Fixed Income Flash

Fed Corporate Bond Buying

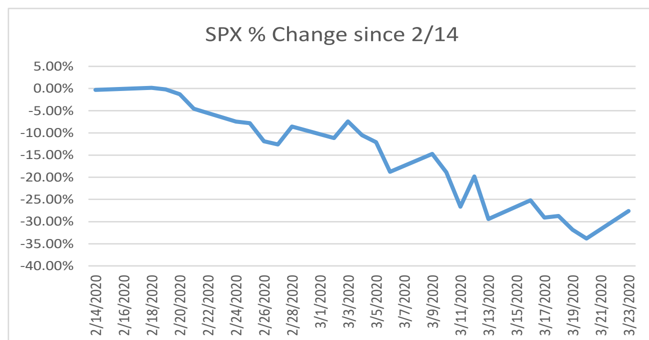
March 24, 2020

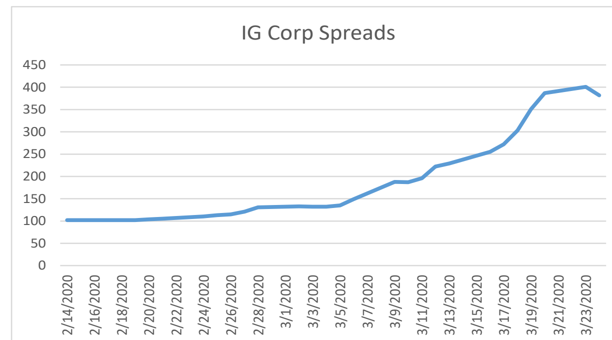
Fed Intervention in Credit Markets

The Fed announced two new lending facilities that will allow the Fed's balance sheet to be used to fund purchases of investment grade corporate bonds and loans. One facility will be for newly issued bonds and the other will be for bonds already trading in the secondary market. The Fed is stating that these facilities are to ensure the proper functioning of the corporate bond market during a time of heightened credit stress. It is unprecedented for the Fed to directly intervene in credit markets in this manner.

Risk Repricing

Investment grade credit spreads came in 19 bps from their cycle peaks and reversed a nine day trend of moving significantly wider each day. U.S. equities rallied 9.4% off of their recent lows. Capital markets are rapidly repricing equity and credit risk in anticipation of the Fed's massive buying of risk assets.





What Now?

The Fed's announced intention to buy potentially trillions of dollars of corporate bonds will definitely make dealers more willing to bid corporate bonds that investors are trying to sell, and this should improve market liquidity and functioning as intended by the Fed. However, these corporate bond buying programs are also likely to distort the price signals from the credit markets and lower corporate borrowing costs below the level supported by economic fundamentals and the financial outlook for many firms, especially those that were already highly indebted going into the COVID-19 pandemic. While in the short run this will help these firms access liquidity and reduce the losses in risky investment portfolios, this will not alter the solvency picture of firms who will need to see a sharp rebound in cash flows in order to remain financially viable.

The announced corporate bond buying programs will not reduce the price of credit for smaller businesses that have been much harder hit by the pandemic, but the Fed is very likely to announce funding vehicles to support the provision of credit to these firms as well. The Fed's intervention in the credit markets comes on top of almost 11 years of intervention in the Treasury market, and so the capital markets will provide an even more distorted signal through asset prices. The most likely lasting impact of the Fed's action will be to create even greater moral hazard in credit markets and further inflate equity and other risk asset prices.