

ICI: Pandemic and Economic Shutdown Drove Financial Turmoil in March

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First Paper in New Report Examines Markets During COVID-19

Washington, DC; October 14, 2020—Financial markets' significant volatility in March reflected a combination of unprecedented factors, including the COVID-19 pandemic, global economic shutdown, and sudden demands for liquidity, ICI says in the first research paper in *Report of the COVID-19 Market Impact Working Group*, a new series examining the impact of the crisis.

Based on empirical evidence and in-depth analysis, this first paper details the reaction of financial markets to the pandemic and the US government's response. 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. ICI is serializing the report, releasing different papers throughout the fall, starting with [“The Impact of COVID-19 on Economies and Financial Markets.”](#)

“A holistic appreciation of how financial markets reacted to the pandemic and worldwide economic shutdown is critical to understanding the experiences of funds and their investors during March,” said ICI President and CEO Paul Schott Stevens and member of the COVID-19 Market Impact Working Group. “Dislocations began in the Treasury bond market several days before money market funds or bond funds came under redemption pressure. Though policymakers already are considering whether and how to bolster the financial sector's resilience, they must recognize that the COVID-19 crisis is different from the 2007–2009 global financial crisis. Policy solutions for the global financial crisis, which was a credit crisis, are not necessarily appropriate for the COVID-19 crisis, which was a liquidity crisis stemming from the global pandemic and steps taken by governments to curb the spread of the disease.”

Liquidity Crunch Affected US and Global Markets

The COVID-19 crisis posed deep challenges around the globe for businesses, governments, households, investors, and financial institutions, including money market funds and bond mutual funds. As ICI's first paper discusses, these challenges arose as a direct result of COVID-19 and governments' decisions to shutter large parts of the global economy. Understanding this is a prerequisite to understanding money market and bond mutual funds' experiences in March 2020.

Treasury Market Showed Dislocations Early

The [first paper](#) details how US government bond markets were first affected 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 market was becoming dislocated. Many factors contributed to this aberrant behavior, including market participants:

- Selling Treasuries to raise cash quickly and to meet margin calls (pages 25–26)
- Rebalancing positions to account for changing market conditions (page 26)
- Unwinding leveraged trades (pages 26–30)
- Anticipating that work-from-home arrangements could impair market making (page 32)

The paper cites another reason: dealers finding their balance sheets filling up with Treasury and agency securities (pages 30–31).

Investors' Demands for Cash Strained Short-Term Credit and Corporate Bond Markets

As [ICI's paper](#) discusses, strains in the Treasury and agency bond 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 (pages 33–46).

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 virtually dried up, risking damage to households, businesses, governments, and financial institutions. With the demand for liquidity far outstripping the supply from the private sector, there was little choice but for central banks to fulfill their role as lenders of last resort. ICI's paper details the Federal Reserve's wide-ranging actions, which included cutting interest rates to near zero; injecting liquidity into the Treasury, agency, and repurchase agreement markets; easing bank capital standards; vastly expanding dollar swap lines to foreign central banks; and establishing a broad array of lending facilities (pages 46–54). [ICI's paper](#) concurs with the assessment of key officials that the combination of the Federal Reserve's actions and the Coronavirus Aid, Relief, Economic Security (CARES) Act calmed the markets and restored liquidity and the flow of credit to the economy.

Report Overseen by ICI's COVID-19 Working Group

The report is being issued under the auspices of ICI's COVID-19 Market Impact Working Group whose members include senior industry executives convened by the Executive Committee of ICI's Board of Governors for this purpose. The Working Group is examining the causes of the market turmoil in early 2020 and the experiences of regulated funds. The report will help provide a sound, empirical basis for any future regulatory discussions or other policy responses that could affect regulated funds and their investors. ICI's research, legal, industry operations and global staff are supporting the working group in drafting the report.