Central banks are keeping their eye on the ball

By: Eric Stein, CFA | April 14, 2020

**Boston** - The best way for investors to sort through the onslaught of policy actions from central banks across the globe, especially those coming from the US Federal Reserve (the Fed), is to understand their two primary goals:

1. **Market functioning.** In the US, that means better liquidity in the Treasury market, better liquidity in the Treasury repo market (repurchase agreements) and less pressure in the dollar funding market. These are the core markets of the financial system. The Fed’s reason for this initial focus as the COVID-19 crisis first arrived was not simply because these markets are very important in their own right, but also because they are the backbone for many other markets, both domestically and globally.

2. **Providing bridge financing to the economy.** By doing so, it will help the broader economy (i.e., consumers, corporations, municipalities, etc.) get through the next couple of months, at least until the economy sees the light of day and people start going out and contributing to normal economic activity.

On April 9, the Fed announced a new Municipal Liquidity Facility, along with some enhancements to existing programs. These actions are directly in line with our thinking that the Fed will continue to add and change programs as they look to best achieve their goals of market functioning and bridge finance.

**Measurable impact**

The Fed has made significant progress toward ensuring success on its goal of keeping the markets functioning as normally as possible. In addition to traditional monetary easing (rates are now close to zero) and quantitative easing that has recently dramatically increased the size of the Fed’s balance sheet (see the charts below), the Fed dusted off a number of programs that proved to be effective in the aftermath of the 2007/2008 financial crisis. Simultaneously, it developed some new programs designed specifically to focus on the problems right now, such as providing support to the corporate credit and municipal bond markets.

**Federal Reserve assets explode amid pandemic shock**

![Chart showing Federal Reserve assets]


Today, we see the Treasury and Treasury repo markets and the dollar funding markets in much better shape than where we were during the most acute part of the financial shock of the global pandemic during the third week of March. We have also seen significant improvements in the higher-rated parts of the municipal bond market, investment-grade corporates and investment-grade emerging-market debt. Some, but not all, of the higher-yielding parts of the fixed-income market have come back from their initial lows, though they certainly aren’t fully healed by any stretch and there are legitimate credit concerns across many markets that will play out depending on the mix between the idiosyncratic credit fundamentals of each issuer, the depth and duration of the economic downturn, and the broader policy support from monetary and fiscal policymakers.

While I do think some of the most acute financial market-driven stress that we’ve seen so far is somewhat resolved due to Fed policy action, I think we have now moved on to a market environment that will be driven more by health, economic and policy fundamentals as opposed to specific stress emanating directly from the financial system.

**Fed provides support to CARES Act**

In addition to the bridge financing that comprised much of the $2 trillion fiscal package (CARES Act) passed by Congress late last month, the Fed announced that it would create a new program to finance loans that banks and other lenders make through the government’s emergency small-business lending program, one of the main components of the stimulus bill. It is a critical part of the bill because companies, municipalities, individuals and nonprofit organizations simply don’t have the financing necessary to keep going. The Fed’s program, like the many it has enacted in the past several weeks, is intended to provide financing to get from where we are today to the future.

Though the Fed and Treasury will continue to enact a multitude of programs designed to help with the bridge finance, it is important for investors to remember the broad goal of providing bridge financing to various sectors in the economy as opposed to being lost in what seems like a never-ending slew of acronym-baring programs that the Fed has launched and will continue to launch. The details of each program matter more to investors in those specific sectors, but for most investors, who focus across other markets, it is still important to focus on what the Fed is trying to achieve broadly and how strongly determined it is to achieve its goals.
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