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THE FED GOES UNLIMITED. REALLY?

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The Fed announces new programs to provide liquidity

In response to the worsening of global macroeconomic conditions, increasing confinement measures taken by U.S. states, the uninterupted fall of the equity market and growing signs of liquidity stress, the Fed has announced a new round of measures to keep financial markets operating smoothly, and to provide lending more directly to those sectors most in need. The new round of measures will:

- Now include unlimited purchases of Treasury and mortgage-backed securities – they had previously been limited to USD500bn and USD200bn respectively.
- ProvideUSD300bn more in new financing to employers, consumers and businesses via a new program to be defined and capitalized by the U.S. Treasury, with USD30bn coming from the ESF (Exchange Stabilization Fund).
- Create two new facilities to support credit to large employers: the PMCCF (Primary Market Corporate Credit Facility), for new bond and loan issuance, and the SMCCF (Secondary Market Corporate Credit) to provide liquidity. Only investment grade companies will be eligible. They will be able to benefit from a four-year financing bridge.
- Ressurect the TALF (Term Asset-Backed Securities Loan Facility) to encourage the issuance of ABS (Asset-Backed Securities) backed by student loans, auto loans, credit card loans and loans guaranteed by the Small Business Administration.
- Make municipal bonds with variable rates and banks' certifcates of deposit elligible for the MMLF (Money Market Mutual Fund Liquidity Facility)
- Extend the securities being targeted by CPFF (Commercial Paper Funding Facility).
- Create a Main Street Business Lending Program to support lending to small and medium-sized businesses.

Different signals from the market showed a multiplication of liquidity stress

A series of indicators had showed that different markets were recently experiencing episodes of stress in terms of liquidity. The treasury market, the ABS market, the market of private debt and liquidity of derivatives all saw a significant widening of spreads scrtutinized by investors. This showed that there is currently no alternative to cash and that asystemic risk is at stake. We have to remember that the freezing of the money market in 2008-2009 was one of the most important triggers of the crisis. Recently, the most striking aspect of this drying-up process in liquidity was related to

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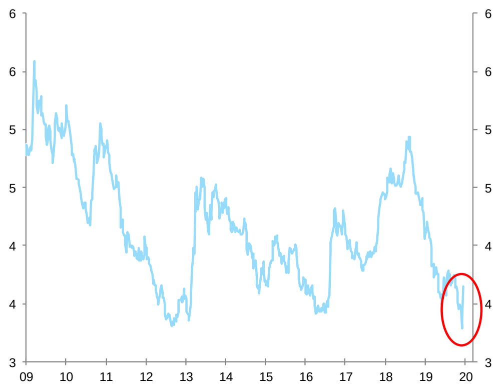
the MBS (Mortgage-Backed Securities) market. Despite huge amounts of liquidity injected into the economy, mortgage rates were increasing as the freezing of the MBS market (backed by mortgage assets) incited banks to significantly tighten their credit conditions. We have clearly here the illustration of an inefficient transmission of the monetary policy (see Figure 1). In order to avoid the current crisis escalating (a total freezing of monetary and financial conditions, which would have even more devastating and long-lasting consequences), the Fed decided to ramp up its arsenal to ring-fence the current liquidity crisis (besides the sanitary and economic crisis).

Figure 1 – U.S. mortgage rates (%)



Sources: Euler Hermes, Allianz Research, IHS

Please mind the policy mistake. Lending under the PMCCF and the SMCCF facilities is only for investment grade companies. This could signal that the Fed is unwilling to support high-yield (HY) companies. These companies have much poorer credit quality and therefore will have a much more difficult time refinancing during the current crisis. This could be particularly risky since there is now a much larger HY market than in the previous financial crisis, or more specifically a much larger share of BBB rated companies, which are on the fringe of junk status. This sector of the bond market is therefore highly at risk of a major re-rating scenario and could experience a sudden stop in terms of access to funding. This re-rating scenario could significantly hinder the recovery. Separating the HY segment from investment grade in terms of giving access to credit or liquidity facilities is comparable to not giving the priority to sovereign spreads when conducting monetary policy in Europe.

Avoiding at all costs a protracted and long-lasting type of crisis. Several of the programs are designed to provide funding directly to employers and consumers. These new facilities, the so-called TALF, PMCCF and SMCCF are pretty close to directly channelling cash to actors of the real side of the economy. They consist of the Fed coordinating with banks and the government to directly lend to economic actors,. adopting the philosophy of a so-called GBCF, a Government-Backed Credit Facility, on the back of Section 13(3) of the Federal Reserve Act. Last week, we considered it as being likely that such a framework would be activated (idea of Kevin Warsh, a former member of the Federal Reserve). By ring-fencing the liquidity crisis and increasingly opting for direct credit to the real side of the economy, the Fed aims at preventing the current temporary shock from transforming into a protracted and long-lasting type of crisis.

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