End of the Fed's Credit Support Facilities Is Positive

Risk of unintended imbalances in the credit market is lower.

January 2021

KEY INSIGHTS

- We believe the Fed's credit facilities met the goal of restoring liquidity and their end is positive for the long-term health of the corporate credit market.
- Fiscal policy has taken the leading role in supporting the broader recovery in the economy and in corporate fundamentals.
- Spread dispersion across industries remains, which presents opportunities for credit selection, particularly as an uneven recovery likely takes hold throughout 2021.

Steven Boothe, CFA
Head of investment-grade credit and co-portfolio manager, U.S. Investment-Grade Corporate Bond Strategies

Lauren Wagandt, CFA
Co-portfolio manager, U.S. Investment-Grade Corporate Bond Strategies

Matt Lawton, CFA
Associate portfolio manager, U.S. Investment-Grade Corporate Bond Strategies

Gregor Dannacher, CFA
Portfolio specialist, U.S. Investment-Grade Corporate Bond Strategies

The success of the Federal Reserve's emergency intervention in March 2020 played a crucial role in stabilizing and improving liquidity in U.S. credit markets. The cessation of the Fed's corporate credit facilities, in our opinion, lowers the risk of unintended imbalances within credit markets that could potentially become a larger problem in the future if left unchecked. With the Fed stepping back on direct corporate credit market support, fiscal policy has taken the leading role in supporting the broader recovery in the economy and in corporate fundamentals. There is still meaningful credit spread[1] dispersion within the investment-grade corporate bond market, presenting attractive opportunities for credit selection, particularly as an uneven recovery likely takes hold through 2021.

Components of Total Spread

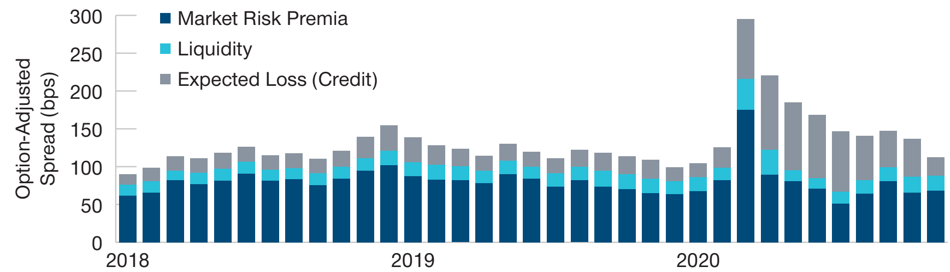
With the magnitude of the COVID-19 crisis still unfolding, the credit markets faced enormous pressure and to a large extent nearly ground to a halt in mid-March 2020. On March 23, the Fed announced that it would establish primary and secondary corporate credit facilities to acquire investment-grade corporate bonds with five years or less to maturity as well as exchange-traded funds (ETFs) that hold investment-grade corporates.

Our quantitative team analyzed the composition of credit spreads prior to the onset of the pandemic, categorizing total spread into three key risk premium components: liquidity, credit, and market.[2] These three risk premiums help enhance our understanding of

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[2] Option-adjusted spread (credit spread adjusted for any early redemption options) can be decomposed into three components: credit, liquidity, and market risk premia (MRP). Credit represents the expected loss from a bond and is derived from a company's probability of default. Liquidity is a measure of the additional spread that is needed due to illiquidity of a security. MRP represents the index level beta/volatility premium, and is the spread required for the general level of risk and uncertainty in the index.

March 2020 Liquidity Risk Premium Peak

(Fig. 1) Corporate bond index[1] credit spread decomposition



As of November 30, 2020.
For illustrative purposes only.
Source: Calculated by T. Rowe Price. Data used in calculation is sourced from Bloomberg Index Services Ltd. Copyright 2020, used with permission. (See Additional Disclosure.)
Spread decomposition based on default rates, liquidity indicators such as bid and ask prices, and volatility of index components.
[1] Bloomberg Barclays U.S. Corporate Index.

how credit spreads are compensating investors and proved insightful for evaluating the effects of the Fed's corporate credit facilities. The components of total spread each behave differently at different points in a credit cycle, vary in length, and are impacted by different market forces. In our work, we have found that Fed actions taken to alleviate market stress primarily influence the liquidity risk premium.

As shown in Figure 1, the liquidity risk premium peaked in March 2020. It had largely returned to normal by June after the Fed implemented the credit facilities and started actively participating in the market (see Figure 2). Since June, the credit risk premium has continued to compress as the economy started to recover and the outlook for corporate fundamentals improved. In the end, the Fed proved to be a very small buyer in the credit markets; nevertheless, we believe the central bank achieved its objectives.

Corporate Credit Facilities Allowed to Expire

In November 2020, the Treasury instructed the Fed to let the corporate credit facilities expire on December 31. The Treasury allowed the Fed to continue its commercial paper, money market, and bank collateral facilities until March 31, 2021.

Some market participants have suggested that the Treasury and the Fed extend all support facilities. We, however, believe the cessation of corporate credit facilities is a good outcome for both the short and long terms. The elimination of these programs reduces the risk of exogenous influences on market pricing sending false signals to both issuers and investors. A prolonged period of this type of misinterpreted activity could potentially lead to capital misallocation and rising credit imbalances. If left unchecked, this could have the unintended consequence of potentially increasing credit market fragility and the risk of another extreme event that damages market function.

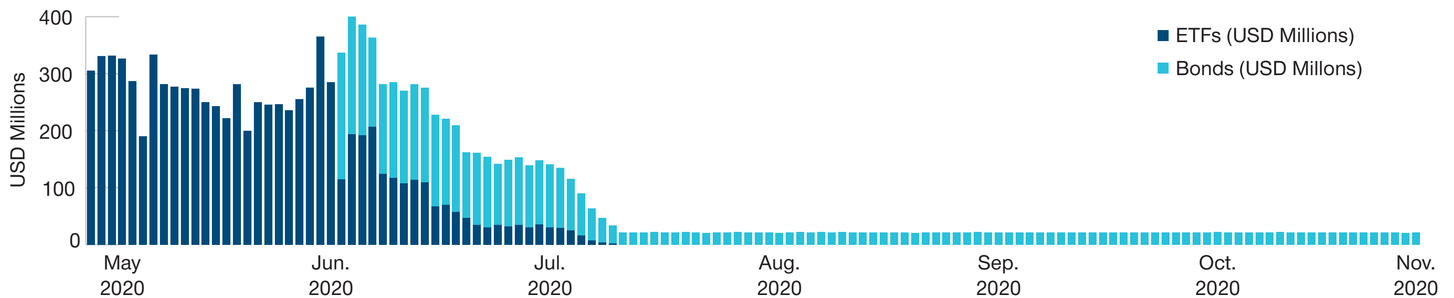
Outlook for 2021

With the Fed's more limited role, fiscal policy actions will take on greater significance in the broader economic revival that we expect in 2021. We believe fiscal actions, such as the USD 650 billion Paycheck Protection Program, have already had a greater impact on the recovery than the Fed's corporate credit facilities.

We are seeing material improvements in third-quarter corporate profitability, which

Fed Buying Slowed After June 2020

(Fig. 2) Daily pace of SMCCF[1] bond and ETF purchases



As of November 12, 2020.
Source: Federal Reserve.
[1] Secondary Market Corporate Credit Facility.

has reduced corporate solvency risk. According to J.P. Morgan, third-quarter corporate revenues (excluding the energy sector) were up 0.6% from the previous quarter and 0.4% from the period a year earlier. In addition, overall profitability was a steady 30.4%, a 0.6% increase from 2019's third quarter. These metrics indicate a rebound from the trough levels of the second quarter of 2020.

It is encouraging that a USD 900 billion relief act was implemented in December with bipartisan support. As part of the stimulus agreement, the Fed will not be permitted to restart its emergency lending programs—including the corporate credit facilities—without approval from Congress. We expect the new U.S. administration will lead action toward further fiscal stimulus in the first half of 2021.

Dispersion in Spreads Across Industries

We expect credit market technicals to improve from 2020 as we anticipate lower net new issue volume and ongoing support for higher-yielding corporate securities versus government bonds with lower—or even negative—yields. There is still meaningful dispersion in credit spreads across certain investment-grade corporate industries and issuers, which presents attractive opportunities for credit selection. An uneven recovery from the COVID-19 pandemic in 2021 could create more opportunities to find relative value in the asset class.

We currently find select bonds in the real estate investment trust (REIT), energy, and travel and leisure segments attractive. We believe these industries still have not fully recovered and anticipate they will benefit from improving 2021 fundamentals. In REITs, we prefer bonds issued by companies focusing on apartments as well as industrial and health care-related commercial properties. In energy, our credit analysts have been finding opportunities in higher-quality credits in the exploration and production industry, where expected consolidation should support fundamentals. As always, we will rely on our deep fundamental research platform to uncover opportunities moving forward.

WHAT WE'RE WATCHING NEXT

While we focus on credit research and selection to inform broad positioning in our investment-grade corporate portfolios, we also consider positioning along the yield curve. We currently see limited room for spread compression in shorter-maturity notes, although they offer some defensive characteristics. Longer-term bonds, including 10-year paper, provide more potential for appreciation from narrowing spreads at the expense of higher interest rate risk.

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