Analyzing the Fed's Unprecedented Actions

*Featuring: **Andy Sparks**, Head of Portfolio Management Research*

Adam:

This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass, and today is April 30th, 2020.

Adam:

This week we'll look at how unprecedented actions by the US Federal Reserve have helped keep markets functioning low volatile. We explore how the Fed is working toward its goals of maximizing employment, stabilizing prices, and ensuring that when the rebound comes it's quote, as robust as possible. Let's turn to Andy Sparks. MSCI's head of portfolio management research for more. Andy, thanks for being here.

Andy:

Thank you. Thank you, Adam. Glad to be here.

Adam:

You're in Westchester County, which for those who may not know is a suburb of New York City. How has life changed there?

Andy:

It's changed a huge amount. For me personally, I used to have a three-hour commute into the city. That was my total commute time, and a lot of people would say, well how could you possibly endure that? But now that I'm working from home, I'm saying it wasn't that bad. It is interesting just walking around the streets. It's generally a very leafy suburb, and normally people in the town I live are very time-constrained, and they're busy taking their kids from one activity to another. They're generally very sleep-deprived, and a lot of that is very different now. So I actually see kids playing in their yards, bouncing balls in their driveway. It's sort of quaint thinking back to my childhood where activities were much less structured, particularly for kids than they are now.

Adam:

Getting back to the present, in a sense, we're recording this shortly after Fed Chair Jerome Powell finished his press conference on Wednesday. Powell discussed the unprecedented actions the Fed has taken.

Andy:

Yeah, they are very unprecedented, both in size as well as scope. They've been buying a huge amount of US Treasuries and agency mortgage-backed securities in a very short period of time. For listeners who are familiar with hedge funds, you could almost think of the US Treasury as the equity holder, and the Fed is the banker providing the lending and using leverage. So as part of the CARES act, $454 billion of that act was given to the Treasury to be used in coordination with the Federal Reserve, and leverage can be applied to that. There's several different facilities that have been set up including for municipal bonds, for money markets, but the ones that I'd like to focus on right now or for corporate bonds.

Andy:

And so the initial funding from the Treasury for these is $75 billion. Levers can be used up to a factor of 10, and so that $75 billion can fund $750 billion worth of corporate purchases.

Adam:

But the Fed hasn't bought any corporate bonds yet.

Andy:

What's been amazing about the announcement of these programs is the market reaction. And so the Federal Reserve has not yet purchased any corporate bonds, but the mere announcement has caused a major tightening in spreads. If you look at the level of spreads just before the Fed's announcement compared to now, spreads have tightened about 125 basis points.

Adam:

And they have a lot of room to maneuver.

Andy:

Exactly.

Adam:

How much room though? Do they have unlimited funds?

Andy:

So there's the Asset Purchase Program, which is for treasuries and agency mortgages that is as needed. There is no limit on the purchase amount. For these corporate bond programs and the other programs for municipal bonds and money markets. The only limit is that the equity for those in aggregate has to meet with the $454 billion that the Treasury has at its disposal, but a lot of that $454 billion has not yet been deployed. And so specific to these corporate bond facilities, they can ramp up a lot more if the Treasury Department working with the Fed deems it necessary. So there's ultimately a limit, but we're well below that limit right now.

Adam:

A few billion here, a few billion there, pretty soon we're talking about real money. Are there any concerns about inflation?

Andy:

If you look at market-implied measures of inflation, over the next year, according to our models, the implied inflation rate is about -0.8%. We did get a consumer price index number recently and it showed month over month a decline in prices of -0.4%. Now a lot of investors are concerned with the huge, huge amount of fiscal stimulus as well as monetary activity that over the longer run, this could trigger inflation. But if you look at market-implied measures, even longer-term market-implied measures, they're still very modest by historical comparison. And so for example, the 10-year break even inflation rate right now is about 1.2%. By the way, the Feds target for inflation is 2%. And CPI inflation year-over-year, if you look at the consumer price index, inflation had been 2.1% year-over-year. And so going forward, the market at least does not seem to be overly concerned about long-run inflation.

Adam:

It sounds like the real worry could be deflation.

Andy:

Deflation is a distinct possibility, and there is some precedent for this by the way. If you go back to the financial crisis, at that time it was close to a 60% decline in the price of oil. Again, a very large decline in aggregate demand, and for eight months in a row, we had year-over-year deflation.

Adam:

We're all watching for signs of when it will be okay for economies to open up and what that recovery might look like. To what extent can the Fed contribute?

Andy:

The Fed cannot affect the infection rate, but what they can do is to provide the conditions so the recovery is as robust as possible. And what the Fed is particularly focused on is sort of trying to minimize long-run damage to the economy. And so the problem with longer-term unemployment is that workers, their skills depreciate some. It may be harder for them to reengage the economy. So the quicker you can get them back to work, the less long-term effects there will be on the economy.

Adam:

What else does the Fed have in its arsenal?

Andy:

The Fed is ultimately sort of sailing into uncharted waters here, and that's why they have a lot of this firepower. It and the Treasury have a lot of firepower that can still be deployed if they see signs that the economy is going to be deteriorating. Their foray into corporate bonds, for example, is an example of a new tool. They had not used that in many decades. And now they will be using it very significantly as I previously mentioned. So if for example, the finances of state and local governments significantly deteriorated to the point where there is a crisis brewing in the municipal bond market, the Treasury and the Fed together, through one of these special purpose vehicles, could provide more funding and could effectively buy municipal bonds.

Adam:

There's been some criticism that the Feds programs either aren't going far enough or aren't focused in the right areas to help the right people. Any thoughts?

Andy:

The Fed is not supposed to take credit losses. And that's why for these special purpose vehicles, they're being set up with Treasury is the equity holder. So Treasury is taking the first losses. So Chairman Powell at today's conference alluded to this, and there was a question about, well what about the firms that face serious solvency issues? And can the Fed do something to directly help them? And that's the limit to what the Fed can do. So you might have certain companies that are really in serious problems, and the Fed cannot just go out and buy those bonds. They can only buy them through these vehicles. And again the Fed, there must be that protection of the Treasury in front of them. And so Chairman Powell was asked this question about, well you may not be providing help to the companies that need it most. And his response to that is, that is where Congress and fiscal measures need to come in because the Feds hands are effectively tied by that restriction in the Federal Reserve Act that they are not supposed to be taking credit loss.

Adam:

That's all for this week. Thanks to Andy and to all of you for joining us. Be sure to follow us on the MSCI LinkedIn page, and to bookmark www.msci.com/coronavirus for all our crisis-related content.

Adam:

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