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Market Turmoil and Liquidity Crunch Rooted in the COVID-19 Pandemic

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The spring of 2020 will be remembered for the outbreak of the global COVID-19 pandemic. Within a few short weeks, the world's leading economies shut down all but the most essential activities—measures that created unprecedented uncertainty in the global capital markets. The result was a period of historic market volatility and precipitous drops in domestic and global markets.

Policymakers in the United States and around the world already are considering whether and how to bolster the financial sector's resilience to future shocks. To ensure these discussions are rooted in facts and an evidence-based analysis, ICI is releasing a new research series, *Report of the COVID-19 Market Impact Working Group*. The series will chronicle financial markets' reactions to the pandemic, and successive installments will describe the experiences of regulated funds—and their investors—including exchange-traded funds (ETFs), money market funds, and bond funds in the United States, and Undertakings for Collective Investment in Transferable Securities (UCITS) and ETFs in the European Union.

The first paper in the series, "The Impact of COVID-19 on Economies and Financial Markets," focuses on the relationship between the pandemic, the economic shutdown it triggered, and the volatility that gripped the markets.

The paper's key insight: the COVID-19 crisis is different from the 2007–2009 global financial crisis. The spring 2020 market dislocations represented a liquidity crisis driven by the economic response to a global health crisis—as compared to the collapse of a housing market bubble that created a credit crisis that roiled markets in 2007–2009. This is important because policies designed to address issues arising during the global financial crisis are not necessarily appropriate for the current crisis.

Holistic Understanding of Markets' Reaction Is Crucial to Understanding Funds' Experiences

The financial turmoil that gripped the markets in March originated from market participants' sudden and immediate need for liquidity to protect against the uncertainty caused by the virus and economic shutdown. Though Treasuries are usually a safe haven for market participants during times of market stress, data indicate that investors were selling Treasury bonds in early March, signaling that the Treasury market was becoming dislocated. Numerous factors appear to have contributed to this aberrant behavior, ranging from market participants rebalancing positions to account for changing market conditions to regulatory capital standards for banks.

Strains in the Treasury markets eventually spilled over into short- and long-term credit markets, including the markets for municipal debt securities, commercial paper, bank certificates of deposit, and corporate bonds. In light of uncertainty about the virus and the economy, investors became extremely risk averse and sought to preserve or bolster their cash positions. As a result, sellers of short- and long-term credit securities far outstripped the number of buyers. These market dynamics affected all market participants, including money market and bond mutual funds.

Federal Reserve's Actions Were Swift and Necessary

By mid-March, liquidity in, and the flow of credit through, short- and long-term credit markets had evaporated, risking damage to households, businesses, governments, and financial institutions. With the demand for liquidity overwhelming the supply from the private sector, there was little choice but for central banks to fulfill their role as lenders of last resort. The combination of the Federal Reserve's wide-ranging actions—which were appropriate, timely, flexible, and necessary—helped restore liquidity and the flow of credit.

Regulated Funds Proved Largely Resilient to COVID-19 Market Turmoil

Other papers in the series will examine regulated funds' experiences in light of the financial market turmoil. They will show that ETFs performed well and helped markets by providing much-needed price discovery. Bond funds faced challenges, but defied predictions that they would destabilize the markets. And while prime money market funds saw significant outflows, reforms after the global financial crisis reduced the impact of those flows on the market at large. These and other detailed findings—backed by data—should inform ongoing and future discussions with regulators and other market observers who may be looking for lessons learned from this tumultuous period.

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