Too much cash can create a crisis

The current conditions in credit markets are bizarre. We're still in the midst of a global pandemic and economic downturn but credit markets are partying like there's no tomorrow. Almost every day credit spreads go lower as anecdotes emerge of banks refusing to take term deposits from new clients. The banking system is flooded with liquidity and there's simply not enough demand to borrow to match the freshly printed central bank cash.

The last time I remember such excessive liquidity was in early 2007. Back then I was managing a cash fund and I remember being rebuffed by several major banks when we called and asked for their rate for our short term cash. When we couldn't find a home with them we turned to the commercial paper market and found some boring vehicles that would take our cash for a handful of basis points over the bank bill rate. We didn't get involved with the racier structured investment vehicles (SIVs) that offered a little more yield, with several of those blowing up as the financial crisis kicked off in 2007.

In a credit spread sense it's not as bad today as it was then with 5 year major bank senior bonds paying around 35 basis points over BBSW today compared to 10-12 basis points then. However, on an all-in (credit spread plus risk free yield) basis it is far worse today as the cash rate in 2007 was over 6%, which was miles above the inflation rate. Today, there's very little global debt with an investment grade credit rating that offers a positive real (after inflation) return. Whilst it is easy to look back and be critical of those chasing additional yield then, it is harder to criticise the same behaviour today when central banks are deliberately punishing conservative investors with negative real returns.

The inevitable outcome of this excessive liquidity is stupid lending is happening on an ever increasing basis. Despite a large swathe of companies on the brink of default, the US high yield market has never had worse covenants and never had lower all-in yields. Several African countries have defaulted or are on the brink of default but others are easily selling new bonds. Italy and Greece have virtually no prospect of ever paying off their debts but their 10 year bond yields are barely 1% more than Germany. Today's growing pile of dead wood debt risks becoming tomorrow's bonfire.

All of this is happening because central banks and politicians are too afraid to tell the truth. An economy built on ever increasing levels of debt isn't sustainable. Trying to prevent investors from taking losses only causes them to take greater risks which leads to larger losses in the long run. We've made a long series of bad decisions to get here and there isn't a painless way out. The glut of cash isn't a sign of good health, rather it indicates financial markets are delirious with stimulus and won't stop partying until there's a crash so big that central banks can't affect a bail out.

Written by Jonathan Rochford for Narrow Road Capital on 5 December 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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