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Fed broadens credit easing in "whatever it takes" policy

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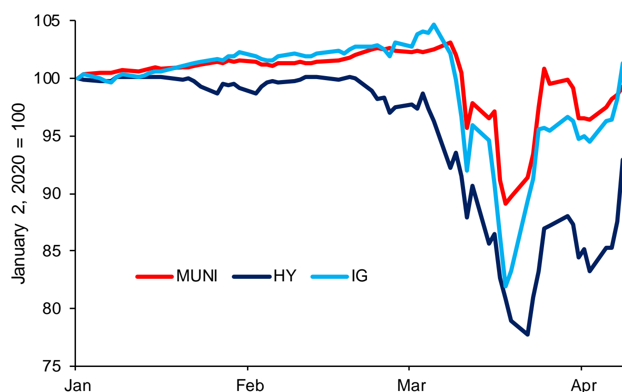
Overview

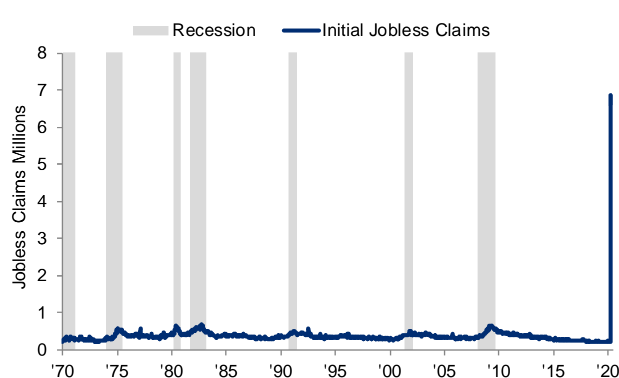
- The Federal Reserve continued to move aggressively beyond all previous credit expansion policies, supporting lending to US municipalities, small businesses and corporations harmed by the COVID crisis. This includes the purchases of corporate credit rated below investment grade, in an effort to ease borrowing costs for impacted companies facing ratings downgrades. As a result, the individual corporate bonds of effected companies are rallying, as high yield and investment grade ETFs gain between 3% to 6% today (see **figure 1**).
- The Fed's stepped up action to provide counter-cyclical credit support to downgraded entities will pressure other central banks to do the same (*see Euro section below*). **Yield declines for credit instruments should provide a "higher floor" for all risky assets and help limit the period of severe stress for the economy.** We believe this will be the case even as markets may refocus for a time on the severity of the immediate economic decline in coming months.
- As Fed Chairman Powell said today, "Our country's highest priority must be to address this public health crisis". The Fed's role is to provide as much relief and stability as we can during this period of constrained economic activity, and our actions today will help ensure that the eventual recovery is as vigorous as possible."
- As **figure 2** shows, US unemployment insurance claims continued to rise by more than 6 million in the latest week. This implies an unemployment rate of about 13% at the start of April on the deliberate steps taken to shut businesses and limit social interactions. This is already higher than the 10% peak at the worst level of the 2008/2009 crisis. However, as a large part of the disruption is a temporary constraint on work and strong macro policies have swiftly been introduced to limit long term impact, we believe the current recession will be both the deepest and shortest on record (please see CIO Bulletin)

Figure 1. US muni, IG corp and HY ETF prices YTD



Source: FactSet as of April 9, 2020

Figure 2. US weekly jobless claims



Source: Haver Analytics as of April 9, 2020.

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Don’t fight the Fed

On April 9, the Federal Reserve announced more unprecedented steps to help support the US economy against the coronavirus pandemic. Not only will the US central bank increase their lending capacity to small and midsized business, but also created new facilities to support municipalities struggling from the loss of tax revenue. In total, up to $1.65 trillion of new funding is being provided, for a total of up to $2.3 trillion in stimulus programs.

Most notable, the Fed expanded the size and scope of their Primary and Secondary Corporate Credit Facilities (PMCCF and SMCCF) to include high yield bonds. This is the first central bank to expand purchase programs to include securities below investment grade. Here are the details of the bond purchase announcement:

- **Municipal Liquidity Facility** - The facility will purchase up to $500 billion of short term notes (< 24 months) directly from U.S. states (including the District of Columbia) and local municipalities with population minimums. These will be primary issuance purchases only.
- **PMCCF and SMCCF size** – Originally $200 billion split between both facilities, has been increased to a combined $750, with $500 allocated towards the primary market and $250 billion to secondary purchases.
- **PMCCF and SMCCF corporate bond eligibility** - To qualify, issuers need to be rated at least BBB-/Baa3 by two or more nationally recognized statistical rating organizations (NRSRO) as of March 22, 2020. Issuers that were rated at least BBB-/Baa3 as of March 22, 2020, but are subsequently downgraded, must be rated at least BB-/Ba3 at the time the Facility makes a purchase.
- **PMCCF and SMCCF exchange-traded funds (ETFs) eligibility** - The majority of ETF holdings will be of ETFs whose primary investment objective is exposure to U.S. investment-grade (IG) corporate bonds, and the remainder will be in ETFs whose primary investment objective is exposure to U.S. high-yield (HY) corporate bonds.
- **Term Asset Lending Facility (TALF)** – Size remains at $100 billion. Eligible securities will continue to include AAA-rated ABS, but now includes AAA-rated commercial mortgage-backed securities (CMBS) and newly issued collateralized loan obligations (CLOs).

For fixed income markets, these are extraordinary moves by the US central bank. By including “Fallen Angels” into the Fed’s purchase programs, issuers that are likely to struggle from the Covid-19 fallout will now be protected. Not only will this help keep financing costs low, but will also provide a forced buyer for those that need to refinance maturing debt.

Bond spreads in both IG and HY have rallied massively on the news. IG bonds are seeing spreads 20-25bp tighter, with all sectors showing improvement. HY bonds are roughly 10-40bp tighter, with high beta sectors outperforming (i.e., energy and consumer discretionary). HY ETFs are also rallying, up 5-6% on the day and now only down 7% for the year. On March 23, HY ETFs were down over 20%.

The March 22 inclusion date may also be no coincidence. Ford Motor, which has $35 billion of index eligible debt outstanding, was downgraded to high yield on March 25. Ford bonds have rallied 6-7pts on the news, with credit default swaps falling 500 basis points. To be sure, the auto industry is one of the most important industries in the United States. As factories remain idle, it’s possible the industry will struggle for some time.

With the US Fed now buying Treasuries, agency mortgage-backed securities, municipals, ABS, CMBS, IG and HY corporates, ETFs and CLOs, it’s clear they will do whatever it takes to keep markets functioning as normal. Not only will financing costs remain low for corporations, but also any near-term refinancing concerns have been lifted. Though this may not prevent downgrades from already troubled companies, it could certainly slow the bleeding and may lessen the probabilities of default.

Hey ECB….your turn

This also creates precedent for other central banks to follow, like the European Central Bank (ECB). Though the ECB has been buying corporates for some time, they have not yet included high yield debt. On March 12 the ECB did increase their asset purchase program by 100 billion euros through the end of 2020. It had previously been running at the rate of 20 billion euro per month. A week later, the ECB introduced a new Pandemic Emergency Purchase Programme (PEPP) of 750 billion euros to buy additional sovereigns and corporates.

The guidelines of the PEPP promised to buy everything issued by national governments in order to keep spreads from widening. This also gives national governments the fiscal space to expand aggressively. That said, these measures together equate to the ECB committing to buying an extra 7.3% of GDP by December 2020.

However, considering the Fed’s recent move, the ECB may now be in a position to do more (see European fixed income – Make yourself at home). Some measures they could consider are:

- Raise the capital key above 33%, allowing them to buy more bonds in particularly stressed countries like Italy.
- Raise the 70% ceiling they currently have on any individual bond holding.
- Allow themselves to buy non-financial commercial paper of sufficient credit quality.
- Introduce a waiver into their purchase programme to allow the inclusion of Greek Govt bonds.
- Allow themselves to start buying high yield corporate bonds.
- Start buying primary offerings.

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