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FIXED INCOME PERSPECTIVE *from the Investment Advisory Group*

The Fed's Fixed Income Frenzy

Andrew Richman, CTFA
Managing Director, Fixed Income Strategies
SunTrust Advisory Services, Inc.

Chip Hughey, CFA
Head of Fixed Income and Strategy Services,
BB&T Scott & Stringfellow

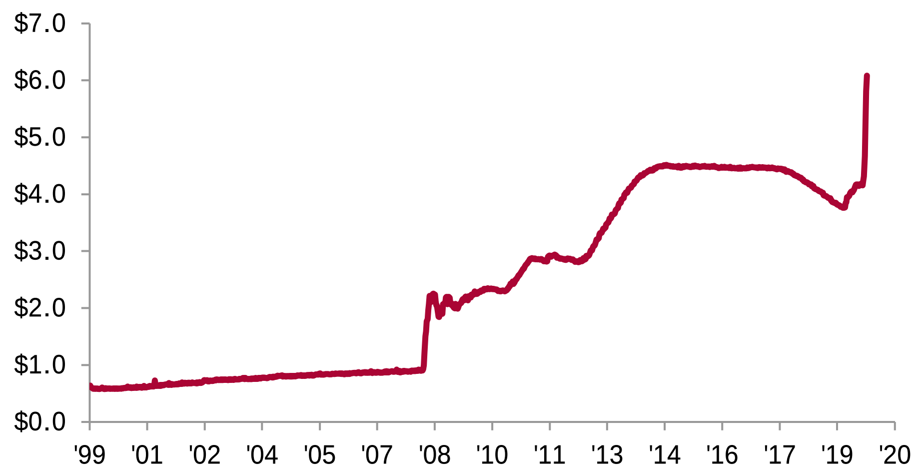
What Happened

Last week, the Federal Reserve (Fed) took additional steps to provide up to $2.3 trillion in loans to support the domestic economy through the economic shutdown and beyond. A good portion of the new announcement carries direct implications for US fixed income markets through three areas of support:

1. Primary and Secondary Market Corporate Credit Facilities (PMCCF and SMCCF);
2. the Term Asset-Backed Securities Loan Facility (TALF); and
3. the Municipal Liquidity Facility (MLF).

These moves by the Fed are unprecedented and represent significant support for fixed income markets. To fund these purchases, the central bank is utilizing $450 billion from the CARES Act and deploying leverage to potentially reach over $2 trillion in buying power. To date, approximately 43% of those funds have been tapped. Therefore, over half of the money allocated has yet to be deployed, leaving significantly more liquidity in play. These actions dwarf the Fed activity seen in 2008-2009 during the Great Recession and will potentially move the Fed's balance sheet from just over $4 trillion at the beginning of the year to as high as $10 trillion.

The US Federal Reserve's Balance Sheet ($Trillions)



Data Source: SunTrust IAG, Bloomberg

“Fallen Angel” Debt Protection Serves as Backstop

This latest round of central bank policy support highlights the Fed’s commitment to its “whatever it takes” pledge to support the US economy in its time of need. It also demonstrates the Fed’s willingness to unveil never-before-seen weapons in its arsenal. Between the PMCCF, SMCFF and TALF, up to $850 billion in new credit will be made available to corporate issuers. The biggest change for the PMCCF and SMCCF is the newly granted authority to purchase “fallen angel” debt.

“Fallen angels” are debt securities that have been downgraded from investment grade status to below the Baa3/BBB- threshold. As long as the issuer’s debt rating was investment grade as of March 22, 2020 and is still no less than Ba3/BB- at the time of purchase, the Fed can buy those bonds either through the new issue or secondary markets. This is a creative way for the Fed to help companies downgraded as a result of the economic lockdown, while not extending lifelines to companies which were already low on the credit spectrum.

The $750 billion pledge for these purchases by the PMCCF and SMCFF account for roughly 8% of the US corporate debt market’s current market value. The initial announcement sent high yield corporate debt soaring just ahead of the holiday weekend. The size of the Fed’s backstop provides comfort that forced selling as a result of pandemic-driven downgrades will not overwhelm the corporate bond market. That should further tighten high yield credit spreads in the near term, which have already retraced roughly 40% of their widening from the February-March timeframe.

Expanded Scope of TALF will support CMBS Liquidity

The Fed also increased the scope of TALF-eligible purchases to include AAA-rated commercial mortgage-backed securities (CMBS) and newly-issued collateralized loan obligations (CLO). The Fed left the size of TALF unchanged at $100 billion, simply adding eligible CMBS and CLO securities to the approved list alongside AAA-rated auto, credit card and student loan asset-backed securities. The relatively small dollar commitment will mitigate the positive impact of their inclusion, but it does provide a modest liquidity boost for the CMBS market and should help unlock some CMBS lending and issuance.

Municipals See Support from MLF

Lastly, the newly created MLF will allow state and local governments to sell their debt to the Fed and create emergency access to cash. MLF will offer up to $500 billion in new lending to qualifying states and municipalities, purchasing maturities no longer than 24 months. Eligible cities and counties must have at least 1 and 2 million residents, respectively. The front end of the municipal bond curve has been one of the hardest hit segments of the US fixed income markets. Indiscriminate selling strained municipal bond liquidity and created a historical disconnect between municipals and US Treasury yields. The establishment of MLF will provide a much needed source of liquidity and should help with that relationship. While we still see value in high-grade, short-dated municipal bonds, MLF will likely lessen the opportunity available in the weeks ahead.

Bottom Line

The most recent round of Fed support aligns well with the tactical overweight in investment grade and high yield corporate bonds presented in our most recent House Views. As a result of the Fed's unprecedented actions, we expect to see continued improvement in the function of the fixed income markets and a tightening in credit spreads. The credit spread tightening since mid-March has somewhat diminished the opportunity we highlighted just under a month ago, but credit spreads still offer an attractive entry point on a historical basis. In this environment, we prefer to "follow the Fed" and focus on the sectors they are buying. Within the municipal bond market, the Fed may now buy money market-eligible municipal bonds (i.e., with maturities up to 24 months); however, it is doing so via new issues only and is not directly buying securities in the secondary market – a differentiation to its approach within the corporate space. Thus, given the recent rally, we prefer up-in-quality essential revenue credits and state general obligation issuers with healthy balance sheets.

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