Gerry's Journal

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The Fed Strengthens the "Three-Legged Stool"

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In the previous Gerry's Journal entry, I discussed three areas that policymakers will need to focus on in order to support the U.S. economy going forward: monetary policy, fiscal policy, and public health policy. Together, these three policy realms make up the "three-legged stool" of economic stability, and on April 9th, we got an important update regarding the monetary policy "leg" of the stool.

On that day, Federal Reserve Chairman Jerome Powell announced a new round of stimulus measures which included three key points.

1. The Fed will begin buying some corporate junk bonds.
2. The Fed will create a Main Street Lending Program that will provide $600 billion in loans to small and mid-sized businesses.
3. The Fed will create a Municipal Liquidity Facility that will provide $500 billion in loans to state and local governments.

The Fed enters the market for corporate junk bonds

Back on March 23rd, the Fed announced plans to purchase investment grade corporate bonds along with exchange-traded funds that have exposure to the investment grade bond market.[1] The goal of this initiative was to bring much needed liquidity (and buying interest) to a corporate bond market that has seen the volume of sellers dwarf the volume of buyers in recent weeks. Jerome Powell's announcement on April 9th expanded the scope of this program by including certain high yield corporate bonds on the Fed's prospective shopping list.

Important to note however, is that the Fed's program is specifically designed to support "fallen angels." These are companies like Ford, Macy's, and Kraft Heinz that were investment grade but have recently received a ratings downgrade. The criteria for which companies qualify as "fallen angels" is quite strict: a company must have been rated BBB-/Baa3 by at least two agencies on March 22nd and now have a rating lower than BB-/Ba3. While the scope of this program is relatively narrow, the decision by the Fed to enter the "junk" portion of the corporate bond market is historically unprecedented.

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[1] https://www.forbes.com/sites/nathanvardi/2020/03/23/the-federal-reserve-moves-to-buy-corporate-debt, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm

A new round of loans for small- and medium-sized businesses

The second move by the Fed was to establish a "Main Street Lending Program". This program will distribute up to $600 billion in loans to small and medium sized businesses, and is in addition to the $349 billion Paycheck Protection Program (PPP) that was authorized through the Corona Aid, Relief and Economic Security Act ("CARES Act") that was passed by Congress late last month.

The Main Street Lending Program is designed for any business that has fewer than 10,000 employees or $2.5 billion in revenue in 2019. Principal amounts will range from $1 to $25 million on a four year term, and interest payments will be deferred for the first year. The interest rate on these loans will be the Fed's current overnight lending rate (currently 0.01%) plus 250 to 400 basis points (2.50% to 4.00%).

As with PPP, these loans will be distributed by major banks, with the issuing bank retaining 5% of each loan. The Fed will then hold the remainder of the loan and the U.S. Treasury will "backstop" losses of up to $75 billion through the program.

Support for state and local governments

The final measure announced by Jerome Powell was the creation of a Municipal Liquidity Facility. This facility will provide $500 billion in loans to state and local governments and — like the decision to purchase some "junk" corporate bonds — the Fed becoming a buyer of state and municipal bonds is historically unprecedented.

This municipal bond program, along with the Main Street Lending Program and "fallen angel" initiative means the Fed's actions in 2020 have significantly exceeded monetary policy actions taken during the 2008 financial crises.[2]

Unemployment and the impact on corporate America

While the Fed's actions are "unprecedented", they are in response to a truly "unprecedented" labor market. Last week the Labor Department reported that 6.6 million new unemployment claims were received during the week ending April 4th, bringing the 3 week total of new unemployment claims to just under 17 million.

And just this week, the Wall Street Journal reported on the impact that COVID-19 has had on corporate America: nearly 300 companies in the S&P Composite 1500 Index — which covers roughly 90% of U.S. market capitalization — have withdrawn their financial guidance. Another 175 companies have

[2] https://www.nytimes.com/2020/04/09/business/economy/fed-economic-rescue-coronavirus.html

suspended stock buybacks or cut dividends, and one hundred firms that employ some three million people said they planned to furlough workers.[3]

Where the three legs of the stool stand now

In light of the Fed's announcement, how would we assess the strength of the three legged stool? Here are our current thoughts.

Monetary Policy

The Fed's response has been impressive, especially considering the truly unique challenges that COVID-19 has brought to the U.S. economy. We like the proactive and aggressive steps taken by the Fed, such as lowering benchmark rates, turning on "the spigot" for quantitative easing, and the March 23rd decision to backstop the money markets.

We've also been impressed by the Fed's willingness to think outside the box in finding new ways to address new challenges. The Fed continues to show leadership and has performed admirably in its role as chief firefighter — financial or otherwise. **Grade: A**

Fiscal Policy

Credit where credit is due: Congress' ability to pass the CARES Act in a partisan environment with a tight deadline was an important fiscal policy step that provided a measure of much needed stability. It's easy to Monday morning quarterback the exact details of the bill, or find ways to improve it (which do exist), but the speed at which the bill was deployed was impressive. **Grade: B-**

Health Policy

Because so much was (and is) unknown about COVID-19, finding the right health policy response provides a unique set of challenges. While the President has proclaimed himself a wartime president and the coronavirus the enemy, based on information that is slowly percolating out, it would appear that the current administration was slow to respond to warnings about COVID-19 received as early January 3.[4] Hindsight is 20/20 in terms of what should have been done, and when, but time and further research are needed to appropriately grade the health policy response. For the time being a patchwork of federal, state and local travel, and other restrictions combined with many corporations implementing policies aimed at protecting their employees appear to be having a positive impact in slowing the rate of infection. One thing is certain: there are still many challenges ahead and a broad-based economic recovery may arrive slower than some are hoping for. **Grade: Incomplete**

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[3] https://www.wsj.com/graphics/how-coronavirus-spread-through-corporate-america/

[4] https://www.washingtonpost.com/national-security/2020/04/04/coronavirus-government-dysfunction/?arc404=true

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Since early February, we have been following the COVID-19 pandemic and its impact on public health and investment markets. We will continue to do so in the weeks and months ahead. If you have any questions or concerns about your investments, the markets, or the ongoing response to the pandemic, please don't hesitate to contact us. We're here to support you during these challenging times.