The Fed Quickly Surpasses Its Financial Crisis Efforts

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Over the past week or so, the Federal Reserve has rolled out an extraordinary phalanx of measures. It has cut its policy to zero, re-opened its swap lines, unleashed unlimited QE purchases of Treasuries and agency MBS, and—in conjunction with Treasury—taken steps to support a range of risky assets. Already these measures exceed the force and scope of the interventions put in place during the global financial crisis. The Fed is signaling that it will do whatever it takes to restore liquidity and smooth functioning to financial markets.

To date, however, the central bank's actions have failed to soften the severe tone in markets. Part of this reflects that the Fed alone cannot "fix" the problem. Fiscal policy is also necessary. And the economy's trajectory will ultimately be determined by the length and severity of the coronavirus' outbreak.

Even so, monetary policy at this scale is powerful. During the weeks ahead, the Fed's asset purchases, facilities, and other efforts will provide a tsunami of liquidity to the markets. We expect that these efforts will help soothe the extraordinary asset-price volatility that has erupted. It's also notable that during the global financial crisis many of the policy interventions that ultimately proved essential were not greeted with immediate applause when they were announced. It often takes time for the full effects of policy responses to take hold.

In the remainder of this piece we look more deeply at the drivers of illiquidity in U.S. financial markets through the current episode. Why have interventions at such massive scale proved necessary?

One immediate answer is that the coronavirus is hitting the U.S. economy—and the global economy—with more force and severity than any shock in the post-war era. During the second quarter, U.S. growth will likely post its sharpest contraction in decades. Similarly, the decline in global economic activity during the first half of the year is poised to be considerably steeper than the worst of the financial crisis. While there are good reasons to expect a sharp bounce back in the second half, the storm clouds over the horizon are daunting. In parallel with the disruptions from the virus, the global economy is also enduring a first-order oil shock. While there will inevitably be winners and losers, the U.S. shale industry—a key part of the high-yield market—will feel another blow.

The resulting deterioration in the economic outlook has caused a commensurate seizing up of financial markets. Even the market for U.S. Treasuries has had bouts of illiquidity, with the 10-year yield bouncing during the past week or so from 0.7% up to nearly 1.3% and then back down to 0.8%. Investors have struggled to unwind complex risk-hedging strategies and raise funds to accommodate possible outflows, all against a backdrop of a deteriorating economic outlook. These developments, along with apparent worries about the trajectory of future U.S. government debt issuance, have created headwinds for the Fed's efforts to stabilize market functioning.

But, in addition, the U.S. financial system is highly dependent on the large broker-dealers, and the commercial banks more generally, to intermediate credit for the financial system and the economy. Given the stresses, these core institutions have been understandably hesitant to provide credit. Further, regulatory requirements, such as the leverage ratio, also appear to have constrained intermediation. As a result, parts of the market have remained illiquid, notwithstanding the Fed's massive liquidity injections. This has particularly prevailed in some corners of the credit market.

A Three-Part Approach

The Fed is well aware of these issues and, in response, is pursuing three types of remedies. Over time, these efforts will further amplify the stimulus from monetary policy. **First**, the Fed continues to ramp up its liquidity injections. The theory here is that, if delivered at sufficient scale, liquidity will eventually find its way into parched portions of the market. The transmission may not be rapid or efficient, but it will ultimately happen. **Second**, over the past week, the Fed has moved in an incremental fashion to loosen regulatory constraints. It has emphasized that the U.S. banks have ample capital buffers and has encouraged institutions to draw on those buffers to support the economy. More regulatory easing is likely in coming weeks.

A **third** approach is for the Fed itself to provide liquidity in parts of the market where it's most needed. Monday's policy announcement included such steps. The Fed reopened the Term Asset-Backed Securities Loan Facility (TALF), designed to support the asset-backed securities market. It also announced the creation of two new facilities that allow it to provide credit directly to U.S. firms and fund purchases of corporate bonds. The underlying challenge here is that the Fed is reluctant to take credit risk onto its balance sheet. Over and above concern about financial losses, such action is viewed as muddying the line between monetary and fiscal actions. In the case of all three of these facilities, however, the Fed is protected by equity capital from the Treasury's Exchange Stabilization Fund.

All told, we see the Federal Reserve now signaling a historic commitment to provide liquidity to the financial system and support the smooth functioning of markets. In addition, the Fed is deploying the full range of its tool kit to help backstop the real economy and support spending. Achieving this second objective, however, will require fiscal support comparable to the Fed's monetary efforts. The large fiscal bill that is currently being debated in the Senate, which we expect to be approved soon, is a constructive step forward. Fiscal policy can support the sectors of the economy that are most exposed to the virus' effects, including small and medium sized enterprises that wouldn't otherwise have the resources to survive the downturn. Fiscal policy can also help workers who lose their job, or feel a pinch in pay, continue to put food on the table and pay their bills. Further, fiscal resources might provide bigger backstops for the Fed's facilities, allowing it to more aggressively absorb credit risk onto its balance sheet and support the economy.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of March 2020.

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