

## Introduction

June, 2020

As COVID-19 and government-ordered shutdowns spread throughout the world, a late-cycle global economy swiftly plunged into a near certain global recession. The U.S. Federal Reserve (“the Fed”) responded with unprecedented speed and decisiveness to keep credit flowing, with the aim of keeping the financial system intact in order to reduce the fallout for households and businesses across the country. This emergency relief draws comparisons to the 2007-2009 financial crisis, as the Fed enacted the continuance and extension of many programs that were previously used to ease acute liquidity shortages. Because the speed and scope of the recent market downturn was unlike any in U.S. history including the Great Depression, the Fed has also expanded its response to include new programs and actions, potentially injecting as much as \$11 trillion into the financial system. The unprecedented stimulus by the Fed as well as \$3.5 trillion of Fiscal stimulus passed by Congress has largely been attributed as a catalyst to the U.S. equity market (e.g., S&P 500) rebounding by over 40% since the March 23 lows. Ironically, it was on March 23, when Fed chairman Jerome Powell announced that the “Fed would do whatever it takes” to support the economy, which had not long ago experienced the longest GDP expansion in U.S. history and held a record 50-year low unemployment rate earlier in 2020.

When the economic outlook rapidly began to deteriorate in February 2020 like it did in 2008, institutions and individuals reacted by seeking safer and more liquid investments, and rushed to convert assets into U.S. Dollars. This immediate surge in demand for cash this year and in 2008 caused asset prices to sharply fall, including even “safer government” bonds and gold. Moreover, the stockpiling of cash tightened lending conditions such that banks are less likely to offer loans and investors are less likely to invest into securities, since they want to keep their cash close on hand as markets decline. This cash accumulation reduced liquidity and disrupted the financial system, affecting companies (which often borrow to fund their day-to-day operations), that must then borrow at higher interest rates to entice lenders to part with their cash. Rising interest rates also affect households both directly, as it raises their cost of borrowing, and indirectly, as businesses struggle to finance themselves and as a result, potentially struggle to satisfy payroll expenses.

This is where the Fed can step in and support the financial system. They have the capability to set and influence interest rates, expand the money supply, and deploy liquidity to lenders through a variety of asset purchase programs and credit facilities, all of which can be implemented independently of congressional or presidential approval. While the main purpose of these maneuvers is to deliver more cash into the financial system and encourage more lending in order to stimulate the economy, it is important for investors to consider the potential future ramifications of each new policy.

## Rate Cuts and Quantitative Easing

In an emergency meeting on March 3rd, the Fed began its response efforts by lowering its policy interest rate by 0.50%. Two weeks later, on March 15th, the Fed dropped its policy interest rate by an additional 1.00%, reducing the benchmark interest rate to the range of 0% to 0.25%. The last time interest rates were at this level was from 2008-2015<sup>1</sup>. Prior to the great recession, the Fed had more “dry powder” to reduce interest rates with the fed funds rate at 5.25% in 2007 before the financial crisis versus only 1.5% at the beginning of 2020. Therefore, with short-term interest rates nearly 4% lower prior to the health pandemic, the Fed’s ability to drastically cut interest rates to aid the economy was not going to be as impactful as it was during the financial recession. The primary intention of cutting interest rates by the Fed is to reduce borrowing costs for banks, financial institutions, businesses, and households.

Cutting the policy interest rate, however, mainly impacts short-term borrowing rates. The interest rates of longer-term fixed income securities, with maturities of ten years or longer, can hold up or even move counter to the direction of short-term bond interest rates. Rate cuts can possibly lead to higher bond yields for long-term bonds if the market believes the rate cuts will lead to stronger economic growth and inflation in the future<sup>2</sup>.

Long-term borrowing rates will have to move in conjunction with short-term borrowing rates to stimulate major purchases for households and companies. For example, consider mortgages, which tend to be long-term lending vehicles. According to data from Redfin, a national real estate brokerage, pending home sales slowed significantly in late February 2020 as the stock market began its steep decline. Pending home sales then fell 42% in March 2020 as government-ordered shutdowns and social distancing measures began<sup>3</sup>. Lowering interest rates for long-term bonds can help counter these slowdowns, as lower long-term interest rates make it easier for households to afford major purchases. It also makes it easier for businesses to finance themselves and expand, stimulating business growth.

To help reduce long-term interest rates, the U.S. Federal Reserve implemented quantitative easing measures, or "QE". The central bank initially committed to purchasing at least \$700 billion in U.S. Treasury Bonds (\$500 billion) and agency mortgage-backed securities (\$200 billion from Fannie Mae and Freddie Mac) but eventually announced that these purchases could go beyond \$700 billion and become open-ended, stating that the "Federal Open Market Committee (FOMC) will purchase Treasury securities and agency mortgage-backed securities in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions and the economy"<sup>4</sup>. This is a major difference compared to the quantitative easing measures from 2008. In each of the QE programs between 2008 - 2014, the Fed announced a specific dollar amount. In this case, the intentional omission of an exact dollar amount for QE purchases indicates that these purchases can be unlimited, signaling that the crucial markets at the center of the financial system have struggled to function potentially beyond what the global markets experienced during the 2007-2009 financial crisis<sup>5</sup>.

## Unprecedented Liquidity Support

Liquidity is the lifeblood of the banking and the financial industry, and the Fed has been committed to using its arsenal of policies to provide bank support and liquidity injections in an open-ended manner. There are four actions that the Fed has employed to allow banks to increase their lending capability to ensure that the demands for the U.S. dollar can be met.

First, the Fed relaunched the Primary Dealer Credit Facility ("PDCF"). Created in March 2008 in response to the subprime mortgage crisis and the collapse of Bear Stearns, the PDCF provides credit to primary dealers in exchange for a broad range of collateral. The PDCF is intended for primary dealers to access short-term loans for up to three months. These short-term loans will improve the ability of primary dealers to provide financing to participants in securities markets which promotes the orderly functioning of financial markets.

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<sup>1</sup>FRED® Economic Data, "Effective Federal Funds Rate", Federal Reserve Bank of St. Louis, 2020, <https://fred.stlouisfed.org/series/FEDFUNDS>

<sup>2</sup>Kathy Jones, "If the Fed Cuts Interest Rates, Will Longer-Term Bond Yields Fall?", Charles Schwab & Co., Inc., 2019, <https://www.schwab.com/resource-center/insights/content/if-fed-cuts-interest-rates-will-longer-term-bond-yields-fall>

<sup>3</sup>Bruce Mizrach and Christopher J. Neely, "Fed Intervention in the To-Be-Announced Market for Mortgage-Backed Securities", Federal Reserve Bank of St. Louis, 2020, <https://research.stlouisfed.org/publications/economic-synopses/2020/04/15/fed-intervention-in-the-to-be-announced-market-for-mortgage-backed-securities>

<sup>4</sup>Board of Governors of the Federal Reserve System, "Federal Reserve announces extensive new measures to support the economy". Board of Governors of the Federal Reserve System, 2020, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm>

<sup>5</sup>Jeanna Smialek, "The Fed Goes All In With Unlimited Bond-Buying Plan". The New York Times, 2020, <https://www.nytimes.com/2020/03/23/business/economy/coronavirus-fed-bond-buying.html>

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Second, the Fed is providing enormous (\$500 billion) support for overnight lending markets or repo funding markets. Banks utilize overnight lending markets and repo funding markets to provide cash-on-hand to help fund withdrawals, supply loans, and fund their operations. The Fed established a temporary repurchase agreement facility for foreign and international monetary authorities ("FIMA"), which will offer short-term loans (at interest rates recently reduced to near 0%) to financial institutions through repurchase agreements, to support the supply of credit to banks, businesses, and households. The FIMA repo facility also reduces the need for central banks to sell their Treasury securities outright and into illiquid markets, which will help to avoid disruptions to the Treasury market and upward pressure on yields, thus increasing liquidity and bolstering broader market confidence in the U.S., as well as in foreign countries<sup>6</sup>.

Third, foreign markets were further supported when the Fed announced the establishment of temporary U.S. dollar swap lines with an expanded list of central banks, which is critical to stabilizing foreign financial markets. This facility is meant to ensure that the demand for U.S. dollars can be met. The coverage of U.S. Federal Reserve dollar swaps to foreign countries is currently the same as December 2007. However, this coverage is lacking in some of the world's largest economies, and those hardest hit by COVID-19, such as Argentina, China, India, Indonesia, Russia, Saudi Arabia, South Africa, and Turkey, as well as many emerging market economies, which may be detrimental to the performance of the foreign and emerging markets not covered with U.S. dollar swap lines<sup>7</sup>.

Fourth, to accommodate the increased demand and trades with money market funds, the Federal Reserve Bank of Boston under the Money Market Mutual Fund Liquidity Facility ("MMLF"), will make loans available to eligible financial institutions secured by high-quality assets purchased by the financial institution from money market mutual funds, reestablishing liquidity support for money market investments<sup>8</sup>.

## New Interventions and Implications

The Fed has implemented new tools to directly provide loans to major lending institutions, as well as to companies. These include three new interventions; the Primary & Secondary Market Corporate Credit facilities ("PMCCF" and "SMCCF") as well as the Main Street Lending Program.

Enacted in March 2020 and further amended in April 2020, the U.S. Federal Reserve Board created both the PMCCF and SMCCF to streamline the flow of credit to large employers if they meet the eligibility requirements. The PMCCF will keep credit flowing to eligible large companies by purchasing their bonds when they are initially issued. The SMCCF is designed to help keep the secondary market for corporate debt liquid by purchasing bonds of eligible corporations (investment-grade and recently downgraded corporate issuers that were previously rated investment grade before March 22, 2020) on the secondary market as well as bond ETFs (both investment grade and high yield)<sup>9</sup>. The combined size of the credit facilities will be up to \$750 billion and these facilities will continue purchasing eligible assets until September 30, 2020.

Announced in April 2020, the Fed established the Main Street Lending Program to support lending to small and medium-sized businesses to maintain their operations and payroll until conditions normalize. These companies must demonstrate that they were in sound financial condition before the onset of the COVID-19 pandemic.

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<sup>6</sup> Board of Governors of the Federal Reserve System, "Federal Reserve announces establishment of a temporary FIMA Repo Facility to help support the smooth functioning of financial markets" Board of Governors of the Federal Reserve System, 2020, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200331a.htm>

<sup>7</sup> Stephanie Segal, "Dollar Swap Lines: Welcome Support but Only Part of the Solution" Center for Strategic and International Studies, 2020, <https://www.csis.org/analysis/dollar-swap-lines-welcome-support-only-part-solution>

<sup>8</sup> Board of Governors of the Federal Reserve System, "Money Market Mutual Fund Liquidity Facility", Board of Governors of the Federal Reserve System, 2020, <https://www.federalreserve.gov/monetarypolicy/mmlf.htm>

The loans are amortized over 4 years, with no payments of principal or interest required during the first 12 months of the loan. As these loans are provided to small and medium-sized businesses (15,000 or fewer employees and 2019 revenues less than \$5 billion)<sup>10</sup>, the U.S. Federal Reserve will purchase 85% - 95% of each loan, while the eligible lender keeps the remaining 5% - 15% of the loan on its books to discourage irresponsible lending. Main Street loans are full-recourse loans and are not forgivable. The combined size of the credit facilities will be up to \$600 billion. These facilities will continue purchasing eligible assets until September 30, 2020. The last time the Fed offered a direct lending program to businesses like this was in 1934.

There are many questions surrounding the long-term implications of the Fed's foray into corporate debt. These programs could exacerbate fundamental deterioration as corporate leverage will rise such that companies will sell more debt to raise funds, which could result in more downgrades. So far in 2020, more than \$120 billion of investment-grade bonds have been downgraded to high-yield status. William Blair & Company, L.L.C. speculates that as much as \$200 billion of debt (about 3.7% of the investment-grade market) could be downgraded over the next 12 to 18 months, placing it into the fallen-angel category<sup>11</sup>.

The Fed has indeed taken some similar actions to support the economy as a result of the health pandemic that it did during the 2007-2009 global financial crisis. However, there are significant differences as some of the actions, programs, and facilities were last implemented several decades ago, or have never been implemented before. There may be long-term implications, but unprecedented actions can lead to unprecedented results that can unpredictably alter the expected recovery. As Plan Consultants and Fiduciaries, we remain committed to providing relevant resources and information to retirement plan sponsors and their participants for the uncertain times ahead.

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<sup>9</sup> Federal Reserve Bank of New York, "FAQs: Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility", Federal Reserve Bank of New York, 2020.  
<https://www.newyorkfed.org/markets/primary-and-secondary-market-faq/corporate-credit-facility-faq>

<sup>10</sup> Board of Governors of the Federal Reserve System, "Main Street Lending Program" Board of Governors of the Federal Reserve System, 2020, <https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm>

<sup>11</sup> Ruta Ziverte, "The Short and Long of the Fed Buying Corporate Bonds", William Blair & Company, L.L.C., 2020, <https://blog.williamblairfunds.com/ruta-ziverte/the-short-and-long-of-the-fed-buying-corporate-bonds/>

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