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THE FED'S LATEST INITIATIVE: A GAME-CHANGER

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The Fed policy initiatives introduced in recent weeks together represent a game-changer for the economy -- in ways that go beyond what you might think.

For the last two weeks plus, the Federal Reserve has been feverishly announcing policy initiatives intended to stem panic in the financial markets and in the economy. We think the direct credit market interventions announced by the Fed this week have the potential to be the most effective steps the Fed has taken in the past 30 years, possibly the most effective ever.

Why are these most recent steps so important? The fact is that wide swaths of the economics community believe Fed policy has had little (no?) effect since the onset of the global financial crisis (GFC) in 2008. The steps the Fed announced yesterday could work around that ineffectiveness and allow Fed policy to once again meaningfully influence the economy.

Monetary policy from the Fed, or from any central bank, works through the commercial banking system. Lower rates and larger supplies of liquidity are intended to stimulate bank lending and money creation, thence spending across the economy. However, the emergence of wide-ranging, stringent capital requirements for banks work to short-circuit that process.

Central banks can flood the banking system with reserves. However, reserves are not capital, and banks are unable to lend out plentiful reserves if their balance sheets are capital-impaired, as they typically are during a recession, or if banks are worried that their capital positions could become impaired.

Prior to the 1990s, capital requirements were generally "honored in the breech" during times of financial stress. However, with the passage of the Basel Accords, imposing a slew of globally implemented capital requirements, and with Sarbanes-Oxley, Dodd-Frank and a number of other laws assiduously monitoring capital requirements across the business cycle, banks have simply ceased to utilize the liquidity that the Fed and other developed market central banks have injected into their financial systems.

For example, under repeated quantitative easings—QE1, QE2 and QE3—the Fed injected $3 trillion of liquidity into the US banking system. The result was a nearly equal increase in banks' holdings of excess reserves, with no comparable acceleration in bank lending nor in the money stock nor in the pace of economic growth.

The latest initiatives have the potential to end-run these impediments. Again, the problem has been that the Fed injects liquidity, but banks sit on it. Well, the latest Fed moves effectively bypass the banking system.

The Fed, operating in effective partnership with the Treasury and Small Business Administration, will be lending directly to private-sector companies, via direct purchases of the corporate bonds of large companies and direct loans to smaller companies.

Furthermore, and perhaps as importantly, the Fed also seems to be effectively waiving the capital requirements on banks, basically giving them license to lend to individuals and companies without having to worry about capital adequacy, at least for a while. The announcements here have been both subtle and vague, as they would have to be given the strictures of various laws. However, banks are likely to get the message.

This is the way the financial system ran during crises/recessions prior to the Basel Accords and Dodd-Frank. Banks were allowed to get credit flowing to revive the economy, and capital concerns were generally put on hold until the economy had recovered. It appears that we are taking a step backward in time in order to move forward presently with the economy.

Finally, even while monetary policy had been stymied in its ability to directly stimulate the economy, it still had the ability to address disorderly market conditions. Again, there is little evidence that the QE of 2008-2014 directly stimulated economic growth, but it does seem clear to us that the Fed's actions in the fall of 2008 to flood the financial system with liquidity did stem the market panic at that time.

In disorderly markets, any semblance of normal trading disappears, price discovery and valuation essentially cease, and what trading does occur proceeds in a near-vacuum. By providing market liquidity and by engaging in a few, selectively targeted trades, the Fed can restore order to markets.

It did so successfully in late-2008 in the fed funds and commercial paper markets, and, eventually, in the Treasury and corporate bond markets. Now, with its stated intention of directly purchasing corporate bonds, the Fed appears ready to work to directly calm markets that are presently frayed as much as they ever were in the dark days of 2008.

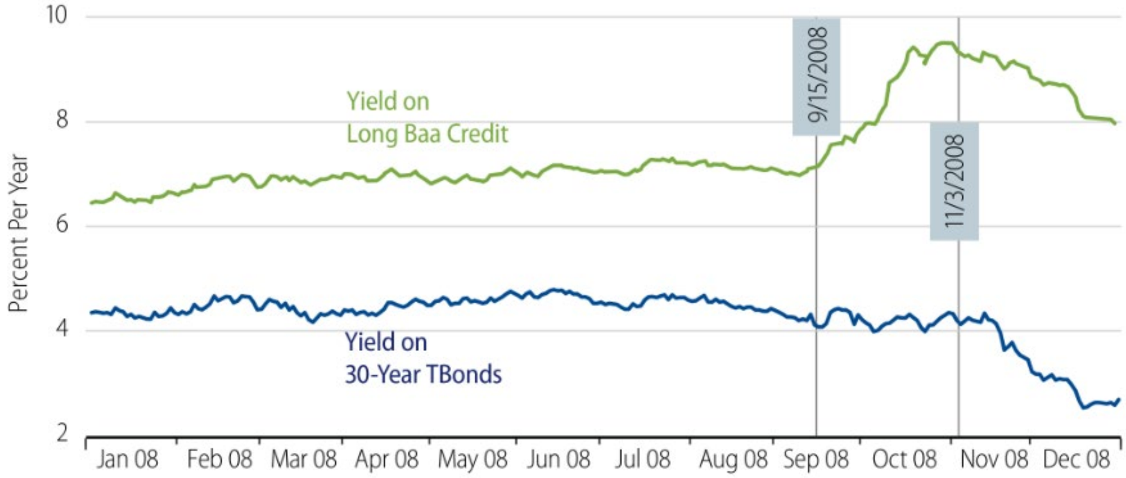
Some analysts are complaining that the $30 billion or so of capital currently amassed for these operations is too small. We believe this attitude is myopic. Again, disorderly markets are an altogether different phenomenon. It doesn't take a lot of funds withdrawn from the market—at the right (meaning "wrong") time—to drive them into chaos.

By the same token, it doesn't necessarily take much trading to restore market order, precisely because trading is occurring in such a vacuum. Furthermore, in any case, our sense is that now that the Fed and Treasury are embarked on this course, Congress will provide them whatever "ammunition" they need to see it through.

Yes, all of this raises issues of government/Fed bailouts and a creeping Fed/government takeover of the economy. For now at least, those concerns are being ignored, for better or worse in the long run.

In closing, the two charts here may be instructive. The first chart shows TBond (U.S. Treasury) and Long Baa bond yields during the GFC. You may not recall that Fed operations did not inject a single dollar of liquidity into the system until September 15, 2008, the day Lehman, AIG and others failed. After that day, the Fed opened the spigots freely. TBond yields had NOT declined much in the early days of the crisis, despite the economy falling into recession in November 2007. Indeed, it wasn't until November 2008 that TBond yields began to decline meaningfully, and long corporate bond yields soon headed down, after having soared previously.

Exhibit 1: Long Bonds and Long Corporates During 2008 Global Financial Crisis



Source: Federal Reserve Board, Moodys. As of 20 Mar 20. "Baa Credit" refers to corporate bonds with credit ratings of Baa. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

In other words, the liquidity squeeze did not end immediately when the Fed started flooding the system with cash. However, as this flood accumulated, TBond yields did eventually work their way lower, and corporate yields declined not long after.

Now, flash forward to current events. Obviously, TBond yields INITIALLY declined from the early days of late-February when virus fears first proliferated. Notice that over that period, corporate bond yields dropped as well. Yes, option-adjusted spreads were widening, but at least corporates showed SOME duration. It was on about March 9, 2020 when a liquidity crunch really set in. Corporate yields went vertical then, and even TBond yields rose—with yet sharper yield increases for off-the-runs and TIPs.

Exhibit 2: Long Bonds and Long Corporates Presently

Source: Federal Reserve Board, Barclays. As of 20 Mar 2020. "Baa Credit" refers to corporate bonds with credit ratings of Baa. "Baa Credit" refers to corporate bonds with credit ratings of Baa.. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

So, what began as an economy-based panic devolved/expanded into a liquidity panic as well over the last two weeks. Yes, the Fed has been quicker on the draw presently and quicker in expending the “reach” of its operations than it was during the GFC. Hopefully, this will allow for a quicker disposition of at least the panic-related aspects of the recent selloff. The economic loss aspects will be harder to dislodge, but addressing panic is never a bad thing.

About Western Asset

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Definitions:
The Federal Reserve Board ("Fed") is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.
The financial crisis of 2007–08, also known as the Great Financial Crisis or Global Financial Crisis (GFC), global financial crisis and the 2008 financial crisis, was a severe worldwide economic crisis considered by many economists to have been the most serious financial crisis since the Great Depression of the 1930s, to which it is often compared.
The Basel Accords, including Basel III is a comprehensive set of reform measures designed to improve the regulation, supervision and risk management within the banking sector.
The Sarbanes–Oxley Act of 2002, also known as the "Public Company Accounting Reform and Investor Protection Act" (in the Senate) and "Corporate and Auditing Accountability and Responsibility Act" (in the House) and more commonly called Sarbanes–Oxley, Sarbox or SOX, is a United States federal law that set new or expanded requirements for all U.S. public company boards, management and public accounting firms.
The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) placed major regulations on the financial industry following the financial crisis of 2008-2009 including the possibility of breaking banks up if any of them are determined to be “too big to fail.”
Quantitative easing (QE) refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.
QE1 refers to the Fed’s initial round of quantitative easing begun in late November 2008 when it started buying $600 billion in mortgage-backed securities.
QE2 refers to the Fed’s second round of quantitative easing, announced in November 2010, whereby the Fed would buy $600 billion of Treasury securities by the end of the second quarter of 2011. In August 2010, Fed Chairman Ben Bernanke pre-announced QE2 at the annual economic policy symposium in Jackson Hole, Wyoming.
QE3 refers to the Fed’s third round of quantitative easing, initiated September 13, 2012, whereby the Fed would buy $40 billion of mortgage-backed securities per month from member Federal Reserve banks. QE 3 also continued Operation Twist, which is the name given to a Federal Reserve monetary policy operation where the Fed buys and sells short-term and long-term bonds depending on their objective.
U.S. Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.
The Small Business Administration (SBA) is an autonomous U.S. government agency established in 1953 to bolster and promote the economy in general by providing assistance to small businesses. One of the largest functions of the SBA is the provision of counseling to aid individuals trying to start and grow businesses.
The federal funds rate (fed funds rate, fed funds target rate or intended federal funds rate) is a target interest rate that is set by the FOMC for implementing U.S. monetary policies. It is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

Commercial paper is an unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts payable and inventories and meeting short-term liabilities. Maturities on commercial paper rarely range longer than 270 days.
"Long bond" refers to bonds, usually U.S. Treasuries, with long-dated maturities, including 30-year Treasuries.
BAA is a credit rating denoting a medium grade, moderate risk security.
The Lehman Brothers investment bank filed for Chapter 11 bankruptcy protection on Monday, September 15, 2008. The filing remains the largest bankruptcy filing in U.S. history to date, with Lehman holding over $600 billion in assets.
On September 16, 2008, the Federal Reserve provided an $85 billion two-year loan to the global insurance company **AIG (American International Group)** to prevent its bankruptcy and further stress on the global economy. In return, the Fed took ownership of 79.9 percent of AIG's equity. That gave it the right to replace management, which it did.
An **Option-Adjusted Spread (OAS)** is a measure of risk that shows credit spreads with adjustments made to neutralize the impact of embedded options. A credit spread is the difference in yield between two different types of fixed income securities with similar maturities.
Duration measures the sensitivity of price (the value of principal) of a fixed-income investment to a change in interest rates. The higher the duration number, the more sensitive a fixed-income investment will be to interest rate changes.
U.S. Treasury Inflation Protected Securities ("TIPS") are bonds that receive a fixed, stated rate of return, But they also increase their principal by the changes in the CPI-U (the non-seasonally adjusted U.S. city average of the all-item consumer price index for all urban consumers, published by the Bureau of Labor Statistics). TIPS, like most fixed income instruments with long maturities, are subject to price risk.
A **central bank** is a national bank that provides financial and banking services for its country's government and commercial banking system, as well as implementing the government's monetary policy and issuing currency.
Barclays Bank is the former owner of the Bloomberg Barclays data series on fixed income.
Moody's Investors Service is a bond rating agency in the business of assessing credit quality, a measurement of a bond issuer's ability to pay interest on the bond in a timely manner. They do so by issuing ratings which inform investors of an investment's credit worthiness, or risk of default. Ratings typically range from AAA (highest) to D (lowest). Please see www.standardandpoors.com, www.moodys.com, or www.fitchratings.com for details.