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Abstract

This impact paper investigates the consequences of the Covid crisis on financial markets, focusing on the wide divergence between equity and commodity markets, the risky involvement of non-professional investors, and the rehabilitation of the banking sector.

Keywords: Financial markets, Commodities, Banking sector, Covid crisis

Coronavirus and financial markets: Uncertainties and lessons from an unprecedented crisis

While the Coronavirus health crisis has placed our globalized society in an unprecedented situation, it is also a great post-Subprime fire test for the financial markets. Following the financial crisis of 2007-2008, the financial markets were unanimously decried as being its source. The current crisis, which is primarily an economic crisis and whose source is totally exogenous to the functioning of the markets, nevertheless provides an opportunity to test their viability, efficiency and usefulness in a context of global crisis. In financial theory, such events are called "Black Swans" (Nassim Taleb (2007)) because they are totally unexpected and their overall impact on the markets is not predictable. Such events help to redefine the role and limits of financial markets and should serve as an element of study and comparison for market participants, as well as for regulators and governments.

In order to learn the lessons from this situation that markets have never seen before, it seems important to assess the extent to which markets represent a synthesis of available information, as Eugene Fama (1998) assumes in his theory of efficient markets. The opposing movements in equity and commodity markets suggest that financial markets, and particularly equity markets, are currently out of touch with reality. Furthermore, in view of the democratization of financial products among non-professional investors, it is also necessary to analyze the extent to which individual savers are exposed to current market conditions, at a time when some ETFs (Exchange Traded Funds) are recording record flows. Finally, 12 years after the collapse of Lehman Brothers, the role of banks in the economy continues to change and could prove decisive in any potential economic recovery and market stabilization.

The wide divergence of equity and commodity markets

The academic doxa still perceives financial markets as a synthetic representation of available information. However, in our world with its uninterrupted flow of often contradictory news, information is plural and therefore threatens the informational efficiency underlying orthodox financial theories. But what happens when financial markets offer us several distinct representations of reality? This is what is shown by the divergence between equity and commodity markets today. While the equity markets are being buoyed by the exceptional expansionary measures taken by central banks and states to reduce the economic impact of lockdown measures and have already rebounded close to the all-time highs they had reached before the start of the health crisis, the commodity markets, particularly gas and oil, are still in the throes of a historic crisis whose repercussions threaten the future of the energy industry in the long term. This is evidenced by the prices of U.S. crude oil, whose major index, WTI (West Texas Intermediate), plunged into negative territory for the first time in history on April 20, dropping to a price of -$40.32/barrel. So how do we explain such a divergence? The key explanation lies in the fact that energy commodity markets, unlike equity markets, are always linked to the macroeconomic reality that drives supply and demand dynamics on a daily basis. The price of WTI became negative for the first time on the eve of the expiry of the May contract. Traders who had to roll their futures position from May to June in order not to receive physical delivery were then faced with the scarcity of storage facilities and were therefore willing to pay to get rid of the oil they did not want or could not physically receive. It was therefore a tangible reality that caught up with the oil market. Although they are sustainable in the medium term, the historically low levels of energy indexes will lead to a profound rethinking of our global energy production model, while pushing traders and analysts in these markets to rethink their forecasting models in order to include scenarios never before imagined in concrete terms. This return to reality has not yet been experienced by the equity markets, however, which are still being boosted by the aggressive policies of central banks. The Financial Times even describes this divergence between the depressed economy and rising equity market to be "so extreme it is leaving many analysts scrambling for explanations". This major dislocation shows that the different markets are offering distinct diagnoses in a new situation where uncertainty is the rule.

Risky involvement of non-professional investors

The fall in oil prices was also very much noticed by non-professional investors and savers as a whole, seeking to take advantage of apparently attractive levels with hopes of rapid capital gains. The colossal flows into the oil ETFs, these funds that aim to replicate the performance of a fund or asset, bear witness to this. USO (United States Oil Fund), the major US oil-indexed ETF, has seen the amount of its assets under management soar by more than USD 2 billion since the beginning of the year. However, these flows from inexperienced investors represent a major danger for the latter and once again highlight the dangers of asymmetric information resulting from the democratization of certain financial products. As the oil market is currently in a contango situation (the spot price is lower than the futures price), investing in spot oil carries a significant roll cost ("negative roll yield"): during a roll period, funds not wishing to receive physical oil will have to sell the (cheaper) expiring contract to buy the (more expensive) contract of the following month. This roll call is something less experienced investors are largely unaware of and puts the managers of these ETFs in difficulty. The USO fund managers have had to review their roll policy more than 3 times in recent weeks in order to reduce the cost and market impact of their massive roll operations (the futures contracts held by USO have represented as much as 20% of the total market, thus endangering the liquidity of the futures market). The health crisis once again points the finger at herd behavior among agents who are not very rational and whose information is limited, to say the least. Misinformation of non-professional agents was already central to the Subprime crisis and continues to plague the retail derivatives market. We can therefore see current events as a new opportunity to call for better regulation of the transmission of information to non-professional investors, as the reforms introduced by MiFID II have had only a limited impact on this issue.

Banking sector: All is forgiven?

If there is one point on which this crisis is the opposite of 2008 it is on the role of banks. While the banks were found guilty of the Subprime crisis, they are now potentially supporting the economic recovery and hope to see their image improve in public opinion. By granting loans that are often guaranteed by the State in order to finance an economy in free fall, the banks have the opportunity to restore their image to some extent. Also, when banks' results are published, it is noted that the role of their market activities paradoxically mitigates the impact of the health crisis on their results. The rise in transaction volumes and explosion in volatility on all financial markets has boosted the earnings of the banks' trading divisions. The example of Barclays whose trading revenues were up 77% in the first quarter of 2020, thereby allowing provisions for credit losses to be increased, is particularly telling. We can therefore expect banks that still have significant market divisions to outperform those that have already relegated these activities to the retail sector. This trend is all the more paradoxical since most banks have tended to focus their strategy on cutting back trading activities, which were often decried after the Subprime crisis and whose declining margins have squeezed earnings.

Faced with the economic difficulties caused by the lockdown policies implemented by governments to contain the virus, banks have posted record provisions in their balance sheets to prepare for possible massive credit losses. The behavior of central banks in the face of these uncertainties then shows a further paradox compared to the previous crisis, as some of them are advising commercial banks not to be too prudent in their provisioning levels, so as not to discourage lending to businesses and individuals in the context of the future economic recovery. Such is the case of the Bank of England, which advised English banks not to be too cautious in the provisions made in the first quarter of 2020. Central banks are therefore advising commercial banks to take more risk, while the latter are being particularly cautious. The current health crisis has indeed pushed the banking industry into an unprecedented situation giving rise to particularly counter-intuitive paradoxes.

Conclusion

Although the crisis did not start in the financial markets, it will nevertheless have profound impacts that will affect the financial industry over the long term. There has been a dislocation of markets by asset class, an explosion of ETF flows increasing the risks for less informed investors, and a rethinking of the role and model of banks. It is also likely that this crisis will have a lasting impact on the risk appetite of all investors, traders and banks.

Regulators will also have to learn from the lessons of this crisis. We might well wonder whether the ban on short selling introduced on certain securities, which has been widely criticized by some market participants, has really had a favorable impact in terms of stabilizing markets, or has simply reduced market liquidity in times of stress.

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