Weekly Update

May 4, 2020

Invesco Fixed Income

Invesco

The Fed and ECB stand pat but will likely shift to longer-term stimulus in the coming months

Fed remains focused on market functioning

The US Federal Reserve (Fed) did not change its policy rate or its path in last week's Federal Open Market Committee meeting. Nor did it introduce new asset purchase or credit easing programs. The Fed has already done a lot and done it quickly over the past month, and the focus is now on implementation, working out details and explaining them to the public. The Fed's current quantitative easing (QE) program is focused on market functioning, which has been largely effective (as highlighted below).

In the press conference after last week's meeting, Fed Chairman Jerome Powell highlighted the ongoing risks to the economy. The health crisis remains highly uncertain, with the risk of renewed outbreaks. The damage to the labor market will likely have lasting effects and parts of the corporate sector will likely struggle or fail. The global economy faces a potential slowdown not seen in decades. Chairman Powell highlighted the importance of fiscal policy and suggested that more needs to be done. He also said that this is not the time to worry about the federal debt.

As for the longer-term and forward guidance, Chairman Powell emphasized that the Fed will not raise interest rates anytime soon and that market pricing is in line with that. While the Fed's current focus is to ensure the orderly functioning of markets, the focus will likely shift in coming meetings to longer-term stimulus and supporting economic recovery. That is, the Fed will likely move from QE aimed at improving market functioning to more standard QE aimed at achieving the Fed's dual objectives of maximum employment and price stability. This could come as soon as the June meeting, when the Fed will have had time to assess the situation and there will be some information about the exit process from country-wide lockdowns. We expect the Fed to announce a new QE program conditioned on these dual objectives that would likely keep the policy rate at the zero bound as long as the unemployment rate is above the natural rate and inflation is projected to remain sustainably around 2%. While it is still too early to forecast the size of potential bond purchases, we expect purchases in the range of USD125 billion to USD150 billion a month.

ECB moves to support corporations and households

At its meeting last week, the European Central Bank (ECB) unveiled a package of liquidity provision measures intended to support the flow of credit to corporations and households. The key measure was sweetening the terms of its important funding-for-lending program, the Targeted Long-Term Operations (TLTRO) program. The borrowing rate for banks was reduced from -0.25% to -0.5%, but if banks maintain a threshold level of lending over a period of time, the borrowing rate can be further reduced ex-post to -1%. These are generous terms for banks. Second, the ECB introduced the Pandemic Emergency Longer-Term Refinancing Operations (PELTROs) program, which is an additional backstop for the banking system. It aims to bridge gaps in the TLTROs and provide support to money markets.

The ECB's asset purchase program, the Pandemic Emergency Purchase Program (PEPP), was not extended in last week's meeting. Currently the PEPP totals EUR750 billion, with about EUR100 billion already deployed. In the press conference after last week's meeting, ECB President Christine Lagarde suggested that she is open to extending the program if needed. We expect the ECB to extend the program by another EUR500 billion at its June meeting and probably more later in the year, and extend the duration of the program beyond 2020. President Lagarde also implicitly stepped back from her previous comments that the ECB is not "here to close spreads" between the borrowing costs of member states. She said the ECB will not tolerate the risk of monetary fragmentation, which to us means that when there is stress on sovereign bond markets and sovereign spreads widen, the ECB will respond. The first line of defense against monetary fragmentation is PEPP.

The Fed and ECB have launched aggressive measures, both in terms of size and speed of implementation. Some of these programs, such as standard QE programs focused on sovereign bonds, are easier to do. Others aimed at supporting the corporate sector require more time to prepare and implement. At the moment, the focus is on these types of programs - in other words, central banks are still in fire-fighting mode. But in the coming meetings, we anticipate the focus to shift to longer-term stimulus to support broader economic recovery.

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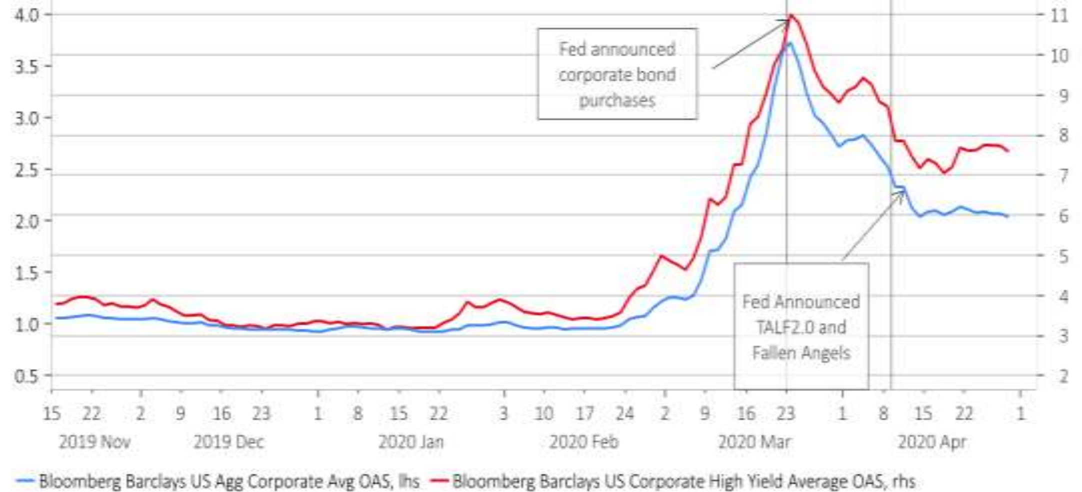
Credit bounceback supported by past Fed action

While neither the ECB nor the Fed announced significant new programs or policies last week, their decisive and unprecedented actions in recent months have been very supportive of market functioning and quality credit assets in general.

Before the Fed action on March 23, when it announced aggressive quantitative easing and credit support for the US economy, the US credit markets were in disarray as the massive demand for credit resulting from the economic sudden stop overwhelmed the banking system and financial markets. High quality commercial paper, Agency mortgage-backed security (MBS) and investment grade bond spreads widened aggressively. Announcement of the Fed action helped to return stability to the markets and marked the wides for most credit assets so far this year, as seen in Figure 1.

Figure 1: Credit bounceback supported by Fed action (Option Adjusted Spreads, %)



Source: Macrobond, data from Nov. 15, 2019 to April 29, 2020.

Markets have responded rationally by favoring quality assets that had been displaced, but that now have Fed support. Lower quality assets, those with less certain fundamentals, and that the Fed is not buying, have lagged in the recent recovery. These assets are less dependent on the resolution of the financial markets pressure and more dependent on the path of the economy and the health outcomes related to the virus, both of which are still uncertain at the current time.

As shown in Table 1, the best performing asset since the wide in spreads on March 23 is US Agency MBS, which have recouped 77% of their previous spread widening. Shorter duration investment grade corporates (which the Fed has announced plans to buy) have recouped 62%, while longer duration investment grade corporates have only recouped 50% of their widening. US high yield corporate bonds have only recouped 40%, and emerging markets (EM) have lagged, recouping less than 30% of their widening.

Table 1: Retracement from the wides

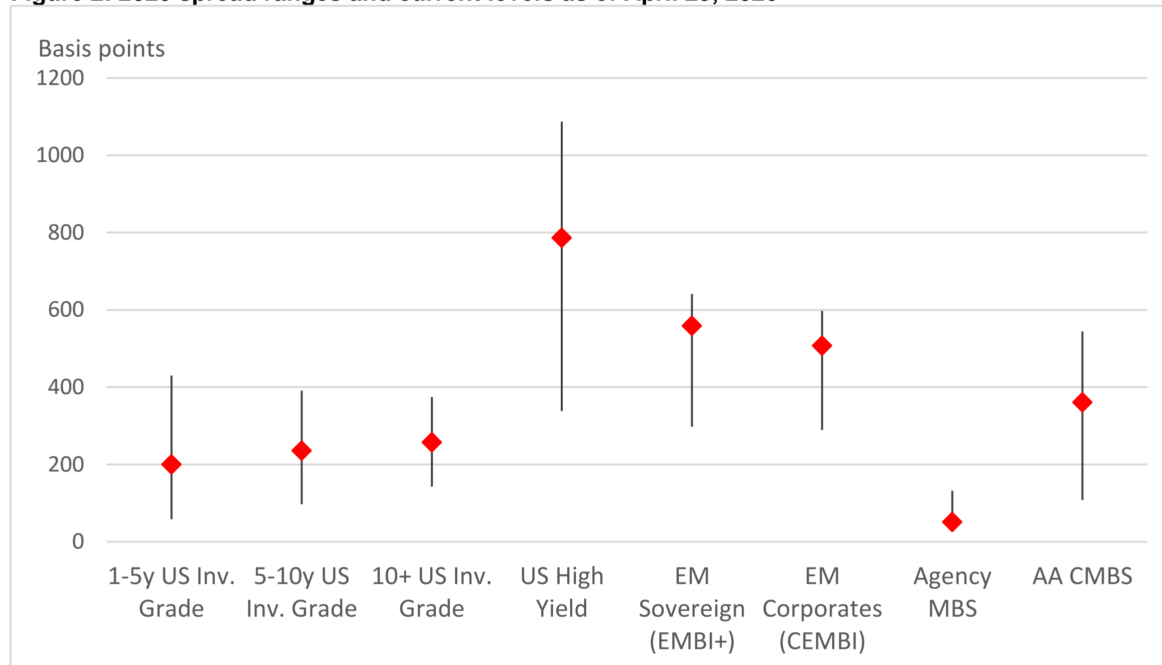
1 to 5-year US investment grade	61.6%
5 to 10-year US investment grade	52.7%
10-year+ US investment grade	50.4%
US high yield	40.1%
EM sovereign (EMBI+)	23.9%
EM corporates (CEMBI)	29.2%
Agency MBS	76.9%
AA Commercial MBS	42.0%

Source: ICE BoA 1-5 year US Corporate Index, ICE BoA 5-10 year US Corporate Index, ICE BoA 10+year US Corporate Index, ICE BoA US High Yield Index, JPMorgan Emerging Markets Bond Index Plus Sovereign Spread, JPMorgan Corporate Emerging Markets Bond Index Composite Blended Spread, Bloomberg Barclays US Mortgage-Backed Security Fixed Rate Avg Option Adjusted Spread, ICE BoA AA US Fixed Rate Commercial Mortgage-Backed Security Index.

This performance speaks to the Fed's effectiveness in returning order to the credit markets and is a stark reminder to investors that the Fed and policy makers play a major role in markets. The Fed has had a large

impact on these credit markets, all while the underlying growth outlook and disease outlook continue to be highly uncertain.

Figure 2: 2020 spread ranges and current levels as of April 29, 2020



Source: ICE BoA 1-5 year US Corporate Index, ICE BoA 5-10 year US Corporate Index, ICE BoA 10+year US Corporate Index, ICE BoA US High Yield Index, JPMorgan Emerging Markets Bond Index Plus Sovereign Spread, JPMorgan Corporate Emerging Markets Bond Index Composite Blended Spread, Bloomberg Barclays US Mortgage-Backed Security Fixed Rate Avg Option Adjusted Spread, ICE BoA AA US Fixed Rate Commercial Mortgage-Backed Security Index.

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