The Federal Reserve: Central Banker to the World

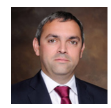
Why the Fed's policy responses have implications for global financial markets.

April 2020

KEY INSIGHTS

- Federal Reserve's aggressive action dominates central bank moves.
- An extended period of low U.S. rates with muted volatility is expected.
- Crisis illustrates Fed's strategic importance to the rest of the world.

Global Fixed Income Team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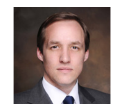
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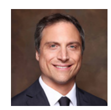
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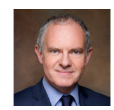
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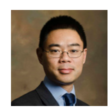
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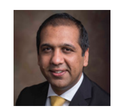
Saurabh Sud

Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

In recent months, four separate, but related, crises hit financial markets at the same time: a public health crisis, an economic crisis, a liquidity crisis, and an energy crisis. In response to these extraordinary events, major central banks unveiled significant monetary easing programs, with the Federal Reserve leading the charge by digging deeper into its crisis-fighting toolkit than ever before. During our latest policy meetings, the investment team discussed the Fed's action and its implications for the vast range of financial markets.

Fed Goes Above and Beyond

Going even further than it did during the global financial crisis, the Federal Reserve cut interest rates and announced multiple programs to support the functioning of markets. For the first time, these programs included plans to buy investment-grade corporate bonds and some types of high yield bonds. "The Fed's action has been unprecedented and goes far beyond anything we have seen before," said Arif Husain, portfolio manager and head of International Fixed Income.

The measures are helping. Markets supported by the Fed have now stabilized after the traumatic events of March, when every fixed income sector ground to a halt as a huge demand for cash even strained trading activity in Treasuries—the most liquid bond market. "The Fed's aggressive action leaves others playing catch up," said Mr. Husain. "While almost all major central banks have launched their own types of easing programs, it's the Fed that everyone is watching for direction."

U.S. Treasuries may Remain the Best "Safe Haven" in Fixed Income

With quantitative easing (QE), and rates near zero, the Treasury curve is well supported right now leaving the two-year yield effectively anchored around the 0.25% level. "The QE program put in place by the Fed has essentially killed interest rate volatility and anchored rates in the U.S.," said Mr. Husain.

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> — **Arif Husain**
> *Portfolio Manager*

This type of environment may persist for some time. The recovery from what could be one of the deepest economic contractions of modern times is likely to be slow, with the potential for setbacks along the way. For risk markets, this could mean more bouts of volatility and swings in prices—conditions in which Treasuries might thrive, thanks to their status as a "safe haven" in global fixed income being reinforced recently by the Fed supporting the market.

"There is no point fighting central banks," said Mr. Husain. "With so much still uncertain about how things will play out, we believe that it may make sense until we get more clarity to maintain duration in U.S. Treasuries and other high-quality government bond markets where curves are modestly steep, such as Australia, Canada, and Israel."

Over a longer-term horizon, it's important to be aware of the risks, however. Historically, the Fed has been keen to lift rates away from zero and taper its balance sheet when the environment returns to normal. "At that point, volatility may return spectacularly," said Mr. Husain.

The Fed's Importance at International Level Is Growing

During the 2008 financial crisis, the Fed opened swap lines with several countries to support the international supply of dollars. The Fed quickly redeployed the program again in mid-March to help ease cash pressure on smaller central banks and non-U.S. industrial borrowers.

To further alleviate funding stresses outside the U.S., the Fed established a new repurchase program, the Foreign and International Monetary Authorities (FIMA) Repo Facility, at the end of March. This program allows certain foreign central banks and international monetary authorities to repo part of their U.S. Treasuries holdings in exchange for cash. The move has been viewed as an attempt by the U.S. central bank to further curtail volatility in U.S. Treasuries.

"The Fed understands that opening repo facilities with foreign central banks in need of U.S. dollars is a good way to limit forced selling of U.S. Treasury holdings," said Mr. Husain. "Another advantage of the new facility is that it is helping to stabilize the U.S. dollar," he added.

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The current crisis has reasserted the perception that the Fed is the world's central bank (although whether the bank aspired to this status or had it thrust upon it remains unclear). For now, all eyes remain on the Fed for direction—and the risk that it may need to step in further and take drastic action is higher today than it has ever been before.

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