Managing Cash in Difficult Times

In a few short weeks the COVID-19 pandemic has brought changes to our daily life that few imagined. Companies have rapidly implemented business continuity plans and are analysing ways to mitigate the effects the containment measures are having on their employees, commercial activities and financial position. In this short piece we focus narrowly on the consequences for the cash and short-term fixed income markets.

The sudden stop to economic activity has seen companies rush to identify and secure their liquid assets. We can see this in the sharp reduction in the volume of secondary market trading in money market and fixed income instruments. At the same time, the last two weeks have seen investment corporates raise $218bn* in the bond market. Just as the panic buying by consumers has led to some temporary shortages of basic goods, so the hoarding of liquidity is causing short-term strains in the financial markets.

** Northern Trust – 1 April 2020*

The Issue

Regulations introduced since the Global Financial Crisis (GFC) have reduced banks' willingness to hold large deposits from corporates and other financial institutions. This has been one of the drivers of the growth and variety of money market and short-term bond funds in recent years. Learning from the GFC and the ebbing of liquidity in money markets we saw then, Central banks have quickly stepped in to ensure that liquidity is available to those who hold high quality assets: cutting rates, extending secured borrowing (repo) lines, restarting Quantitative Easing (QE) and buying high quality credit. Likewise, regulatory authorities have or are likely to relax rules that would compel banks to shrink their balance sheet (e.g. the counter-cyclical capital buffer) or insurance companies to liquidate assets. Nonetheless, liquidity in fixed income and money markets is likely to remain poor for some weeks yet.

The financial and economic implications of the pandemic extend far beyond the money markets. Governments action to date has been to mitigate the damage to household and corporate balance sheets. The longer the current economic freeze lasts the more likely governments are to increase their support for critical sectors and vulnerable households. This will weaken sovereign balance sheets making sovereign defaults or inflationary policies more likely, if still remote.

Revisiting the Principles

Amidst all the changes we are experiencing, it is important to focus on the key disciplines of managing cash and short-term bond funds. The relative recent experience of the GFC provides a guide. The principal risks to which our clients are exposed are credit and liquidity. We begin by recalling what we mean by these risks, how they can be mitigated and will conclude by suggesting ways in which they may arise in coming months:

Table 1 – Risk types

Risk	Definition	Reason for seeking the risk	Mitigation
Credit risk	The risk that the issuer of the debt instrument is unable to repay in full or on time.	Higher yields may provide compensation for the risk.	• Diversification by industry and issuer. • Credit quality appropriate for risk appetite of investors. • Analytical resource and systems dedicated to identifying and pricing of credit risk.
Liquidity risk	Actual liquidity needs differ from assumptions causing investors either to forego higher returns or to sell assets to meet cash calls.	Those requiring liquid funds may pay higher yields to those willing to forego immediate liquidity.	• Transparent natural liquidity ladder. • Holdings of high quality assets to meet unanticipated liquidity needs. • Natural and market liquidity profile appropriate for risk appetite of investors.

Credit

In normal circumstances – i.e. not the current environment – the principal form of credit risk is not default but a weakening in credit quality. An unexpected deterioration in the credit quality may force the cash manager to sell a bond or money market instrument before maturity resulting in a loss to investors. Selling deteriorating credits to adhere to client guidelines or the conditions required to maintain a fund credit rating are the main sources of credit risk. Defaults are rare events that result in large losses, but on average they contribute less to credit risk than credit downgrades.

Diversification, by issuer and sector, is the main control against unanticipated credit losses. This is why many cash investors have moved from holding deposits at a handful of banks to investing in a portfolio of money market and short-term bonds.

The focus of credit research is to avoid issuers where credit deterioration is anticipated. This requires dedicated analytical resource either within your own business or at your investment manager. This is particularly acute today, when we expect the stringencies of the current environment to lead to widespread credit deterioration. For example, in the current market, portfolios might be tilted towards better credits, issuers in sectors less adversely affected and more senior structures such as AAA rated Covered Bonds and ABS. The good news is that the yields on these instruments now exceed those available at the turn of the year on poorer or more exposed instruments.

Liquidity

The textbook approach to liquidity management is to quantify how much cash you need under normal and stressed conditions. Normal conditions inform the design of the "natural liquidity" ladder: liquidity that arises from assets naturally running-off or maturing. Stress conditions inform the decision on how much to invest in high quality assets that remain readily realisable at known prices even in stressed market conditions.

However, for many cash investors it is likely that current conditions are worse than their stress case and they find themselves having to transact at poor prices in the secondary market. Those with the more severe stress cases will likely emerge better than those who were less conservative.
Diversity is also important in the management of liquidity risk. There are more options available to the manager of a diversified portfolio of money market and short-term bonds than the cash manager who places deposits with a panel of banks. A lesson that many learned the hard way in the GFC is that bank deposits are not liquid. The breaking or early repayment of a bank deposit is at the sole discretion of the deposit taker, who may not be so minded.

There are other options available to access liquidity without having to sell assets, principal amongst which are repurchase agreements (repo). However, these are limited to the more sophisticated investors with the appropriate investment freedoms and, in any event, can only be secured on assets of sufficient quality

Is It Different This Time?

The nature of the current crisis is different from any we have experienced in living memory. The GFC had its origins in the banking sector and the provision of liquidity by central banks and of capital injections by governments served to limit the effect on the wider economy to 'only' a severe recession. The current crisis appears likely to result in material damage to the balance sheets of households, corporates and sovereigns. As such we think that credit and liquidity risks will manifest in unusual ways.

Credit

Despite unparalleled support from governments and central banks, the sudden economic stop will severely squeeze corporate and household balance sheets, which will have consequences for banks. This could result in widespread credit rating downgrades forcing many cash investors to sell. Governments are likely to provide further assistance to ailing sectors. In normal circumstances it would be prudent to assume that governments will not bail out investors. This would mean that if they lend directly to companies, they will lend senior to existing interests, forcing current senior debt holders (bonds and money market instruments) further back in the payment queue.

Lenders to banks face a new risk. After the GFC, which resulted in multiple bank bailouts at the expense of taxpayers, regulators and policy setters created a set of rules that are intended to reduce the likelihood of this recurring. The new bank resolution regime includes the ability of regulators to bail-in bank liabilities, allowing them to cancel, write down or convert all or part of investors debt holdings (including money market instrument and bank deposits) into shares. With most cash investors, including money market funds, mainly invested in financial institutions, this becomes an issue of increasing importance in times such as these.

The application of these new rules is at the discretion of the regulator and they may choose not to do so, which will mean taxpayers again shouldering any burden of bailing out the banks. Likewise, governments may decide to make equity injections to assist companies in ailing sectors, which would preserve private sector capital at the cost of putting taxpayers on risk. These are political questions and much will depend on the length and severity of the economic contraction. It will pay cash and fixed income investors to be alert to the risks.

Liquidity

We are seeing significantly increased demands for cash from a wide range of investors to post margin, cover fund outflows or simply as a precautionary measure in the face of increased uncertainty.

Regulations introduced since the GFC have also introduced new liquidity risks for investors. Most obviously, dealer balance sheets have been severely constrained, limiting their ability to offer secondary market liquidity. However, the 2019 regulations governing Europe's $1tr money fund market* may be just as material. Under these regulations, short term money market funds offering a constant net asset value (CNAV), which make up the majority of the market, are bound by new rules regarding redemptions. Should a fund receive redemption requests of more than 10% of fund NAV in any one day and the amount of weekly liquidity held fall below 30% of fund NAV then a fund's board of directors must consider limiting withdrawals (gating) or charging fees to do so in order to protect clients. These measures become mandatory in the event of a fund's daily liquidity holdings fall below 10% of NAV. At the same time, these funds are under the same regulatory obligation to switch to daily pricing should their mark to market price fall below 99.80 or so called "breaking the buck".

These regulations were introduced to reduce the systemic risk arising from bank and shadow banks. The consequence has been to shift the burden of the risk to investors. So, while the extreme we scenarios for which the rules were drawn up may not occur, cash investors need to monitor their bank exposures closely in the current environment.

**IMMFA – Total value CNAV fund type 6 March 2020.*

Final Thoughts

The hoarding of liquidity and the collapse of investor risk appetites is creating a challenging environment in the cash and short-term bond market. A close focus on credit quality and liquidity requirements is likely to bring rewards. At Cameron Hume, we focus solely on managing cash and fixed income portfolios and believe that we are uniquely well-placed to apply our skills and resources to the management of our clients' cash. We would be happy to share our views and opinions with you on any of the cash challenges you may have today. If appropriate, can also offer a segregated cash management services, harnessing the expertise we have to offer. We are not a one size fits all provider and would be delighted to listen to your concerns or help you steer through these turbulent times.

April 2020