The "live" stress test of the entire financial system

A live exercise is always better than any test

Are we not experiencing a “live” stress test, never imagined or conceived by a human brain, of a major crisis? At inception, it was certainly a health or biological crisis, which also quickly generated financial consequences. Will it pass this full-scale test? That is the question. I think it can be presupposed. After the 2008 Global Finance Crisis, everyone thought they saw the worst. But as it is unfortunately never certain, the "worse" has found stronger than it... the "worst". Isn't the current global crisis and stock market crash which likely bring to light the remaining weaknesses of our capitalist system? Perhaps... panic and anxiety being bad counselors, one can fear the domino effects, never highly recommended. To be on the market right now you need a well-hung heart like when you enter the Space Mountains at Disneyland (when it's open). We've entered areas of acute and violent turbulences. It will hurt no doubt. We will recover, of course, but not without collateral damages in passing. We now need to be patient. However, as always after a crisis, time will come to understand what could have been set up to prevent the crisis or in this case the consequences of it.

Medicine terminology used by finance too

Contamination and contagion are also terms borrowed by finance from medicine. Like a virus, a crisis does not respond to antibiotics. We must find the vaccine and I'm afraid it's a little late. We are in the middle of the ford and will have to reach the opposite bank early on. There are worrying factors: uncertainty, especially over the duration, the indebtedness of the States and of the companies, already enormous, is increasing. Eventually, the indebtedness of households also increased over last years, especially in the USA, where individuals are heavily impacted. People tend to forget former crisis.

It is fair to say that a certain euphoria had gained Americans. Did the American not live one of the most successful economic development times and the longest growth period in their history? On a clear day, we always forget what a storm is.

Storm warning on the "High Yield"

The "high yield" will give investors cold sweats. Low rates were a sham. Businesses borrowed at full throttle because rates were low, and spreads were favorable. From now on, spreads will increase, and economic difficulties will disrupt debt service. Companies, as in 2008-09, which will have to refinance themselves shortly, will pay dearly for the bill. They will be vulnerable and fragile. Investors will flee bonds with negative or low yields, and the credit crunch will not be impossible for the weaker ones. There are numerous “zombie companies” which can only survive because of low interest rates. They could default in case of crisis, as riskier. The risk of default will resurface and despite the courageous and proactive statements of a President Macron, it will continue ... Shale oil is going to leave dead people on the way to the US (but not only there). Oil producers (we're not going to complain) will be going to taste troubled times. The oil producing countries will row to cope with the inevitable fall in the price of a barrel.

The « perfect storm »

Isn't this the storm of the century? What Americans call the "perfect storm"? The race for bridge lines of credit, welding credit, crisis credit, etc. is launched. The risk of a liquidity crisis is very real. We know the Central Banks and the States will be there. But we also know that central bankers have exhausted their ammunition. Strategies to support economies are a little out of breath. To say that the "game is over" is perhaps going too fast in the work. Central banks are kind of “paper tigers”. It is to be hoped, however, that they will help restore confidence, because that is the main problem to be faced, in order to put an end to the possible chaos. The States will take on even more debt, the central banks will buy back the new debts of these States.

But isn't it just "monetary financing," which when rates at zero stop, will be a problem? All currencies are moving towards zero rates (e.g. USD, AUD, GBP,...). Fortunately, commercial banks are stronger than in 2008 and the risk of bankruptcy / default is lower. The key issue remains liquidity because any paper will have to find a buyer, at the risk of tipping everything. Scalded individuals place their savings and the proceeds from the sale of their securities and financial assets in "cash" It has as a consequence to further increase the problem of banks paying the individual better (i.e. zero percent) than that what they receive from the central bank. We should not exaggerate because the problem is already enormous for many of them. Will investors buy the paper that corporates and the "real economy" will have to issue to get back on track? Again, a crucial issue to be resolved.

Potential liquidity crisis?

Some multinationals have been pulled "to the full" on their credit lines as a precaution. Think of *AB-INBEV*, which has drawn its 9 billion lines. Before them, *Boeing, Hilton Worldwide*, *BA* and *IAG* had done so. Cash will help these companies under pressure or heavily indebted to maintain some financial flexibility. Restaurants, bars and closed hotels do not encourage the sale of beer? Since the beginning of the year, *AB-INBEV* shares have lost 50% of their value. There it is the shareholder who must be flexible ... or at least patient! They have 3 billion bonds maturing in 2020. It's time to protect yourself... Everyone is scrambling a little bit, becoming defensive and trying to shore up their balance sheets any which way they can.

This additional debt capacity is the key to whether maintain its credit rating. You will have to agree to pay "utilization fees" (while saving on "non-utilization fees"). A secure and confirmed line of credit always has a price (i.e. 35% of the spread applied). In the case of *AB-INBEV*, the world's largest brewer, total debt amounts to USD 95.5 billion (before the Corona virus crisis). The debt was oversized to allow the purchase of *SAB-Miller*, despite a reduction of almost 8.5 billion initiated before the crisis. This example is interesting because it illustrates the risk of the most exposed multinational companies (because of their operating activities e.g. travel, movie theaters, airlines, ...) and the highly indebted groups (because of their capital structure and maturing borrowings) that could frighten the whole financial world.

The recent cuts in the US interest rates are explained by the risks related to corporate debt. Some borrowers / issuers entered the dangerous zone of “junk bonds” (e.g. *Kraft-Heinz* recently). In UK, *Flybe* airline went bankrupt.

The full equity approach could be painful for small investors in the US

The investor, particularly in the United States, has never held as many listed shares (i.e. equities) as it does today. It may be tempted to sell even at a loss, keep proceed in cash, or to pay off its debts, otherwise when the crisis will have hit it. What about high-frequency trading and short selling, which we are trying to limit, which could also play a role in reinforcing panic. Very high-frequency trading (HFT), algorithm specialists, flash traders, quantitative funds and other specific players could also strengthen the bearish movement. Our markets and their players should be reasonable, consistent and disciplined. We will have to be patient and not panic because if machines started selling to machines, mechanically, the world economic order would be disrupted. Lockdown is not for markets and everything must be done to stabilize them.

World economy, once treated, will be recovering from COVID-19

The global economy is also on extended sick leave. The central banks' actions have failed in their attempt to contain the contagion on financial markets, despite aggressive measures to provide enough liquidities. The central bankers around the world haven't succeeded in stopping the hemorrhage. No one has envisaged the supply shortage and now the demand radical decrease. The shutdowns and quarantines have heavy effects we have not considered. The manufactured goods can be stored. Nevertheless, services cannot. SME's are suffering the most. The ability to play on interest rates to help has shown its limits. We are now negative. What more could Christie Lagarde do? The supply of liquidities is only beneficial to those who have access to them. Banks will not lend to SME's and riskiest sectors. Did central bankers burn all the wood reserve for winter, is a key question to address. Monetary policies cannot do everything. We need a strong fiscal stimulus to recover from the pandemic and healthcare support to poorest, cash handouts, guarantees from States to banks, etc… Let's be inventive and creative to avoid being too dependent on central banks as we often do.

Not to succumb to panic

It is all our role not to give in to panic. We must avoid becoming "liquid" again and sell everything, we must avoid the massive withdrawals of cash as some individuals are doing, and search for our lost wits. It won't be easy. This new life-size stress test will allow us to further repel our resilience and ability to withstand (which I have no doubt). The fear now is that weakness in the economy will coincide with a rash of cuts in credit ratings, amplifying or boosting a market sell-off. Nothing will ever replace in terms of sensitivity testing, the actual tests "live" as imposed on us this perfect example (if not beautiful) of the "green swan" (which if you remember I had told you more than, a month ago). Oscar Wilde said humorously: "*It is better to know the worst, whatever it is, than to remain in a terrible uncertainty*." Did he really mean what he said?

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