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Fed's words prove more helpful than their actions

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The Federal Reserve ("Fed") shocked markets on March 23rd when it announced extraordinary measures to ensure liquidity flows throughout financial markets. It launched 2 credit facilities to help provide credit to large employers: (1) Primary Market Corporate Credit Facility "PMCCF" for investment grade ("IG") new issues inside of 4 years to maturity and (2) Secondary Market Corporate Credit Facility "SMCCF" for IG bonds inside of 5 years, IG ETFs, and high yield ("HY") ETFs. On April 9th, the Fed announced that IG "fallen angel" bonds (investment grade bonds downgraded to HY status) were also eligible for purchase.

After all that commotion, where are we now? Since March, the Fed has purchased over $2t of treasuries and mortgage-backed securities. It took until May 12th for the Fed to initially begin purchasing ETFs. During its first week the Fed purchased over $1.3b worth of ETFs, 83% being IG and 17% (or approximately $220m) being HY. Through June 16th, the Fed had accumulated over $6b of ETFs, which assuming the same pace and split, **equates to the Fed potentially owning roughly the equivalent of 1% of the HY market by the end of June.**

What about the buying of individual corporate bonds? Whereas the Fed has still not purchased any new issue bonds as part of the PMCCF (that was scheduled to begin on June 29th), it did begin purchasing secondary market bond issues on June 16th, almost 3 months after their announcement of the SMCCF. On June 28th, we witnessed which bonds the Fed was buying. In our opinion, it is difficult to understand the need to financially support many of these companies.

Since the target maturities were inside of 5 years, we included the blended yield-to-worst for those company's bonds with maturities ranging from 1-5 years (via the ICE BofA 1-5 Year US Corporate Bond Index) as well as for all of their bonds (via the ICE BofA US Corporate Bond Index). This revealed that the average yield of a bond purchased by the Fed was about 1% and the average yield for all bonds issued by those companies was approximately 2% (as of June 12th prior to the Fed purchase start date). In other words, **by the time the Fed purchased bonds in the secondary market, the borrowing cost for those companies had already fallen drastically.**

List of initial SMCCF Fed purchases

ISSUER	Par Value Purchased	1-5 Yr. YTW*	YTW*	Bond Rating**
UNITEDHEALTH GROUP INC	$15,500,000	0.73	2.02	A
AT&T INC	$15,500,000	1.19	2.86	BBB+
COMCAST CORP	$12,000,000	0.76	2.13	A-
ANTHEM INC	$12,000,000	0.98	2.16	BBB+
MICROSOFT CORP	$8,500,000	0.53	1.44	AAA
WALMART INC	$8,000,000	0.57	1.60	AA
CONSTELLATION BRANDS INC	$8,000,000	0.97	2.06	BBB-
IBM CORP	$7,000,000	0.73	1.62	A
BOEING CO	$7,000,000	2.71	3.85	BBB
CVS HEALTH CORP	$7,000,000	1.13	2.20	BBB
ABBVIE INC	$7,000,000	1.19	2.13	BBB
GENERAL ELECTRIC CO	$7,000,000	2.00	3.87	BBB+
COCA-COLA CO/THE	$6,000,000	0.63	1.39	A
PHILIP MORRIS INTL INC	$6,000,000	0.80	1.84	A
MEDTRONIC INC	$6,000,000	0.77	1.56	A
PEPSICO INC	$6,000,000	0.60	1.68	A+
MCDONALD'S CORP	$6,000,000	0.69	2.20	BBB+
BECTON DICKINSON AND CO	$6,000,000	1.24	2.01	BBB-
SABINE PASS LIQUEFACTION	$6,000,000	2.33	2.66	BBB-
DUPONT DE NEMOURS INC	$5,000,000	1.50	2.25	BBB+
EVERSOURCE ENERGY	$5,000,000	0.92	1.83	BBB+
EXXON MOBIL CORPORATION	$5,000,000	0.86	1.90	AA
CHEVRON CORP	$5,000,000	0.76	1.09	AA
BERKSHIRE HATHAWAY ENERGY	$5,000,000	0.52	1.82	AA-
SYSCO CORPORATION	$5,000,000	1.71	3.04	BBB
CATERPILLAR FINL SERVICE	$5,000,000	0.72	1.44	A
MARRIOTT INTERNATIONAL	$5,000,000	3.21	3.37	BBB-
PROLOGIS LP	$5,000,000	0.52	1.53	A-
MASTERCARD INC	$5,000,000	0.66	1.70	A+
PFIZER INC	$5,000,000	0.57	1.83	A+
LOWE'S COS INC	$5,000,000	0.86	2.30	BBB+
GENERAL MILLS INC	$5,000,000	0.94	1.79	BBB
FLORIDA POWER & LIGHT CO	$5,000,000	0.86	1.89	AA-
MARATHON PETROLEUM CORP	$5,000,000	2.25	3.26	BBB
TOYOTA MOTOR CREDIT CORP	$5,000,000	0.89	1.04	A
VISA INC	$5,000,000	0.48	1.57	AA-
BP CAP MARKETS AMERICA	$5,000,000	1.06	1.55	A
WALGREENS BOOTS ALLIANCE	$5,000,000	1.22	2.51	BBB
GILEAD SCIENCES INC	$5,000,000	0.63	1.81	A-

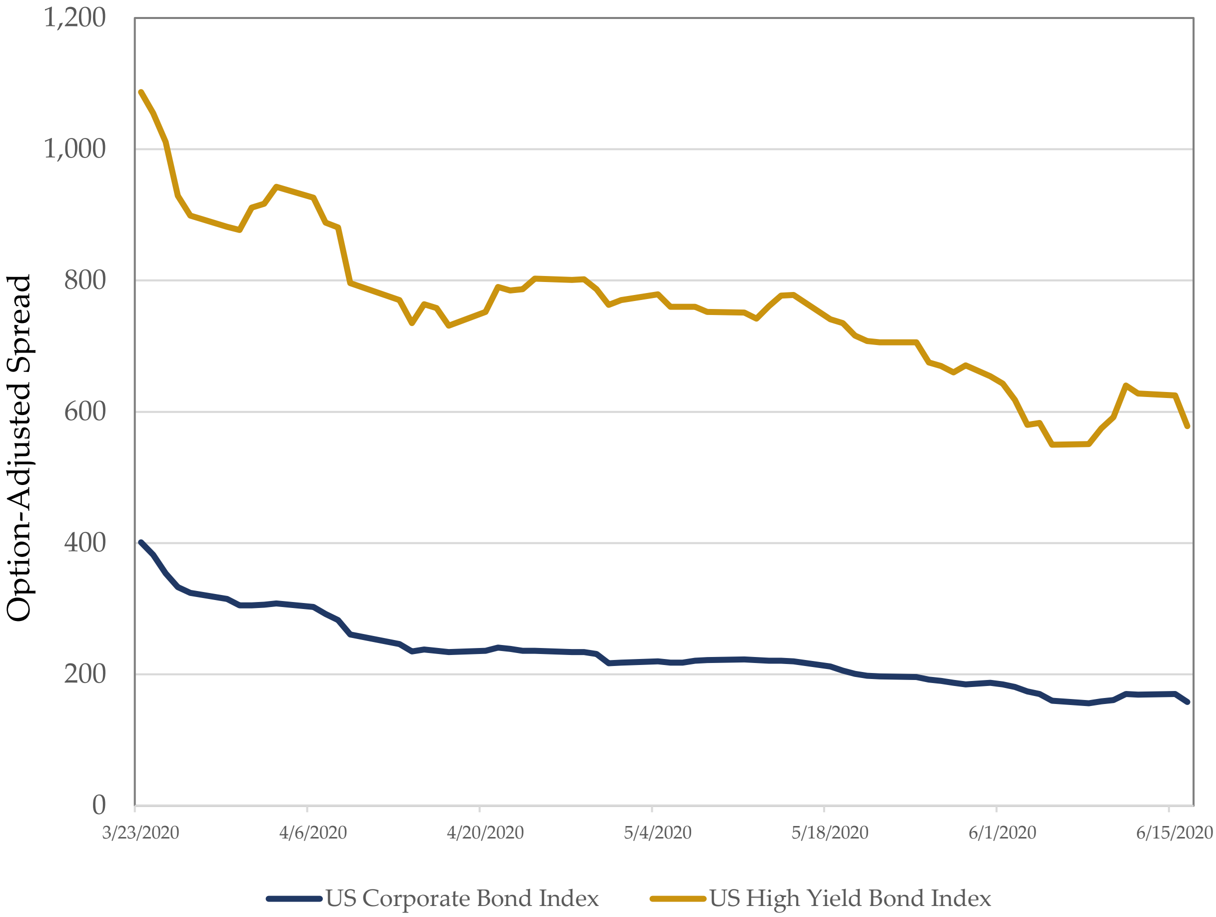
Source: Federal Reserve

*as of 6/12/2020. **composite rating according the ICE BofA Index

Between the time the Fed announced its programs and purchased their first individual corporate bond, credit spreads for the IG market were cut more than in half from +407 bp to +158 bp. The HY market fell from +1,087 bp to +578 bp. There are lots of sayings when it comes to the Fed, perhaps most apropos is **"It does not so much matter what the Fed *does* as much as what it *says*."**.

When analyzing the list of initial SMCCF purchases, it is worth noting the quality level. **Of the top 39 issuers, none were "fallen angels" and only 2.4% of the par value purchased was rated BBB-**. More than half were rated A- or above.

Spreads since Fed Announcement



Source: Bloomberg. US Corp Bond Index: ICE BofA US Corporate Index; US HY Bond Index: ICE BofA US High Yield Index.

The Fed will now tailor their purchases of corporate bonds to a self-created broad market index in order to avoid the perception of playing favorites. A few points are to be made when reviewing the list of issuers in their index, which was published by the Fed. First, the list is concentrated amongst large and solid companies. The top 15 issuers, out of 794 in the index, account for over 20% of the index weight. Second, the 3 largest are US subsidiaries of foreign companies: Toyota, Volkswagen and Daimler. BMW surpasses Microsoft for the last spot in the top 10. Only one name in the top 50 is a "fallen angel": Ford.

SMCCF Index – Top 15 Issuers

ISSUER	Sector	SMCCF Index Weight
TOYOTA MOTOR CREDIT CORP	Consumer Cyclical	1.74%
VOLKSWAGEN GROUP AMERICA	Consumer Cyclical	1.74%
DAIMLER FINANCE NA LLC	Consumer Cyclical	1.72%
AT&T INC	Communications	1.71%
APPLE INC	Technology	1.60%
VERIZON COMMUNICATIONS	Communications	1.60%
GENERAL ELECTRIC CO	Capital Goods	1.48%
FORD MOTOR CREDIT CO LLC	Consumer Cyclical	1.34%
COMCAST CORP	Communications	1.32%
BMW US CAPITAL LLC	Consumer Cyclical	1.25%
MICROSOFT CORP	Technology	1.18%
ABBVIE INC	Consumer Non-Cyclical	1.04%
GENERAL MOTORS FINL CO	Consumer Cyclical	1.01%
CVS HEALTH CORP	Consumer Non-Cyclical	0.98%
BP CAP MARKETS AMERICA	Energy	0.92%

Source: Federal Reserve

All this makes us wonder: is it all worth it? Throwing money at these cash-rich companies after spreads have massively compressed. Probably not, but what is more important is that the Fed makes sure it has the mechanisms set up and working in order to quickly act if spreads should test their wider levels again. So far, Fed spending is a drop in the bucket compared to the $750b it has authorized to purchase in both secondary and primary bonds. Their focus on short and intermediate-term bonds, fallen angels, and HY ETFs certainly helps create a "halo effect" around the upper tiers of the HY market as well. It may provide an invaluable sense of confidence that an "Armageddon" scenario is off the table.

If you think the Fed will let the program expire on September 30th, think again.

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