

ORDER

NEW GLOBAL

After a decade of quantitative easing and mission creep, central banks are now formidable forces. Treasurers will need to develop a sixth sense to discern true market signals amid the central bank noise. **Anthony J Carfang** explores the implications



As a corporate treasurer, you source and manage your company's liquidity. That runs

the gamut from short-term cash management to long-term capital structure as well as payments. To do that successfully, you rely on market signals regarding rates, risk premia, inflation, FX and more. Getting these signals wrong for your company could be costly, if not catastrophic.

Last year, I wrote of central banks: "During the crisis, they morphed from being a market facilitator to a market participant, a profound change. Most central banks had barely begun unwinding from the 2008 crisis. Now they've ballooned again and will be reluctant to give up their expanded roles." (*The Treasurer*, December 2020/January 2021, page 18).

That was quite an understatement. Central banks

now dominate the financial markets and dwarf all other participants. This obscures the vital market signals you urgently need to ensure your company's financial vitality. Your job is now to dig deep and find the true market signals.

CENTRAL BANKS ARE NOW THE MARKET

Historically speaking, the role of central banks had been to provide a stable currency, encourage high-employment economic activity, oversee a level economic playing field and facilitate secure payment flows. They set the economic guardrails.

Since the global financial crisis of 2008, central banks have captured authority far exceeding their original scope and mandate. Rather than facilitate markets, they now dominate them. Consider:

- Since 2008, many developed country central banks have expanded their balance sheets exponentially. Central bank

assets are now an unfathomable eight to 10 times their 2008 levels. Many central banks have grown assets from 5% of GDP to over 35% of GDP, crowding out other market participants.

- They have become the largest buyers of government debt.

In many countries, they now buy, on net, more than half of all newly issued government debt, essentially becoming 'the market', and artificially reducing rates and muting market signals.

- They have also become the largest buyers of government agency debt, directing capital into favoured sectors, further creating/shifting risk and muting market signals.

- They have crossed what had historically been a bright line. They are now directly buying corporate debt. If your company's debt is on the approved list, congratulations – you will enjoy a low, but distorted, cost of capital.

Further, the risk premia on your debt will be compressed. Good for you, bad for your

competitors and distorted market signals for everyone.

- Central banks band together in global superstructure organisations such as the Basel Commission on Banking Supervision (BCBS) and the Financial Stability Board (FSB). In the name of global stability and harmonisation, they directly control how banks allocate capital. Through constructs such as leverage caps, liquidity ratios, funding requirements, ‘risk-based’ capital regulations and interest on reserves, they dramatically limit the flexibility of banks. These feed the demand for certain market instruments while dampening the demand for others, thus distorting market signals and shifting, but not eliminating, risk.
- The US is a case in point. Since the 2008 financial crisis, bank domestic deposits have grown by nearly \$10 trillion.

Historically speaking, the role of central banks had been to provide a stable currency

Yet their holdings of government securities and government-backed federal reserves have increased by \$6.5 trillion. More succinctly, two-thirds of all new bank deposits since 2008 have gone into government-backed instruments. It’s not much of a stretch to suggest that central banks have turned large commercial banks into quasi-government bond funds.

- Not to be overlooked, via their cross-border market operations and swap lines, central banks now play an outsized role in FX markets.

DEVELOPING A SIXTH SENSE

Economic theory tells us that the short-term rate on government securities is the risk-free rate for that market. All other rates scale up from that point based on duration and risk premia. However, in a central bank-dominant market, it’s likely that quantitative easing (QE), central bank market operations and central bank-inspired regulation have depressed nominal rate on government securities to a level that is lower than the true risk-free rate. With the fundamental building block, the risk-free cost of capital, being artificially driven, the mispricing cascades dangerously across the entire market. Capital is mispriced, risk is mispriced and duration is mispriced.

Market signals are muted and distorted. How can a corporate treasurer in 2022 and beyond optimally source and manage a company’s liquidity and payments? We believe that it will require a keen set of modelling and analytics, as well as closely monitoring the central bank policy shifts in each jurisdiction. It will be important to deconstruct each treasury activity and develop a framework for understanding how the muted market signals impact it. Here is an outline:

- **Short-term investing** – Today’s artificially low rates leave almost no favourable opportunity to deploy excess cash. It becomes very important to evaluate risk/return trade-offs, especially since rates are depressed and risks are hidden. Monitor closely to capitalise on changes in rates, risk premia and yield curve slope.
- **Short-term borrowing** – Conversely, depressed rates may be an opportunity to secure additional short-term debt or to negotiate more favourable payment terms.

- **Long-term borrowing** – In most jurisdictions, central banks have been buying securities well out along the yield curve, depressing longer-term rates. As a result, you may find borrowing opportunities at terms much lower than your ‘true’ cost of capital. Model these opportunities, especially in the context of how they will perform should rates, slope and risk premia revert to historical ranges.
- **Capital structure** – This is highly challenging. While capital structure planning involves many variables, two important components are the absolute level of rates and the slope of the yield curve. Again, careful scenario-based modelling is required. For example, an artificially flattened yield curve may suggest taking on longer-term debt. Low rates overall may suggest preemptive borrowing, holding more cash than normal.

- **FX, hedging and cash repatriation** – Managing corporate finance across multiple jurisdictions becomes exponentially more complex. Treasurers must not only be watchful of central bank actions in their domicile, but in every country in which they have revenue, expense, assets or liabilities. Modelling the cross-correlations and stress testing a range of scenarios prior to engaging in a transaction is imperative. Expect non-intuitive solutions.

- **Payments** – Central banks are playing a determinative role in the evolution of next-generation payments. Given their huge balance sheets and their regulatory superstructures, they have the capacity to pick the digital winners and losers, and will certainly do so. Central bank digital currencies would easily come to dominate the crypto world. For example, proposed Basel risk-based capital recommendations for

banks on the most popular digital assets will either render the currently popular cryptocurrencies useless in the long term or force them into the shadow markets, neither outcome of which is sustainable.

- **Price levels** – QE-induced inflation is a real threat to both income statements and balance sheets. Different jurisdictions will experience these risks differently, requiring significant attention and diligence. Analytics, as well as forecasting, are required to assess how and whether to hedge these risks.

CONCLUSION

We’ve heard that QE might end, tapering might begin, normalcy might return. History has shown, however, that central banks are reluctant to return newly accumulated powers. Global central banking clubs such as the FSB and BCBS, are – in my view – likely to continue adding complexity in the name of harmonisation. Highly regulated financial institutions are unlikely to fight the dominance of central banks.

For corporate treasury, that means that the stakes are higher than ever. To an important extent, treasurers are flying blind. The ‘market’ is no longer a true market, and its signals are unreliable. There is no escaping the need to develop a sixth sense. That combines keen observation of central banks, deep understanding of one’s income statement and balance sheet dynamics, and robust analytics and modelling. ♡



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