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Exclusive interview: Earl Burns Jr, Senior Front Office & Risk Executive Part 2

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Earl most recently worked for Phillips 66 in executive level positions in the US and Europe, in the commercial trading and risk areas. Here, he follows up last weeks discussion with thoughts on areas to keep an eye on as we move forward in 2020.

Last week, in the first of a two-part interview, Earl spoke to David Baranowski, Director at Human Capital in Houston, about the recent unprecedented trading conditions. Here, David continues that conversation with questions about VaR, product markets and corporate liquidity.

David Baranowski: Much has been written about the increased interest in

VaR (Value at Risk) models as a means of dealing with current volatility. Does this measure of the risk of loss have limitations?

Earl Burns Jr: VaR, and tweaking those models as needed, is the right thing to do at the moment, given the price action we have seen in commodity markets. But yes, it does have limitations – it is not additive, does not provide worst-case loss, is only as good as its inputs and does not invoke a standardised methodology. Those limitations have been well documented over the years – VaR is not an all-encompassing portfolio control, and is not the best. What it is, though, is a universally understood metric established initially in the nineties across capital markets relative to floating pressure, and nothing more.

VaR, therefore, has value to those who are looking for some standardised measure of control at a macro level, such as institutional investors or boards of directors, but it should not be leant on as the main measure of portfolio safety or control. The heavy lifting of understanding a position's size, concentration, spread volatility, pricing profile, liquidity and potential up or downside is much more important. In short, there is no free lunch, because reviewing VaR daily does not replace this.

Personally, at all the places I have worked as a trader or a senior trading leader, I have never experienced or witnessed being stopped out or having a position reduced significantly because of a VaR breach, and I have never seen a well-articulated request for VaR to be temporarily increased denied. In my view, no competent trading leader will ever manage their book's exposure profile primarily off the back of a VaR calculation, and nor should they. VaR is owned by the front office – it is just calculated and monitored by the risk function.

DB: What do you see happening in clean product markets? Does seasonality exist anymore?

EB: Covid has wrecked demand for mogas at a time when it was already experiencing a lull. That means the relationship between gasoline and heating oil has inverted severely, causing massive yield shifting by refiners maximising diesel production to avoid making mogas and incremental jet fuel.

Now, we have a sea of diesel and gasoline demand is creeping back up, leaving refiners no choice but to chase the yields. Covid is still lurking and could hit light ends again if we see a second lockdown. Alternates have emerged for the old heating oil plays in the northeastern US and northwest Europe, and renewables and electrics will continue to take a bite out of mogas demand. Blending used to be easy money for both sides but not any more.

The one new blending game that everyone was looking forward to was IMO 2020, and that has not been as lucrative as expected, depending on your positioning. So, the old game is over for now and we are yet to figure out the new one. What is clear is that volatility is here for a while.

The growing concern about zombie companies is real. Those offering overly equity friendly versus debt deserve additional investigation. Counting on more favourable times for a future recapitalisation is risky.

DB: What is the situation around corporate liquidity?

EB: Since late Q1, we have seen a parade of announcements from blue-chip, investment grade firms across the global Fortune 500 reaffirming their access to capital after Covid hammered their earnings projections. Some of them have been quite ebullient and, to be fair, assurance was needed early on and should be communicated. It is good to have access to as many pools of capital as possible and to get it on as favourable terms as possible.

But, that said, the ability to access the capital markets is one of the benefits of being a blue-chip investment grade firm, and is why the markets assign a premium to those firms' valuations. In reality, funding was available to all but the most distressed firms at reasonably attractive terms. The US Federal Reserve's corporate bond-buying program also represents a significant backstop for corporate debt, with no lack of willing subscribers. Rigorous capital discipline, exceeding expectations relative to returns, leveraging tax efficiency, and staying on the right side of ESG considerations are what these firms are supposed to do.

The story of the entity that has been growing progressively and moving towards that blue-chip investment grade status, taking well-reasoned risk and cleaning up its balance sheet, is a more compelling one. It is a much easier time for the capital markets to question these names with shorter track records and slightly less robust financials, who are getting access to incremental funding a good levels.

The other potentially more interesting topic is the blue-chips that are having trouble obtaining funding, where distressed and volatile credit markets are great at uncovering situations where ‘the emperor has no clothes’. The growing concern about zombie companies is real. Those offering overly equity friendly versus debt deserve additional investigation. Counting on more favourable times for a future recapitalisation is risky.

I am not judging what anyone is doing with funding accessed at the moment, whether for maintaining operational liquidity, covering key maintenance capital needs, funding distressed assets or to help shore up dividends. The point is, when it comes to accessing the capital markets, maybe we should save our applause for those who pull a rabbit out of a hat. The balance sheet discipline, positioning and financial performance accomplished in the past by a business is deserving of the true recognition – going to the market and simply leveraging that prior good work is to be expected.

Putting that into trading context, successful physical origination, deal structuring and futures execution are recompensed on vastly different scales and deservedly so.

DB: What do you make of central banking support for equity markets right now?

EB: I think anyone who has speculated in and studied financial markets realises that central banks have been supporting equity markets in an unprecedented fashion. In the case of the US, the Federal Reserve announced plans to inject north of $6.5tn into stressed money markets to ensure liquidity, and then cut its benchmark interest rate to near zero, making clear that a lot of the money being printed is going into equity markets.

The question is how it ends. The idea that central banks are neutral entities to ensure that liquidity remains in the market and serve as a lender of last resort is becoming a stretch. Federal Reserve chairman Jerome Powell was clear when he said an asset price contraction would be very bad for employment so, in the medium term at least, it looks like they will continue to indirectly support the markets. When they set out their intention to buy corporate debt to the extent necessary, that was just icing on the cake. But the ability of central banks to intervene will eventually be limited, as has been proven time and time again, sometimes painfully. The imbalances will always work themselves out.

DB: If future recapitalisation is going to be necessary, given the massive leverage, what will that look like, do you think?

EB: As a counterpoint to the blue-chip firms I mentioned, there are entities that have had to truly fight for liquidity to simply keep the lights on, often at onerous terms. For the pure traders, the stakes are very high; without significant liquidity, there is little chance for resuscitation. You do what you have to do, but the volumes relative to the raw amount of leverage being taken are truly staggering.

Prominent voices in the managed money sector are concerned about where the capital will come from for the scale of the recap needed, and there’s no clear answer. Deep deleveraging at scale is generally disorderly, if not outright ugly. It remains to be seen whether global markets will be healthy enough to withstand that anytime soon.

That said, one can argue that deleveraging is an essential cyclical step needed for healthier markets, and the market will dictate the velocity of the process, whatever the consequences.

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