Thursday, February 20th, 2020

Dear Chris,

My father's dark brown attache case, with its light, soft suede interior, lay invitingly open on his bed. The case was filled with intriguing goodies for a 10yr old to examine. There were files and photos of building sites (he was an engineer), a cluster of pens and a case of well sharpened Staedtler pencils, his passport, current and old stapled together and a multitude of colourful bank notes that I took out and spread out on the bed, making a pile of each kind. There were super large French Francs, small Deutsche Marks, crisp Japanese Yen, grimy UAE dirhams, grand looking British Pounds, AMEX travellers' cheques, but the largest stack was of inky green US Dollars.

As I finished my piles, my father, who was watching, motioned me to bring the globe from his desk. "Can you match the notes to the countries on the globe." I nodded and started from Japan, making my way to the United States. Putting his hand on the world he said - "you can pay for things with these notes - pointing to the francs, marks, yens, pounds - only in their own country, but these" - pointing to the dollars - "you can pay for anything....everywhere" "Wow", as I held up the Dollar, "this is magic money;" he flashed a brief smile. "Yes, now put it all back in the briefcase." Magic money......I was hooked.

Over the last four weeks this 'hook' has felt more like black magic and all my previous crises (1987, 1998, 2001, 2008) have felt as if rolled into this last month. Perhaps we all need a step back from the daily market fury and see what this pandemic has exposed. In January and February we all saw the events in Wuhan and the cruise ship in Yokohama; the market shrugged. But abruptly in March the virus mattered. Why?

The Asian supply chain was shut down; this is a 90 day credit chain and by March it had run out of credit and needed more. Suddenly there was a demand for US Treasury collateral with which to create credit and this collateral became unstable, with the Treasury yield falling 70% in a few weeks. This collateral was assumed to be stable given it is the keystone of the future global financial architecture.

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The lesson from the 2008 crisis is that we needed secured lending rather than unsecured lending to create credit. This therefore meant a move from the old LIBOR system to the new SOFR (Secured Overnight Financing Rate); this transition is due in January 2021. What Covid-19 has done is give this future SOFR system an early test by fire.

The virus exposed that fact that the collateral is anything but stable. As the treasury collateral became unstable all assets around it became unhinged, from investment grade bonds, to high yield, to munis, to commercial paper, to US$s for settling trade and finally to equity markets.

Given the Covid-19 test the upcoming SOFR system has shown vulnerability on two counts: first, collateral can be unstable and second, there are not enough trade dollars for settlements. The Fed will have to address the first by actively controlling the yield curve and the second by opening up substantial US$ swap lines to other central banks. The Fed's balance sheet cannot be challenged so it will either the castrate levered / hedge fund money so they cannot destabilise the treasury market again or they will temporarily lift the leverage regulations on the banks, as the banks assist the Fed in its policy rather than take it on like a hedge fund.

Our payment system is a credit system, and we need to have enough credit to settle our payments, even if we have no money. And this credit system needs a stable collateral and lots of US$s to work efficiently.

Four and a half decades may have passed but the world still needs its magic money found neatly stacked in my father's briefcase.

Hoping to see you post isolation. Mustafa