Insights

April 27, 2020

Don’t Fight the Fed

Price action in investment grade corporate credit during the month of March was historic. At its low, year-to-date total return for the Bloomberg Barclays U.S. Corporate Investment Grade Index was a dismal -10.7%. This was still far off from the -15.2% year-to-date total return achieved by the end of October 2008, but the veracity of the 2020 sell-off was beyond compare. Peak to trough occurred over two weeks whereas the 2008 trough, measured from the Lehman collapse, took two months. In both of these instances, further price degradation was arrested by monetary and fiscal intervention.

A key takeaway from 2008 is that strong external support can lead to substantial outperformance. In the final two months of 2008, after the fed funds rate was cut to zero, the investment grade index generated over nine percentage points of return. This momentum carried into 2009 and 2010 with total returns of 19.7% and 8.8%, respectively. The rebound from March 2020 lows has been more impressive with nearly 12 percentage points of return from the trough in a little under a month. This reflects enthusiasm over the magnitude of monetary and fiscal support announced to date.

For institutional cash investors, the current market dynamics and historical trends point to some interesting strategic considerations for investment of excess cash:

- Since the Fed has shown its willingness to loosen financial conditions if needed, it may be overly prudent to hold excess cash in treasuries, government money market funds, or bank deposits that are likely to return close to 0% in this low rate environment
    - Outside of Fed programs, high-quality institutions should be able to easily meet unexpected liquidity needs via external markets where demand remains insatiable
    - Deploying excess cash in credit offers strong relative value because the Fed is broadly backstopping this market even if the outlook for some industries is not good
- Balance sheet stress will take time to play out, so we believe most investments in the one to two year part of the curve will remain safe due to the Fed’s backstops
    - As long as investment grade companies are able to maintain sufficient liquidity and rollover their debt, risk of default should be very low even if fundamentals remain weak
- In two years’ time, it should be much clearer which companies will make it past the aftermath
    - Some companies that have raised debt to bolster liquidity in hopes of weathering the storm may be unable to deleverage if demand is permanently lost
    - Incremental risk for longer duration securities (over two years) is much greater since the Fed’s backstops are not meant to inflate asset prices

In summary, we think investment grade credits in the one to two year part of the curve offer the best risk/return prospects for excess cash as credit spreads remain wide due to uncertainty in economic recovery. Certain “speculative” investment grade credits in cyclical industries are especially attractive as these issuers should remain viable due to the Fed’s broad-based backstops. For these speculative credits, it will take two to three quarters to fully assess whether a worst case economic scenario will be realized. By that time, these investments would have rolled down sufficiently to minimize any incremental risk of default. Conversely, investments maturing beyond two years will be more exposed to repayment risk than what is priced in today if, for example, the Fed becomes more selective in its support. As such, we believe a better entry point for long duration could emerge with more clarity.

"Don't Fight the Fed"

- Aggressive Fed policies have been put into place to ensure that credit markets have ample liquidity and corporations have access to financing markets

Program	Size	Description	Impact
CPFF Commercial Paper Funding Facility	**$200bn**	Purchases newly issued commercial paper from U.S. issuers when private sector normal market investment is not sufficient or absent	Improves liquidity in the short-term funding markets, primarily used by corporations for working capital
PMCCF Primary Market Corporate Credit Facility	**$500bn**	Purchases newly issued corporate debt from issuers	Increased confidence in corporate credit markets allowing corporations to borrow
SMCCF Secondary Market Corporate Credit Facility	**$250bn**	Purchases existing corporate debt or corporate debt exchange-traded funds on secondary markets	Increased confidence in corporate credit markets allowing corporations to borrow
Main Street Lending Program	**$600bn**	Supplies liquidity for PPP; assists the flow of credit to small- and mid-sized businesses; expands PMCCF, SMCCF, and TALF; establishes a municipality fund	Provides support to households and businesses of all sizes and help governments deliver critical services
PDCF Primary Dealer Credit Facility	**$30bn**	Provides overnight loans to primary dealers through their clearing banks in exchange for eligible collateral	Improves market liquidity and promotes the functioning of financial markets in general
TALF Term Asset-Backed Securities Loan Facility	**$100bn**	Facilitates the purchase of newly issued, highly rated ABS by providing non-recourse financing to investors	Ensures ABS market liquidity and function to facilitate consumer purchases (autos, credit card purchases, etc.)
MMLF Money Market Fund Liquidity Facility	**$500bn**	Provides non-recourse loans to financial institutions to purchase assets that money market funds are selling to meet redemptions	Reduces the probability of runs on money market funds which results in funds force selling assets for liquidity