THE FED ENTERS THE PARTY

Much has been made in respect to the 23rd March announcement that the Federal Reserve ("Fed") would be including corporate bond purchases in their latest actions to ease credit conditions and support markets in response to the economic and market turbulence caused by the COVID-19 pandemic. Simplistically, the programme is a direct mechanism allowing the Central Bank to protect jobs and corporations by way of supporting companies' credit requirements, whilst alleviating the potential for stress in the secondary market.

The announcement of the intention to buy corporate debt, accompanied by the news the Fed will be purchasing an unlimited amount of US Treasuries, made an immediate impact on markets and conceivably signalled the bottoming of the bear market. Credit spreads instantly tightened as the below chart indicates, with the average A-rated US corporate bond index narrowing from 260 basis points (bps) over Treasuries on the day of the announcement to 111bps today. This kind of move has been replicated across the credit spectrum, with the corresponding BBB Index tightening from 3.37bps to 170bps and the broad High Yield benchmark from 1088bps to 569bps.

Tightening credit spreads

As our second chart shows, the news also benefitted equity markets – the broad MSCI global index spiked 8.4% the day after the announcement and has gone on to climb 39% from its low point.

Global equity performance

Source: Bloomberg

Initially the Fed's intention was to make the purchases via ETFs, though individual credits have subsequently been included in the programme, based on a broad cross section of the US credit market which satisfy certain criteria such as maximum maturities and credit rating considerations. In addition, there are requirements placed on issuers in regards to qualifying characteristics of companies' operations and employees.

The principal beneficiaries would appear to be the largest borrowers, having borrowed to finance acquisitions and share buy backs, as they would have the largest share of indices and similarly in any cross section of the credit market.

Though this type of policy has been implemented in Europe, it is unfamiliar territory for the Fed and the concern is this level of market manipulation encourages companies to borrow and comes with unintended consequences. For instance, the criticisms levelled at the facility highlight the availability of easy credit at depressed yields encourage the existence of 'Zombie' companies, in which poor quality businesses that are ordinarily denied access to capital at affordable rates are offered that opportunity by artificially low yields and thereby allowed to remain solvent.

Despite the surge in issuance, the proportion of total corporate debt held by private investors has been declining, due primarily to Fed purchases, resulting in yields becoming depressed. Meanwhile, with the Fed acting as backstop for the market and ensuring continuous demand, the expectation is for volatility in credit markets to dampen and yields to remain tight. Moreover, critics say, the Fed's growing share of the market grows amounts to a de facto part nationalisation of corporate America.

I would encourage readers to revisit MitonOptimal's market insight from the 20th February 2020 entitled "Peak Credit – are we there yet?" where our thoughts on the credit space were articulated by my colleague Shaun McDade. Though we have come a long way from the 20th of February our opinions on the asset class by and in large remain, albeit with an additional rather hefty market participant in the form of the Fed.

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