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Rubrics Fixed Income Update

Crossing the Line

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Introduction

Has central bank interference in capital markets gone too far? Thursday's announced extension to the Fed's corporate bond purchasing programme to include fallen angels and high yield ETFs marks a truly astonishing development. Perhaps even calling into question the role of capital markets within the economy itself.

Interference

Throughout this crisis many have asked whether the continued economic shutdown is a price worth paying to fight the virus. It represents a trade-off between saving lives and health services today and prolonged economic hardship tomorrow. As difficult a question as it may be, it can in some way be quantified. The impact of central banks' interference with the operation of capital markets on the other hand is a far more nuanced issue. The real economy needs significant support and fast. The capital markets need to know that there is adequate liquidity to operate with some degree of efficiency and stability. However, when do we know when central banks have crossed that line from market support to market manipulation, and who decides who wins and who loses? Who even controls the process when the lines between the treasury and central banks have become so blurred? When we see US Hedge Funds looking to tap into the Paycheck Protection Programme, notwithstanding the fact that the Fed is already lending enormous support to their over-leveraged portfolios, we do have to question what dimension we are living in!

Power

Much as Trump has done in claiming "total" authority in deciding how and when to re-open the US economy (is this really true?) Jerome Powell has also highlighted the absolute power at the Fed's disposal in asserting they "won't run out of ammunition" in providing liquidity to the market. Liquidity or support for asset prices? It was interesting to note that Thursday's Fed announcement coincided with the horrendous jobless claims release. Remarkably it was only a week ago that the ex-head of the New York Federal Reserve William Dudley claimed that the Fed would never buy high yield bonds, that such an act would be supporting businesses that had previously acted irresponsibly. And yet here we are. Morgan Stanley and JP Morgan reacted swiftly to hail the decisive actions of the Fed with forecasts in for new all-time highs by Q1 2021. However this positive view was far from universal, with many questioning the Fed's latest policy.

Bad Bail-Outs

The Fed has a history of jumping from one rescue package to the next creating ever-growing boom-bust cycles. This time around, they claim that no one is to blame, just the virus, hence there are no limits to what they can do, no line they cannot cross in supporting the economy and asset prices. We would argue however that the Fed themselves have played a central role in creating a financial market that was very susceptible to external shock. In attempting to remedy the situation, the problem lies in the fact that the Fed has a much greater chance of supporting the markets than the economy directly due to the difficulties in providing immediate financing to small businesses. This will not sit well with much of the onlooking populace, no longer wealthy enough to own assets due to the increased inequality created by previous Fed policies. Bailing out the "bad actors" from this cycle is probably going to play even worse with the public than the bailing out of Wall Street in 2008. We have already seen heavy criticism of the airlines looking for bailouts in spite of the wasted billions on share buyback programmes (many of which were in essence underwritten by the Fed in the first place).

More Debt

The problems for the Fed are manifold. The real economy has had to come to a complete stop. The dichotomy between financial markets and the real economy at the end of January 2020 was perhaps as large as it had ever been - however critical in the “Fed’s eyes” was the need to ensure consumer sentiment and spending stayed strong. When the economy began shutting down the financial markets cratered in part due to the fractured structure of the financial markets (thanks to 12 years of central bank interference and backstopping). The Fed did what they had to do and provided the necessary liquidity to restore order to the markets. Everybody we have spoken to agree this was a job well done by the global central banking community. The underlying problem is that in the long run asset prices will once again reflect economic reality. That reality is that business who borrowed billions to buy back their own stocks will have even more debt post this crisis with even more elevated asset prices. A situation which cannot continue indefinitely. The central banks openly admitted only six months ago that they were out of effective monetary tools - so what we are seeing today are blunt instruments. Liquidity in name, debt by nature. When the Fed adds liquidity to the markets in most cases all they are doing is adding debt. Markets buying assets with surging debt levels and cratering revenues will last only so long. Having just witnessed the swiftest bear market in history, we would caution against investors rushing to front run the Fed and buy into over-leveraged businesses.

Fine Line

No doubt this is a very fine line for the Fed. They need to support the real economy and support income for the quarantined and operating cash flow for businesses, all of which is necessary and critical. Governments will need to provide most of this through the help of central bank purchases of government bonds. Liquidity for the markets is also essential. However in buying High Yield ETFs we believe they have crossed the line. A wave of fallen angels can for sure disrupt the high yield market, however many of these companies had already begun the re-pricing process – and that was for a reason. It is worth remembering that companies had been issuing debt prior to this announcement, even in the high yield space, leading us to question how necessary this latest round of measures really were. Maybe if the Fed had not given the markets licence to ignore reality, corporate balance sheets would have been in better shape coming into this crisis. Perhaps the companies that acted responsibly over the last cycle could adapt to their changing environment and be rewarded without having their margins cut by zombie competitors relying on zero cost Fed Funding. Maybe, just maybe, businesses would have been much more productive - Boeing could still build planes that stay in the air and GE could make light bulbs.

Ultimately, economic reality will always get the better of the Fed. We are currently facing challenges which can be potentially worse than those of the Great Depression. Whitewashing the role the Fed played in building an unstable market based around QE programmes at the expense of economic productivity has left us in a much worse situation than we needed to be in. With economic uncertainty at unprecedented levels, it is difficult to know where that fine line lies. However my gut tells me the Fed have just crossed it. To increase the ability for something approaching a v-shaped recovery, the less “bad actors” we have the better.

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