitative easing.

2. Municipal Bonds – As investors rushed to exit these investments all at once, the ratio of municipal bond yields to Treasury yields (referred to as the "municipals over bonds" or MOB spread) reached record highs, exceeding the 2008 peak. While the rise in yields may reflect concerns about the financial strain on state and local governments due to the drop in tax revenues from businesses closing and unemployment rising, it is likely much of this was due to the lack of liquidity in the underlying market. The outflow from funds likely forced some managers to sell into the declining market to meet redemptions.

3. Investment Grade Credit – During an economic expansion, Investment Grade (IG) bonds trade at relatively stable spread levels over Treasuries, and defaults remain very low. But, they trade a high spread levels for a reason, credit risk. Spreads have widen to the largest since 2008, but the biggest hit in this space has come in the shorter maturities, where the probabilities of defaults are higher in the short run. If companies can survive today, then they are far less likely to default in the future. Under a program called the Secondary Market Corporate Credit Facility, the Federal Reserve will be able to purchase corporate bonds, not just Treasuries. That alone is big news, but this program also allows for the purchase of ETFs that track the U.S. investment grade corporate bond market. Good news for investors, looking for some yield over Treasuries and normalcy in the corporate space.

The recent turmoil in the financial markets has allowed investors the opportunity to review their allocation profiles, and perhaps make changes to their existing positions. At TD Capital, we have been working on the following themes:

- Harvesting losses in taxable accounts, where beneficial
- Reducing international stock exposures
- Building up "quality" balance sheets in the U.S. equity holdings
- Increasing quality "dividend" stocks for future cash-flow support

As we have preached in the past, and continue to preach today, maintaining an appropriate balance of short-term cash-flow coverage (not exposed to stock risk), allows investment portfolios time to work through near-term disruptions like today. If you have any questions regarding your individual portfolio allocation / cash-flow coverage, please do not hesitate to reach out to us. We are here to provide you support and guidance through this period, and welcome the opportunity to communicate.