

Why Liquidity is Essential for Preserving Market Stability

Over the past week, governments have endeavored to slow the coronavirus' spread by expanding quarantine efforts, closing non-essential businesses across the U.S. and sealing national borders in Europe. However, these containment efforts are creating financial strains for businesses and consumers — and growing demand for liquidity. Tuesday's 6 percent equity market rally partly reflected relief associated with the Federal Reserve's significant efforts to expand liquidity and support financial markets.

Liquidity — the ability to buy and sell securities rapidly without causing a significant change in price — is essential for markets and financial institutions to function efficiently. Investors fleeing risky assets to invest in government securities and cash have widened high-yield bond spreads, increasing financing costs for more highly leveraged businesses. Concern about access to financing in the energy, tourism, retail and other sectors impacted by the coronavirus has contributed to the plunge in equity prices. Despite its impact, this liquidity crunch is likely a temporary phenomenon caused by surging demand for liquidity at a time when capital requirement regulations limit banks' ability to provide it. These conditions do not represent a structural weakness, such as an over-leveraged financial system that contributed to the Great Financial Crisis.

In what has been described as “using the bazooka,” the Fed has taken a series of major actions to increase liquidity and “unclog the pipes” in financial markets. The Fed's actions include:

- Cutting interest rates by 100 basis points to near zero.
- Injecting \$700 billion of quantitative easing
- Expanding facilities to support short-term business lending

This week the Fed launched a lending facility to support short-term commercial credit markets, helping to assure companies access to financing. The availability of commercial paper financing should increase banks' ability to expand longer-term lending. Federal regulators have already taken steps allowing banks to loosen their capital requirements for lending, and consideration of other measures is pending.

Tuesday's market rebound also may reflect the Trump Administration's proposed \$1 trillion fiscal spending package, including \$250 billion in direct payments to American business owners and consumers. The Fed's actions to ease credit conditions and additional efforts to provide fiscal support are essential precursors to a financial market recovery.

While we are encouraged by the steps the Fed has taken and the anticipation of massive fiscal stimulus, we do have to acknowledge that we are in uncharted territory and market conditions could get worse before they get better. Under these difficult circumstances, it is normal to feel pressure to sell at already-depressed prices in order to avoid the potential for additional losses. However, if past is prologue, the decline in equity valuations, coupled with deteriorating sentiment indicators, may have improved the risk/reward tradeoff for long-term investors. This argues more for selectively buying this market than selling in fear.

Market commentary represents a review of issues or topics of possible interest to Glenmede's clients and not as personalized investment advice. It contains Glenmede's opinions, which may change after the date of publication. Information gathered from third-party sources is assumed reliable but is not guaranteed. No outcome, including performance, is guaranteed, due to various risks and uncertainties. This document is not a recommendation of any particular investment. Actual investment decisions for clients are made on an individualized basis and may be different from what is expressed here. Any reference to risk management or risk control does not imply that risk can be eliminated. All investments have risk. Clients are encouraged to discuss anything they see here of interest with their Glenmede representative.