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Weekly Market Flash

The Fed Is Not Dead

April 9, 2020

Central banks arguably saved the global economy from a full-on depression in the period following the financial crisis of 2008, and they stayed around for many years afterwards, keeping interest rates at historical lows and pumping money into the economy via a succession of quantitative easing programs. The economy was healthy enough to keep trucking along once the Federal Reserve, the US central bank, ended its third QE program and started to hesitantly raise rates in the middle of the last decade. But it never approached pre-crisis levels of growth; moreover, when it became clear in the fall of 2018 that the Fed intended to keep raising rates while reducing its QE-inflated balance sheet, markets took a steep nosedive. But for a fraction of a percent, the bull market that ended in February 2020 would have met its demise on December 24, 2018 when the S&P 500 closed 19.9 percent below its previous high.

What's In Your Wallet?

Since that late-2018 pullback one very big question has kept investors up at night: what happens if the Fed runs out of tools? How does the economy endure a sudden and sharp downturn if it can't even stay healthy on its own in a world where the Fed funds rate is 2.5 or three percent (a relatively low number compared to previous growth cycles)? What happens then?

It is safe to say that we now have a pretty good answer to that question, which is that the Fed's monetary toolbox is a great deal more robust than many thought. In the weeks since the coronavirus crisis became the defining aspect of life for the majority of the world's citizens the central bank has unleashed a torrent of innovative facilities and programs on the economy, pulling money out of a seemingly bottomless wallet. The effect on markets, if not yet on the actual economy, has been impressive.

Credits and Swaps and Loans, Oh My

In the middle of a pandemic that has resulted in 17 million jobs lost in just three weeks, with an economic recovery still some time away and uncertain as to its eventual trajectory, the Fed's blizzard of money has stabilized credit markets which at one point looked to be completely off the rails. Possibly the most constructive single move the bank made was to establish a facility for purchasing corporate bonds. In the dramatic asset sell-off of mid-March, as we noted in our commentary several weeks ago, investment-grade corporate bonds (normally deemed one of the safest of asset classes) took a beating. This was most noticeable in the exchange-traded funds that hold pools of bonds and allow investors to trade them as a single asset. The price of these ETFs diverged sharply from the value of the underlying securities and could have fallen into a near-bottomless loss-of-confidence spiral had the Fed not stepped in with its direct bond-buying facility.

But the central bank also targeted other, normally less visible parts of the market, such as establishing dollar swap lines to give foreign central banks better access to much in-demand US dollars. It dusted off the old QE playbook of direct US Treasury and mortgage-backed securities purchases, and then threw out any upper limit on the size of those purchases. And it was a silent partner in the $2 trillion relief program passed by Congress. This morning the Fed ended the silence on its role there and spelled out just what it stands ready to do as the funds from the relief program are – with some well-documented operational difficulties – rolled out to its target recipients.

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You Put In One, We'll Put In Ten

Fed money will be printed to inject into three of the signature programs in the relief package: the one for small and mid-sized businesses, a second one for a somewhat vaguely-defined "Main Street," and one for state and local municipalities. Each of these programs got a specific earmark from the Treasury Department under the terms of the Congressional bill: $345 billion for small business loans, $75 billion for the Main Street fund and $35 billion for municipalities.

But each of these will be augmented by the Fed. The central bank will make an additional $2.3 trillion available in loans to small and mid-sized businesses, and also provide an operational tool to help banks involved in the $350 billion relief program for small businesses to execute their loans. It will backstop the $75 billion Main Street program with up to $600 billion, and likewise it will lever up the $35 billion municipal program to the tune of $500 billion.

When the Bill Comes Due

It is an impressive array of actions, to be sure, and for the time being at least it has had a very calming effect on asset markets. And for as long as we are in the vortex of this health crisis – for as long as job losses numbering in the millions show up each week, for as long as our inadequate virus testing and critical health care supplies call into question the viable timing and trajectory of the economic recovery – there will not be too many questions asked about what this is all going to cost. But let us be clear, the bill will come due one day. The Fed cannot make grants or charitable contributions, it can only make loans. Those loans will have to be paid back one day by someone. As we saw in 2018, once you have created the abnormal conditions of the central bank being the single entity holding the entire world economy together, it is really hard to unwind it all and take the patient off the industrial strength opioids. What we are talking about today is of a scale that far surpasses Fed at its most bloated level post-2008.

But for now, that is a problem for another day. The Fed is not dead, and for today that is good enough.

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