Fed to the Rescue: Providing Liquidity to the Corporate Bond Market

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To help support investment-grade corporate bond market liquidity, the Federal Reserve (Fed) introduced two facilities this week:

- Primary Market Corporate Credit Facility (PMCCF)
- Secondary Market Corporate Credit Facility (SMCCF)

With these steps, the Fed seeks to unfreeze financial markets and narrow bond spreads. Its bond buying will include both short-term debt (through the commercial paper facility) and long-term debt. (See recent Loomis Sayles paper: *Fed Acts Fast and Furious...Again: Announces Rescue Liquidity for Corporate Sector*)

Can the Fed Preempt a Depression?

The broad shutdown of businesses and the resulting loss of incomes have triggered significant demand for cash. Investors are selling assets and straining the financial system. As the only entity that can create cash, the Fed is stepping in to provide a market for corporations needing to borrow and for investors needing to sell bonds and generate cash.

The Fed staff has clear memories of the GFC and is focused on preventing the epidemic from causing a financial crisis. I think those recollections are in large part why the central bank is acting so quickly.

Potential Corporate Bond Market Implications

- The market could experience widening spreads between debt rated BBB- and higher that can access Fed support versus those below-investment-grade issues that cannot.
- With regard to the risk the Fed is taking by creating these facilities, it is historically highly unusual for a BBB-rated credit to jump to default. (We have seen BBB debt evolve lower in the rating scale over time and eventually become CCC and then default.) The Fed anticipates being paid back at par for its purchases.
- The government has learned lessons from the GFC. In the coming days, the government could include provisions in fiscal legislation prohibiting future stock buybacks and golden parachutes for companies accessing government funds.
- In the short run, these facilities could appear to be corporate bailouts. But in the longer run, the economy should benefit.
- We expect the rate of new viruses reported globally will continue to move the markets.
- A selloff like the one the markets are enduring typically does not happen often (thank goodness) and does not last long. In our view, this can be a buying opportunity in companies that we believe are credit worthy and represent good values.

WHAT'S NEXT?

Policymakers face a different scenario compared with the GFC experience. In this new scenario, the shock did not emanate from the financial markets. Instead, it was the pandemic that hit the real economy. We expect to see the Fed continue to use special facilities in an attempt to preserve the real economy. Steps will likely include:

- Actions aimed at helping small businesses.
- New legislation that helps the Treasury backstop Fed efforts in private sector lending.
- Revival of Term Auction Facility (TAF), which will allow banks to bid for funds from the Fed.
- Could see legislation to approve a proposal by the US Treasury to temporarily guarantee money market mutual fund liquidity.

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