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IMPACT OF COVID-19 AND GOVERNMENT RESPONSE ON CAPITAL MARKETS

This article intends to provide financial services executives with a perspective on COVID-19 and the latest Federal Reserve and government actions, and their implications on the capital markets industry. The epidemic outbreak continues to progress further, and some of the views in this article may fall out of date. This article reflects Capco's perspective as of April 13, 2020.

QUESTIONS FOR THE CAPITAL MARKETS INDUSTRY IN A TIME OF CRISIS

The coronavirus virus (COVID-19) has affected millions of people globally and exponentially grown into at least 200 countries, with the US emerging as the largest epicenter. On a positive note, China, South Korea, and countries in Europe continue to report the lowest number of new cases in weeks, giving a glimpse of hope for the rest of the world that some of the measures taken to date may help slow the rate of spread.

Still, the end of the unprecedented public health crisis remains to be seen. Stock markets have already posted the largest losses since the 2008 financial crisis. Commodity prices tumbled even further, signaling sustained damage to global demand and supply – according to Goldman Sachs, it may take at least six months for the global supply chain to recover[1]. The US government has recently passed a $2 trillion economic relief package, the CARES Act, providing direct financial aid to individuals and fiscal support to impacted industries, states, and local governments. The latest Federal Reserve actions to introduce dollar lending to other central banks and unleash up to $2.3 trillion in additional aid comes as another aggressive containment measure after cutting interest rates to zero and buying $700 billion in government and mortgage-related bonds several weeks ago. Central banks and governments in other G-7 countries are following suit in attempts to contain the effects of the pandemic at a domestic and international level.

Capco has issued several COVID-19 related perspectives since the start of the outbreak, including impact on the economy, wealth and asset management, as well as the importance of thinking about strategy and having a robust business continuity plan in a time of crisis. In this article, we will focus on what this means for the future of the capital markets industry. We will explore three influencing factors – elevated volatility, industry-specific implications, and government actions – and the underlying opportunities that should be considered when it comes to leading capital markets businesses through this turbulent time.

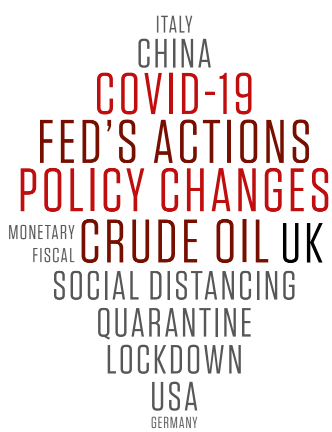
1 https://roselawgroupreporter.com/2020/03/exclusive-notes-on-inside-goldman-sachs-economic-analysis-of-coronavirus/

1. ELEVATED VOLATILITY

The future is less predictable than ever due to growing uncertainty on how long the pandemic will last and the scale of the economic damages we are facing. On March 16, the volatility index ($VIX) breached $80 for the first time in index history, surpassing the previous 2008-crisis peak ($79). As investors worldwide are counting trillions of US dollars in losses, we are navigating a unique market event, and participants are unsure of what will happen next[2]. As the impact is being assessed, it begs the questions about the future of capital markets and the opportunities that market participants may find amidst the current uncertainty.

Trading desks capitalize on near-term market events

In markets filled with fear, opportunities will be dictated by changes across key areas, including the rate of COVID-19 spread, the Fed's and government's actions, domestic and international policy changes, and oil price dynamics. Strategies seek to capitalize on macro trading scenarios, monitoring upcoming news and events to dictate entry and exit points. They take advantage of larger asset class correlation movements and seek to predict which historical correlations will hold in these times of stress. While pre-COVID-19 trade pricing models have become outdated and algorithms themselves may not add to a bank's bottom line. Still, traders can modulate simple variables and use them as ideal tools for pairing (e.g., time: a trader can instruct an algorithm to run between specified dates, and identify a correlation that may have arisen in the span of the recent crisis). The largest institutional banks appear to be at the front-end of capitalizing on this volatility as equity derivatives desks are producing record profits[3]. In times of stress like this, similar macro 'risk-on/risk-off' approaches will dominate market dynamics until the '$VIX' returns to sub $20 levels.



Banks can capitalize from the elevated risk of credit default

Increased volatility is also shifting credit markets and creating opportunities in the short term. Market fears are growing as the CDX (which measures the perceived risk of credit in US corporates) jumped 120 basis points on the week of March 9 (its most significant increase since the Lehman Brothers fall in September 2008)[4]. As the fear is pushing investors to hedge their assets against the perceived risk of credit default, financial institutions are seeing increasing demand and secondary trading in related derivatives, i.e., credit default swaps, for downgraded corporate debt. Equally, investors and borrowers are likely to fail to meet eye-to-eye in the near term as a result of the accelerated rise in the risk, driving spreads wider and profitability higher. For example, the latest fallout in higher risk leveraged loan volumes by c. $50 billion (60 percent) between the end of January and the end of February can be attributed to this pattern[5]. We expect to see a similar hold-off trend in equity markets as well due to short-term differences in valuation methods and diverged investor and founder sentiments.

While we cannot yet draw any conclusions on the impact of volatility on capital markets, we can stress its importance as a key influencing factor for decision making in the near term for all market participants. In the next section, we will explore how an industry-by-industry approach is also becoming increasingly important amid COVID-19 and other related events.

2 https://www.forexlive.com/news/!/vix-hits-highest-closing-level-on-record-indicating-stocks-have-more-to-fall-20200317
3 https://www.bloomberg.com/news/articles/2020-03-26/jpmorgan-s-equity-derivatives-haul-said-to-soar-to-1-5-billion
4 https://www.bloomberg.com/news/articles/2020-03-09/u-s-credit-market-fear-gauge-surges-most-since-lehman-chart
5 https://us.spindices.com/indices/fixed-income/sp-500-investment-grade-corporate-bond-index

2. INDUSTRY-SPECIFIC IMPLICATIONS

In the March 12 article, we noted that COVID-19 is causing the disruption to global supply chains and making immediate demand shocks to industries such as travel, tourism and entertainment. Since then, the US government and other countries announced guidelines for social distancing and self-quarantine, which in turn reduced demand for physical retail and services industries. While these measures adjust the magnitude of the virus threat to public health, they prolong the disruption to critical industries, and we anticipate the list to grow. How can capital markets businesses maintain focus and serve the industries through this turbulent time? We recommend readers to evaluate implications of COVID-19 to each industry, primarily where banks operate using sector-based coverage models (see Exhibit).

HIGH EXPOSURE	• Apparel • Automotive Manufacturers • Automotive Suppliers	• Consumer Durables • Gaming	• Lodging/Leisure & Tourism (includes Cruise Lines) • Passenger Airlines	• Retail (Non Food) • Global Shipping
MODERATE EXPOSURE	• Beverages • Chemicals • Manufacturing	• Media • Metals & Mining • Oil & Gas/Oilfield Services	• Property Developers (China) • Services Companies	• Steel Producers • Technology Hardware
LOW EXPOSURE	• Construction/Materials • Defense • Equipment Transportation	• Rental • Packaging • Pharmaceuticals	• Real Estate/REITs • Food/Food Retail • Telecomms	• Waste Management
***POTENTIAL* POSITIVE IMPACT**	• Internet Service Companies	• Retail (Online)	• Gold Mining	• Online Gaming

Source: Moody's, moodys.com/coronavirus

The latest fiscal stimulus will provide much-needed aid to some highly exposed industries

Both the Federal Reserve and US government confirmed multi-trillion-dollar emergency aid policies that dedicate support for individuals and impacted businesses via multiple federal, state and local funding mechanisms. With the definitive effects of the stimulus remain to be seen, specific highly exposed industries such as airlines, shipping, and hospitality are tapping into the direct loan and grant funding to contain further damage from the pandemic.

For instance, the $25 billion of government loan guarantees for airlines can provide near-term bridge funding for unrealized revenues to pay employee salaries. And, in turn, help lessen the stress on other highly-dependent businesses, including airports, as airlines will have additional liquidity to cover airport fees[6]. While this gives some relief in the near-term, readers should assume all potential outcomes are still possible, including a continued rise in unemployment and reduced spending power across categories (mandatory and discretionary). This may result in an industry-driven contraction or even long-term economic depression.

6 https://www.bondbuyer.com/news/federal-stimulus-for-airports-will-help-stabilize-budgets

Opportunities from the credit-related disruption in energy and travel industries

In debt capital markets, you already see signs of systemic damage in some specific industries. The global economy currently holds $20.9 trillion of non-financial corporate debt. Some seven percent of that debt globally is owed by the industries walloped by COVID-19 and eight percent owed by the energy sector affected by the recent crude oil price slump[7]. Corporate bonds in the industries mentioned above have been or risk being downgraded, forcing companies to restructure their debt or borrow at a higher expense. Even if the latest US government and the Fed stimulus is poised to bridge some near-term liquidity needs, the market provides banks with temporarily higher-yielding bond issuances, as they can lend to borrowers at relatively higher interest rates.

Banks must monitor emerging opportunities in secular industries

Identifying secular industries that can remain largely unaffected or, benefit from current events may provide emerging opportunities for capital markets businesses. While supply and demand shocks have shrunken global markets, the sectors that do not rely on brick-and-mortar presence such as internet services and retail (online) are already benefiting from changing consumer sentiments and needs. For instance, remote work and education are becoming a 'norm' today and in the immediate future. Internet services industries are further solidifying proof of concepts for digital conferencing and online classrooms, leveraging this window of opportunity to transform sentiments and ways of working for the future. According to Cisco, a teleconferencing provider, "the way we work is going to change forever. Employers are going to be able to hire workers from wider geographic areas because staff will not have to come to the office as much."[8] We expect technology firms to continue hiring aggressively as they move to take advantage of a world shifting increasingly to digital as a result of COVID-19, despite increasing downsizing in some high exposed industries and growing concerns over plummeting global markets[9].

What are the industries that have increasing banking needs in the current environment? We urge capital markets executives to invest time in understanding the impact of COVID-19 on each individual industry, so their business strategies can account for the underlying risks and focus on proactive support to clients, which may lead to emerging opportunities.

> *"...the way we work is going to change forever. Employers are going to be able to hire workers from wider geographic areas because staff will not have to come to the office as much."*

7 https://www.economist.com/printedition/2020-03-14
8 https://www.bloomberg.com/news/articles/2020-03-23/cisco-sees-video-demand-surge-for-webex-zoom-s-larger-rival
9 https://www.ft.com/content/da4a64bf-144c-49d0-8659-ecb179f2b526

3. THE FED'S AND GOVERNMENT'S ACTIONS

We maintain a view that the latest moves to inject $2.3 trillion in economic aid and stimulate dollar liquidity to the international financial system confirm that the Fed is playing the role of central banker to the world[10], and using almost a full arsenal to contain the effects of the pandemic. Combined with central bank policies elsewhere, the Federal Reserve's policies will continue to influence growth-related decisions for capital markets executives in the coming months. We are also seeing the growing importance of fiscal stimulus that the US administration and other G-7 governments are executing as we publish this perspective. We cannot ignore the fact that adding trillions of dollars in liquidity injections are opening market activities. It is worthwhile to understand the immediate opportunities that this may create for capital markets businesses.

Banks are taking steps to 'destigmatize' the Fed's discount window

On March 15, the Federal Reserve has urged US banks to tap into its short-term funding facility 'discount window' to make it easier for credit to continue flowing through the damaged economy[11]. While the window intends to help combat market stress, it has, for years, carried a negative stigma, prompting banks to avoid borrowing from it, as they may be perceived to be under financial stress. Large banks, including Morgan Stanley, Bank of America, and Citigroup, have taken measures to 'destigmatize' the use of the discount window. The banks have done this by increasing their support of the collateralized (overnight) lending market[11]. Taken advantage of the discount window is fueling relatively lower-cost liquidity into banks, and in turn, passing on savings through lower-cost credit offerings for corporate borrowers. We anticipate that smaller capital markets businesses will shortly follow suit and surge demand in discounted lending as more low-cost liquidity is becoming available. We expect similar patterns in international markets as well, with the Fed's aggressive moves to inject dollar liquidity for central banks elsewhere.

Investment-grade bond opportunities from the Fed's move to buy corporate debt

In an unprecedented action, last week, the Fed announced it would purchase highest-rated (investment-grade) corporate bonds in support of credit markets amid the dramatic economic impact of dealing with the pandemic[12]. The Fed's move comes just in time as corporate treasurers are rushing for liquidity in an attempt to prevent further financial damage and create a short to medium-term cushion for economic uncertainty. In March, global corporate bond issuance by investment-grade companies has reached a record of $244 billion, with Berkshire Hathaway, Pfizer, and Intel being some of the many firms following this trend[13]. Due to the risk of an extended economic recession, borrowing will remain critical to corporate balance sheets, and we anticipate the Fed's – along with other central banks – will continue with their quantitative easing measures. We recommend readers to watch the space and be prepared to support the trend.

Fed's and Government's actions: what comes next?

In the March 12 article, we referenced Federal Reserve Chairman Powell accepting the Fed's actions are limited to navigating the ongoing economic damages from COVID-19[14]. Since then, the Fed and the US government announced unprecedented monetary and fiscal measures that are poised to make a positive impact on the global economy by assisting American households and highly exposed businesses and preventing international liquidity squeeze

10 https://finance.yahoo.com/news/fed-takes-role-world-central-191339893.html
11 https://www.nytimes.com/2020/03/16/business/fed-discount-window.html
12 https://www.nytimes.com/2020/03/23/business/economy/coronavirus-fed-bond-buying.html
13 https://www.ft.com/content/b5e1de86-eea1-4cb3-b911-878781e36c24
14 https://www.wsj.com/articles/federal-reserve-cuts-interest-rates-by-half-percentage-point-11583247606?mod=e2tw

amid a worldwide rush into dollars. Fiscal policies can directly help workers who are told to stay home and make sure companies have access to bridge capital to ensure they can navigate an extended disruption in revenue. However, the fiscal measures have limitations too, as it cannot reconnect supply chains broken by quarantines and bottlenecks, nor restart air travel on canceled routes. Expansionary fiscal policy can also lead to longer-term economic shocks, such as hyperinflation or, albeit unlikely, a Greek-style debt crisis. While the real effects of the Fed's and government's actions remain to be seen, we invite capital markets leaders to consider all the possible factors when preparing for potential outcomes.

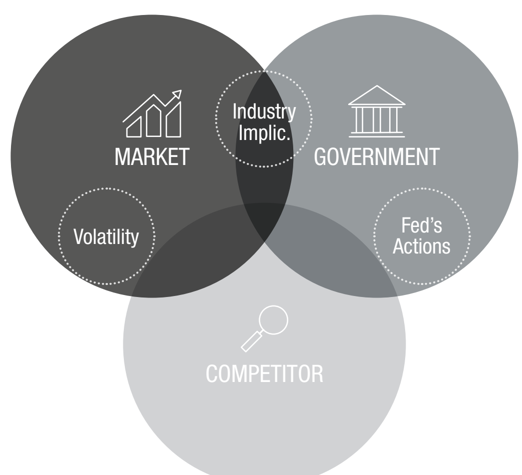
CONCLUSION: AMIDST OPPORTUNITIES IN CAPITAL MARKETS, THE FUTURE REMAINS UNCLEAR

The pandemic is continuing to spread to all parts of the world, raising dire public health risks and damaging effects on the economy. While the long-term impact on capital markets will remain unclear, we have highlighted some of the key influencing factors emerging through this turbulent time: elevated volatility, industry-specific implications, and the Fed's and governments' actions. The list is not exhaustive and will continue to evolve as the impact of COVID-19 and related events materialize in the coming weeks and months. In the short term, we invite capital markets executives to consider the underlying opportunities when it comes to leading their businesses and reassessing their business strategies.

Although we did not focus on competitor-related factors in this article, we recommend industry leaders considering the three vital influencing areas: market, government and competitor (see Exhibit). This framework is not aimed to conclude the impact of the pandemic. Instead, it should provide readers with a framework to ensure that some of the 'unknowns' covered in this article are acknowledged, and form part of their key decision-making processes.

As a way of concluding, Capco continues to urge financial services leaders to proactively address business challenges and help mitigate the impact of the COVID-19 outbreak in whatever ways they can. While these are uncertain times, comprehensively evaluating decisions and potential outcomes will help industry leaders maintain focus for their organizations and minimize the impact of the unprecedented economic 'flu' we are confronted with.

Influencing Areas and Factors



For additional information and other COVID-19 perspectives, visit www.capco.com/Intelligence/Capco-Intelligence.
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