ARTICLE

The Fed Saved Financial Markets Without Really Doing Very Much

This month marks the one-year anniversary of the COVID-19 pandemic in America that has so far claimed over 500,000 lives. The first confirmed case of COVID-19 virus in the United States was reported in Washington state in mid-January 2020, and community spread was occurring by February.

But the gravity of the situation and our unpreparedness to aggressively confront the virus became apparent to the public in March, at which point all 50 states had reported COVID-19 cases, and much of the country entered panic mode as state-mandated shutdowns or stay-at-home orders began. Nearly 4,000 COVID-19 related deaths and 190,000 confirmed cases in the U.S. were reported in the month of March 2020, with the White House then projecting that up to 240,000 Americans could die of COVID-19 even with most Americans staying home[(1)]. Financial markets didn't wait around for further details or refined COVID-19 projection models. The S&P 500 plunged 24% in the first three weeks of March—an epic selloff — while corporate credit markets began to seize up. Leveraged credit issuance screeched to a halt in March. Little did anyone realize that financial markets would begin the recovery process that very month — enduring just a few weeks of pain — while Americans would have to contend with the ravages of the virus for the next year.

The Federal Reserve is widely credited with rescuing U.S. financial markets amid the early days of the pandemic, and rightly so. We can pinpoint the bottoming of equity and credit markets to a precise date: March 23, 2020 (**Exhibit 1**). It's no coincidence that the Fed announced two emergency programs to support corporate credit markets on that very date—the Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF). The PMCCF authorized the Fed (via a special purpose vehicle (SPV)) to purchase newly issued bonds or to make loans directly to investment-grade (IG) issuers or to companies that held an IG rating just prior to the pandemic but had since been downgraded no lower than a Ba3/BB- rating at the time of the transaction, while the SMCCF authorized the Fed to purchase bonds of these eligible companies in secondary markets or in ETFs whose primary investment objective was the holding of IG or high yield (HY) bonds. These programs were set up via an SPV with $75 billion of equity funding from the U.S. Treasury Department and a 10-to-1 leverage factor, meaning that the programs were authorized to make up to $750 billion in purchases/investments on a combined basis. The SMCCF became operational on May 12 with respect to ETFs and on June 16 for corporate bond purchases, while the PMCCF went live on June 29. Both CCFs were set to expire on December 31, 2020, after which no additional loans or purchases could be made by the SPV.[2] [3] Furthermore, the Fed also announced its Main Street Lending Program (MSLP) on April 9, 2020, which was authorized to provide up to $600 billion of five-year loans to eligible small and medium sized businesses, including non-profits. (The MSLP was something of a misnomer, as eligible companies with up to 15,000 employees or sales of $5 billion could have applied for such loans[4].) The MSLP became operational on July 6, 2020.

These policy measures by the Fed were unprecedented, not only in their size and scope but in the speed with which they were announced and rolled out. The intention was clear: The Fed was going to use its full arsenal of policy weapons and its widest authority under Section 13(3) of the Federal Reserve Act to mitigate the impact of the nascent pandemic on U.S. markets and the broader economy.

Markets responded quickly and enthusiastically to these emergency measures by the Fed, though the pain was just beginning for millions of individuals and small businesses. The S&P 500 rallied 30% in April off its low of March 23, on its way to all-time highs by late 2020. HY corporate bond issuance snapped backed from nearly nil in March 2020 to $37 billion of monthly issuance in April and May, ushering in a streak that would see U.S. HY issuance enjoy its best year ever at more than $400 billion while HY interest rates fell to record lows.[5] Financial markets moved passed the pandemic by 3Q20, just as a second wave of COVID-19 was hitting much of the country, surpassing pre-pandemic valuations and yields.

The Fed's policy initiatives in 2020 to save panic-stricken markets from selling contagion is a familiar story by now and is consistent with the "Fed put" narrative that investors have relied on since 2008. That narrative continues today, with most investors believing to varying degree that "the Fed has their back" and will take policy actions that support markets when adverse events occur. Much has been written about the moral hazard the Fed has encouraged with these actions, as investors take on more risk in the belief that the Fed will continue to directly support private financial markets and large non-bank entities when shock events hit — something that was never considered part of the Fed's original purview. The consensus among market commentators seems to be that, yes, the Fed has complicated and amplified the moral hazard problem with its recent actions but that these actions were essential in preventing a collapse of markets and the economy in March. Translation: We'll worry about the moral hazard problem later.

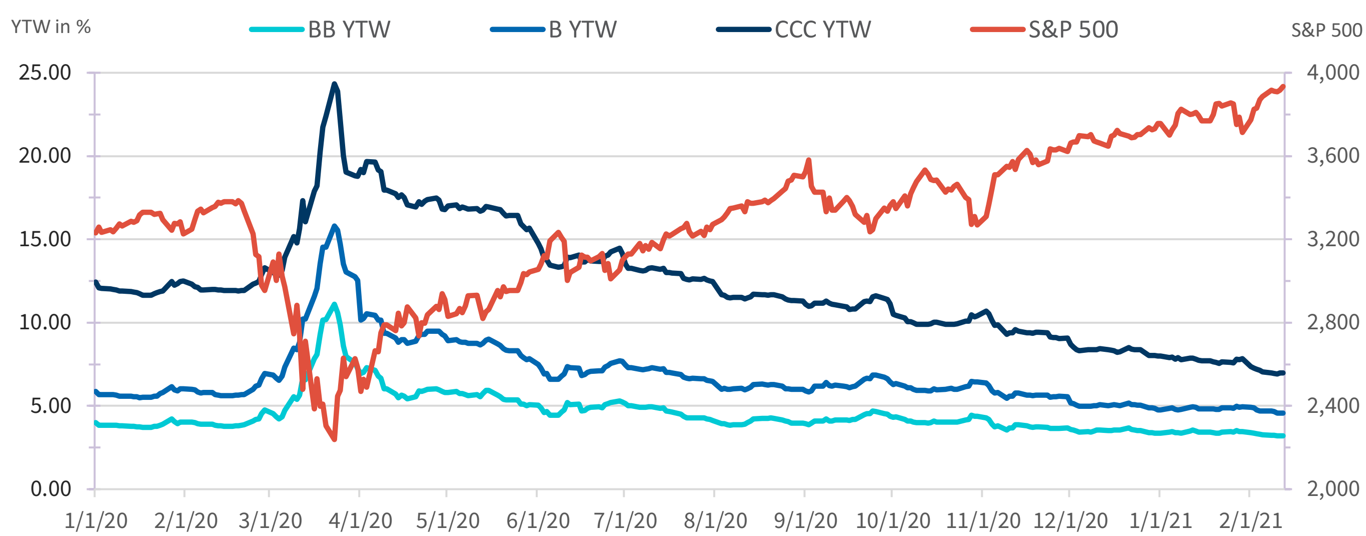
These three programs have now reached the end of their investment periods, and what has gone little noticed and under-reported is how underutilized they all have been. The Fed's final update report to Congress on these lending facilities indicates it never made a single loan under the PMCCF while just $14 billion was invested under the SMCCF, a majority in ETF purchases.[6] The MSLP took on just $17.5 billion of loans, or 3% of its authorized investment limit[7], as participating banks, through whom the loans were made and processed, never embraced the program for a variety of reasons.

So, it was mostly a "con game" (as in confidence) played by the Fed that restored investors' risk appetites and set off a multi-trillion-dollar recovery in financial asset prices. In terms of actual market interventions, the Fed hardly stepped into corporate credit markets to support prices or provide liquidity with respect to these three programs, though certainly it was prepared to do so. Apparently, its verbal commitment was all it took to grease the skids for investors. Ultimately, this episode demonstrates the enormous influence that the "Fed put" narrative wields over investment decisions, the incredible fragility of market sentiment and the self-reinforcing nature of investors' behavior.

So why do investors place such faith in the Fed's ability and willingness to save them from the consequences of their risky or ill-timed decisions and what are its limits? What if another virus with far greater lethality than COVID-19 truly shuts down our economy for months, or a cyberattack indefinitely cripples the nation's power grid, or a major natural disaster strikes? Should the Fed be stepping in to buy the market securities of private-sector companies or provide liquidity to teetering companies in such instances? Why shouldn't investors in free markets bear the fallout of extreme, unforeseen events? This central issue regarding the appropriateness of using the Fed's authority and monetary power to benefit financial markets and investors remains a controversial topic that will be debated vigorously for as long as the Fed is perceived to employ it.

As for the moral hazard issue, one only needs to look at the distorted risk/return dynamics of today's leveraged credit markets and the ability of deeply spec-grade companies to borrow even more aggressively amid such economic uncertainty to recognize that perhaps the Fed has helped create a monster it will have to confront sooner than it expected.

Exhibit 1 -S&P 500 INDEX AND U.S. HIGH-YIELD BOND YTW



Source: Bloomberg

Endnotes

1. Coronavirus Updates, CBS News, April 2, 2020
2. Board of Governors of the Federal Reserve System/ Policy Tools, Primary Market Corporate Credit Facility, Term Sheet (July 28. 2020)
3. Board of Governors of the Federal Reserve System/ Policy Tools, Secondary Market Corporate Credit Facility, Term Sheet (June 28. 2020)
4. Main Street Lending Program, Federal Reserve Bank of Boston
5. Refinitiv LPC
6. Periodic Report: Update on Outstanding Lending Facilities Authorized by the Board under Section 13(3) of the Federal Reserve Act, February 8, 2021
7. Banking Dive, February 10, 2021

MICHAEL EISENBAND
Global Co-Leader, Corporate Finance & Restructuring
+1.212.499.3647
michael.eisenband@fticonsulting.com