Aggressive Fed Actions Address Illiquidity

Liquidity has improved enough to support credit stabilization.

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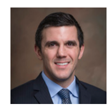

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KEY INSIGHTS

- Aggressive measures by the Fed to support liquidity in financial markets have resulted in incremental improvements in conditions in many of those markets.
- In addition to monetary policy actions, the central bank has relaxed some regulatory capital requirements to give banks more ability to supply liquidity.
- We believe the Fed's measures have created an environment where credit stabilization can occur by reducing risk premiums for liquidity.

Aggressive measures by the Federal Reserve to support liquidity in various financial markets after the sudden onset of the coronavirus pandemic have resulted in incremental improvements in conditions in many of those markets. After trading in some markets completely broke down following the "double black swan" of the coronavirus and Saudi Arabia's decision to increase oil production, liquidity is moving closer to normal. While continuing bouts of volatility show that liquidity problems are not yet completely fixed, we believe that the Fed's actions have created an environment where credit stabilization can occur by reducing risk premiums for liquidity.

Complete Shift in Environment in One Month

It is hard to believe that, as recently as February, there were questions about whether the Fed would continue to purchase USD 60 billion per month of Treasury bills, a program that it started to alleviate upward pressure on overnight lending rates in 2019. In early February, we published "Fed Likely to Expand Liquidity Programs," detailing our outlook for the Fed to use its balance sheet to address periodic problems with the financial system's plumbing. It's remarkable that the environment has completely shifted from expected reflation to a pandemic shutdown with a Fed quantitative easing (QE) program that dwarfs its early-year purchases of Treasury bills.

The Fed's reaction to the scramble for cash triggered by the pandemic has been aggressive and very quick relative to the central bank's moves in past crises. By rapidly cutting the federal funds target range to 0%–0.25% and implementing various programs to support functioning markets, ranging from backstopping the commercial paper[1] market to buying

[1] Short-term debt issued by corporations.

More than USD 1.6 trillion

The amount of the Fed's balance sheet expansion in March.

investment-grade corporate bonds, the Fed has already done more in a month than it did in all of 2008—the height of the global financial crisis. The Fed's new QE purchases of Treasuries, mortgage-backed securities, and corporates had already expanded its balance sheet by more than USD 1.6 trillion as of late March.

Regulatory Capital Requirements Relaxed

While the Fed's monetary policy actions have been well publicized, the central bank has also significantly relaxed some regulatory capital requirements, giving banks more ability to use their balance sheets to supply liquidity. The Fed allowed banks to use their last four quarters of retained earnings for determining capital requirements, smoothing out major drops in earnings that would have restricted the capital they can deploy in markets. Regulators also delayed the implementation of current expected credit losses (CECL) accounting, which should also free up more capital. Very significantly, on April 1, the Fed announced that it would temporarily remove Treasuries and Fed deposits from regulatory calculations of bank leverage in an effort to encourage banks to lend.

Improvement in Money Market Liquidity Supports Financial System

The liquidity improvement has been most apparent in money markets, which are most important for overall financial system functioning—they are essential in the plumbing of the financial system. The Fed was able to stop a run on prime money market funds[2] through its Money Market Mutual Fund Liquidity Facility (MMLF). In the span of two weeks, money markets went from 2008 levels of pressure and dislocations to 2014 levels of liquidity and low rates for high-quality paper. However, there is still stress in the market for lower-quality paper not included in the MMLF, as well as for longer-dated paper.

Air Pockets in Corporate Credit

Corporate credit markets have recently experienced some outsized gains characterized by "air pockets," or gaps in liquidity, after a brutal two weeks of illiquid downward price gaps following Saudi Arabia's oil production announcement. Investment-grade issuers have rushed to take advantage of the improved conditions and raise cash to ride out the pandemic, leading to USD 100 billion of new issuance in the week ended March 27—a weekly record. In the high yield bond market, fast food company Yum Brands brought one of the first new deals to market since early March. Investors flocked to the USD 600 million issue, which was heavily oversubscribed.

As of March 27, credit spreads[3] in both investment-grade and high yield corporate bond markets had retraced approximately half of their widening earlier in March. Liquidity in both markets has improved, although the high yield market is lagging. Even in investment-grade corporates, the air pockets on positive moves show that liquidity is still inconsistent.

Improved Liquidity Boosts Municipal Debt

Municipal bonds endured a particularly steep sell-off on very limited liquidity. However, later in March, municipals rallied strongly on much improved liquidity to finish the month by recovering much of their difference in yield relative to Treasuries. The Fed's decision to include high-quality municipal debt with maturities of 12 months or less in its MMLF stabilized shorter-maturity paper, which allowed liquidity to flow into longer-maturity segments of the municipal market.

[2] Prime money market funds can hold instruments with credit risk.
[3] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

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Credit spreads on the highest-quality securitized debt that is part of the Fed's QE rapidly tightened on much better liquidity. High-quality asset-backed securities experienced significant credit spread tightening in the week ending March 27. The market for AAA rated non-agency mortgage-backed securities also thawed.

Equities Not Immune to Limited Liquidity

Although they are somewhat more insulated from problems in the overnight rates market than credit sectors, equities have not been immune from illiquidity and pricing gaps. Relative to historical conditions in the asset class, liquidity in U.S. equities has been just as limited as in credit markets. Like some fixed income segments, at least some of the impressive rally in stocks during the week ending March 27 probably stemmed from liquidity air pockets on the sudden move higher as opposed to simply a change in risk appetite. Even stocks in the utilities sector—typically thought of as defensive, low-beta[4] holdings—recently priced in implied volatility of 40% to 60% as a result of liquidity concerns.

Significant Overall Liquidity Improvement

A sustainable recovery in risk assets will depend almost entirely on the timing of improvement in the global health situation. Before the Fed's recent aggressive actions, we doubted that market liquidity would be sufficient to allow true stabilization to take hold. Now that the unprecedented monetary policy support from the Fed and other global central banks has addressed potential problems with the financial system's plumbing, it appears that liquidity in various markets would support longer-term stabilization in credit markets and other risk assets. However, it will take time for liquidity to completely normalize.

WHAT WE'RE WATCHING NEXT

We continue to monitor the use of the Fed's dollar swap lines that allow foreign central banks to borrow U.S. dollars in non-U.S. currencies to support the international supply of dollars. Also, on March 31, the Fed announced that it would lend other central banks dollars in exchange for Treasuries they hold, which should further alleviate dollar funding stress outside the U.S.

[4] Beta measures a stock's volatility relative to the volatility of the broad equity market.

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