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The Short and Long of the Fed Buying Corporate Bonds

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HEAD OF FIXED INCOME

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By enhancing liquidity and improving functionality in the corporate bond markets, new U.S. Federal Reserve (Fed) programs have been good news in the short term. Yet a number of unknowns remain regarding the rollout of these programs, and we foresee potentially challenging impacts for more highly levered companies over the longer term.

The Fed's Rapid and Aggressive Actions

The Fed has rapidly deployed its tools to improve liquidity and stabilize markets that were rocked by the economic impact of COVID-19.

The Fed's efforts, announced on March 23, included new programs that allowed the purchase of corporate bonds, aiming to enhance the flow of credit to corporations.

The central bank established two credit facilities. Through the first, the Primary Market Corporate Credit Facility (PMCCF), the Fed can buy new-issue investment-grade bonds with maturities of up to four years. Through the second, the Secondary Market Corporate Credit Facility (SMCCF), the Fed can buy secondary-market investment-

grade corporate bonds with maturities of up to five years as well as exchange-traded funds (ETFs) that invest in investment-grade corporate bonds.

On April 9, the Fed dramatically increased the size and scope of these facilities. It raised their combined size to \$750 billion, and expanded both programs to include recently downgraded corporate issuers that had previously been rated investment grade (a BBB-/Baa3 rating or higher) as of March 22—so-called “fallen angels.” The Fed also said it could buy high-yield ETFs through its SMCCF.

In addition to these programs, the Fed has rolled out many other initiatives to improve market functionality and liquidity, including emergency rate cuts and quantitative easing (QE) programs.

With serious concerns about liquidity and stability in all areas of the fixed-income market, the Fed has taken a more aggressive stance than it did during the Global Financial Crisis, combining QE with other initiatives all at once rather than sequentially.

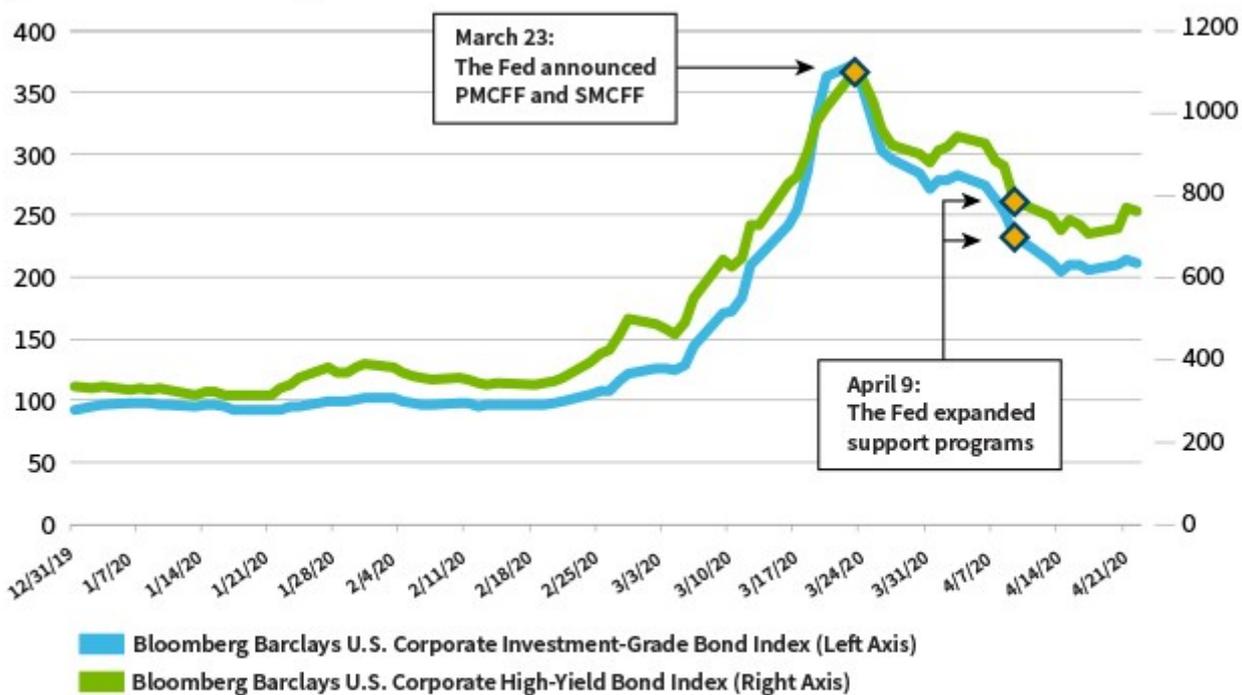
The Short Term

While the Fed has announced programs geared at purchasing corporate bonds, to date it has not actually made these purchases. Still, its programs have already had a positive effect on corporate credit spreads.

Through April 8, for example, the Fed’s corporate bond programs (the PMCCF and SMCCF) caused investment-grade spreads to tighten by 120 basis points (bps) and high-yield spreads to tighten by 229 bps from their widest levels on March 23 (the day the Fed launched these programs). This is notable because spreads reflect the difference in yield between a Treasury and a corporate bond, where widening is typically perceived as default risk rising.

In addition to leading to spread tightening, the Fed’s announcement led to a surge in new investment-grade bond issuance, led by high-quality credits, in March.

Impact of Fed Programs on Corporate Bond Indices (in Basis Points)



Source: Bloomberg, as of April 22, 2020. The Bloomberg Barclays U.S. Corporate Investment-Grade Bond Index consists of publicly issued U.S. corporate and specified foreign debentures that are registered with the Securities and Exchange Commission and meet specific maturity, liquidity and quality requirements. The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged index that covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Index performance is for illustrative purposes only. Indices are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Past performance is not indicative of future returns.

Corporate spreads continued to tighten after the Fed's April 9 announcement, increasing the size and scope of these facilities and including fallen angels and high-yield ETFs (in the case of the SMCCF).

Even though ETFs only represent approximately 3.5% of the high-yield market, this announcement boosted investor sentiment, driving investors to high-yield bonds. As a result, the high-yield new-issue market reopened after essentially being closed in March.

The Long Term

There are still many unknowns surrounding the Fed's foray into corporate debt. It remains unclear when the Fed will begin buying corporate bonds, and when it does, at what pace the purchases will take place. Our current expectation is sometime in May. More details will likely be announced in the coming weeks.

These facilities are likely to remain active through September, but the ultimate length of the programs will depend on the path of the recovery, which is a big wild card. We see the recovery likely being staggered, but it is not easily predicted given that a [virus-driven, global economic downturn](#) is unprecedented.

We do expect, however, that corporate leverage will rise across the board as companies see their earnings

decrease and sell more debt to raise funds. We expect this to result in more downgrades.

This process has already begun. This year more than \$120 billion of investment-grade bonds have been downgraded to high-yield status, and we see the potential for much more as the year progresses. Approximately \$300 billion of BBB-rated debt in the investment-grade sector is on watch for downgrades or has a negative outlook set by rating agencies.

We estimate 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.

We expect these fallen angels to be heavily concentrated in the energy and manufacturing sectors. But other sectors—including leisure, transportation, and consumer products—also have sizable debt that is on watch for downgrades by rating agencies. Those sectors may be hit as well.

We anticipate seeing downgrades across the full rating spectrum: A-rated credits downgraded to BBB, BBB credits downgraded to BB, BB credits downgraded to B, and so on.

Increased leverage will likely lead to more defaults and bankruptcies, especially for companies that entered this downturn with already-high leverage levels. We expect these bankruptcies to be concentrated among companies with lower-B and CCC ratings as well as companies in cyclical sectors, particularly energy. Oil prices at today's historically low levels are uneconomical for a high-yield company.

Overall, we don't expect the Fed's programs to provide much support for lower-quality credits given the expected fundamental deterioration.

Implications

In sum, the Fed's aggressive actions have benefited the markets in the short term. Longer term, however, we think there will be downgrades, defaults, and bankruptcies, particularly among companies that came into the downturn with high leverage.

In this environment, we are being more defensive, seeking value in high-quality investment-grade credit. There will be plenty of time to increase risk as we come out of the downturn—but for now, there are simply too many unknowns.

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