Bailout Nation 2.0

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The past few weeks have been nothing short of extraordinary. The world continues to be mired in the COVID-19 pandemic that has impacted lives, fractured complicated global supply chains, cloistered millions and sent ripples through economies and markets.

The policy response to the pandemic is awe inspiring for both its size and the speed of delivery. What took months in 2008 & 2009 now takes mere days. We take time in this note to answer three things:

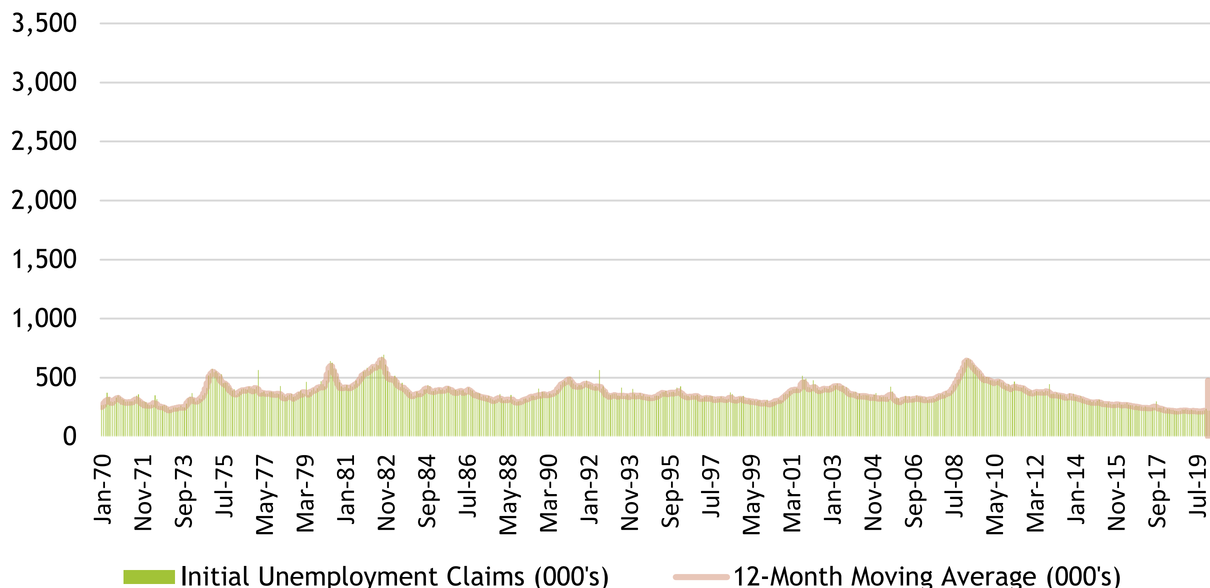
1. Why such a strong response from fiscal and monetary policy makers?

2. What are the various aspects of the policy responses?

3. How have markets responded?

Why such a strong response from fiscal and monetary policy makers?

One chart says it all. Below is the chart of weekly initial unemployment claims – our first meaningful domestic economic read since the crisis took full impact. For the week ending March 20th the U.S. saw a record 3.28 million people file for unemployment benefits. This number dwarfs the previous record of 695 thousand seen in 1982. For comparison sake, the worst week in 2008 & 2009 was 665 thousand. With 152 million people on recorded payrolls, the week of March 20th saw 2.15% of the work force lose their job. What is more shocking is the likely understatement of this number as many state offices reported difficulty in processing the volume of claims received. Economists believe there is more to come as the Bloomberg consensus is calling for another 3.3 million initial claims this week. Simply put, shutting down activity in a services-based economy is painful. Policy makers are set to do what they can to offset the negative impact from the virus.



What are the various aspects of the policy response?

To date, we have seen massive stimulus efforts by both fiscal and monetary policy makers in attempt to weather the storm as our economy feels the grim impact of being largely shut down. We will briefly summarize both efforts below

Fiscal Policy

The U.S. congress acted in remarkably quick fashion to craft and pass a $2.2 trillion stimulus package to come to the rescue of the rapidly weakening economy. This package is equivalent to 10% of GDP and is on top of the $1 trillion deficit already projected. Below is a brief highlight of the key aspects of the package.

- Stimulus Payments to Individuals – Approximately $560 billion will be sent out to individuals and families to help offset lost income and help stimulate consumption.
- Bolstered Unemployment Benefits – Unemployment benefit eligibility is expanded, and benefits are increased.
- Loan Program for Small Businesses – $349 billion is earmarked to be lent to small businesses and not-for-profits with the goal of keeping people employed.
- Assistance to Business, State and Local Governments – $500 billion will be spent and lent out to impacted businesses and government entities and the state and local level.
- Relief to Hospitals & Medical Industry - $130 billion will be given to the medical industry to help support the increased case load and demand for supplies.
- Authorizes US Treasury to Make & Guarantee Loans – the U.S. Treasury is granted broad authorization to make loans of guarantee loans to states, municipalities and eligible businesses. Additionally, certain financial regulations were rolled back with the goal of increasing lending activity and the availability of funds to those in need.

Monetary Policy

While monetary policy won't kill the virus, the Fed stepped up to do their part to help the economy through this unique and damaging event. In sum the Fed is throwing the kitchen sink and some toward the problem. They also vow to add additional programs and policies should it be needed.

The Federal Reserve slashed rates back to a range of 0.00% - 0.25% on March 15th and restarted quantitative easing with the ability to purchase at least $500 billion in U.S. Treasury securities and $200 billion in agency mortgage-backed securities. So much for tapering the balance sheet. Additionally, to avoid currency pressures, the Fed made currency swap lines available with several major foreign central banks. Gone are the John Conolly, former US Treasury Secretary, days of "the Dollar is our currency, but it is your problem". Today's markets are interconnected and complicated.

On top of the traditional policy tools, the Fed also enacted a series of programs intended to stimulate the economy, keep credit channels open and stem the dislocations occurring in every corner of the market. Below is a brief description of the efforts to date. We will note this is still fluid and subject to change.

- Primary Dealer Credit Facility (PDCF) – The Fed designed this facility to offer attractive (discount window rate) collateralized financing to primary dealers to finance their holdings of U.S. government securities, investment grade debt, commercial paper and a whole host of other qualifying assets in attempt to smooth market making functions and ease the strain in markets.

- Commercial Paper Funding Facility (CPFF) – the Fed will purchase top-tier (A1/P1/F1) commercial paper from US issuers (corporate and municipal) at a spread of 110 basis points (1.10%) over matched-term federal funds. This program is expected to begin in early April. The facility will be funded with $10 billion from the U.S. Treasury and is expected to be approximately $100 billion in size. The facility will essentially have no issuer limits.

- Primary Market Corporate Credit Facility (PMCCF) – The Fed will purchase investment-grade rated bonds issued by companies headquartered in the United States. The facility will purchase bonds at prices "informed by market conditions". Securities must have a maturity date of 4 years or less and may be callable. The fund has the ability of essentially financing all of the outstanding debt of eligible corporations. The facility will be funded with $10 billion from the U.S. Treasury and is expected to be approximately $100 billion in size.

- Secondary Market Corporate Credit Facility (SMCCF) – This program allows the Fed to enter the secondary bond market to purchase bonds issued by investment-grade rated corporations that are headquartered in the United States. The facility will purchase bonds with maturities of 5 years or less and may purchase up to 10% of the outstanding debt of an eligible corporation. Additionally, the facility can purchase exchange traded funds (ETF's) that invest in the US investment grade market. The facility may purchase up to 20% of an ETF's outstanding market capitalization. The facility will be funded with $10 billion from the U.S. Treasury and is expected to be approximately $100 billion in size.

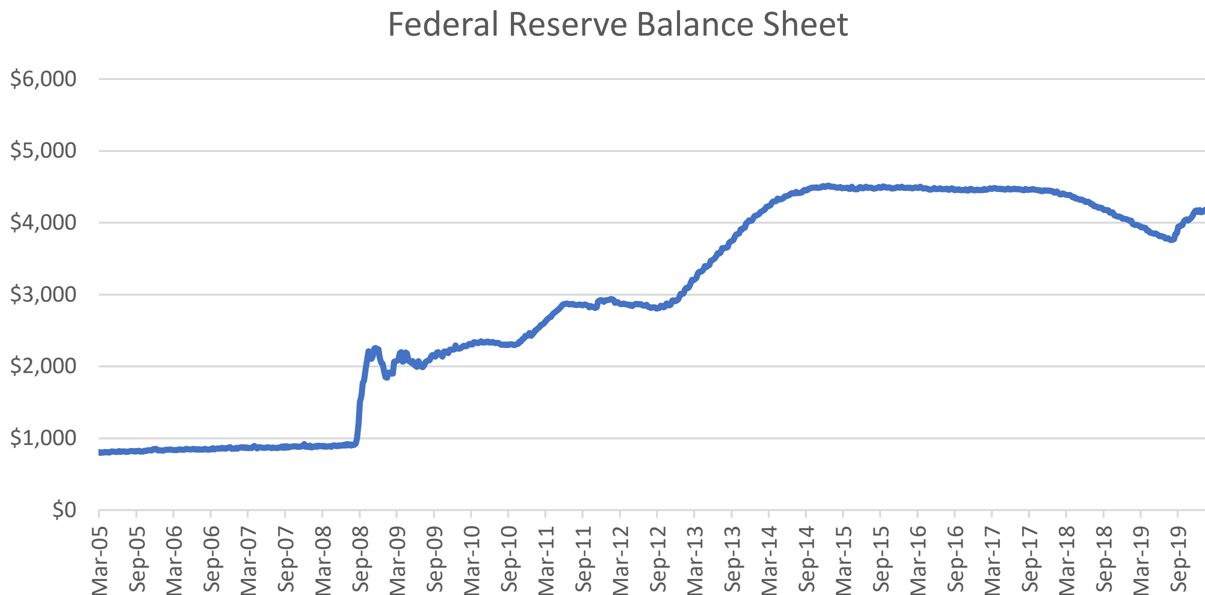
- Term Asset-backed Securities Loan Facility (TALF) – The Fed will purchase up to $100 billion of asset-backed securities issued by a U.S. company that are collateralized by eligible collateral. Eligible collateral includes auto loans and leases, student loans, equipment, credit card receivables and other similar collateral types. Loans from the facility will have a maximum term of 3 years. Eligible collateral must be AAA-rated or the highest short-term ratings. The facility will price at the LIBOR swaps rate plus 100 basis points (1.00%). The facility will be funded with $10 billion from the U.S. Treasury and is expected to be approximately $100 billion in size.

- Money Market Mutual Fund Liquidity Facility (MMLF) – To ease the strain on money-market funds, particularly prime and municipal funds, the Fed will lend money to eligible money-market funds and take eligible securities as collateral. The term of the loan will be no longer than the maturity of the collateral instrument. The program is an attempt to stem the losses money market funds are incurring as investor redemptions are forcing funds to sell securities into a depressed and illiquid market. The facility will be funded with $10 billion from the U.S. Treasury and is expected to be approximately $100 billion in size.

If you boil down all the above, the Fed is open to buying nearly every domestic credit asset except high-yield, loans and non-agency mortgage securities.

One thing we wish to note to clients is that, thus far, the programs established by the Fed are vastly different than programmatic risk-asset buying we have seen in other global central banks, notably the ECB. The programs established by the Fed are moderate in size when compared to the addressable market (investment grade credit is a $7 trillion market alone), are costly to use and rely on market pricing to dictate yields at which they will lend. What we believe the Fed is messaging is that they are here as an ultimate backstop, but they are not here to overly interfere with markets and misprice the cost of risk.

While many of the Fed programs aren't operational yet, that did not slow the central bank from taking immediate and significant action. The Fed's balance sheet grew a staggering $1.1 trillion, or 26%, in the first three weeks of March. The Fed accomplished this growth largely by purchasing U.S. Treasuries ($500 billion), expanding repurchase agreements ($209 billion) and extending currency swap lines to foreign central banks ($206 billion). At this point, it is safe to say that the rapid growth will continue.



How have markets responded?

Despite inflation, $3.25 trillion is still a lot of money and markets took notice. We do not think it is a coincidence that the Fed's announcement on March 23rd marks, for now, the low in the S&P 500 for the year. We also note that most credit and municipal markets found their footing in the last two weeks and now trade at much more "rational" levels. However, we are far from calling the situation over. There is no doubt economic data, corporate results and municipals finances will show signs of strain. How deep and how long, no one knows. We continue with our strategy and urge patience when moving into risk-assets. Said differently, the road ahead is likely to be bumpy so let's take it slow.

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