In our last coronavirus update, we described the Fed's more aggressive actions announced Sunday March 15, 2020. The goal of those actions was the proper functioning of the financial markets due to the extreme illiquidity all sectors were experiencing. Well, that was not enough! Yesterday, the Fed went "all in" to ease continuing liquidity strains. These actions will likely prove decisive, even though the economic damage from the health crisis is not yet known.

The Federal Reserve's Actions

Yesterday morning the Fed announced it would purchase U.S. treasury and agency mortgage-backed securities "in the amounts needed to support smooth market functioning and effective transmission of monetary policy." Essentially, the Fed will purchase an unlimited amount of treasuries and mortgages to ease the liquidity strains. This, combined with new facilities and others announced last week, places the Fed at the center of all borrowing-related financial market activity. These actions are truly unprecedented and targeted at an economy that, overwhelmed by the epidemic, is shutting down.

In addition to the unlimited quantitative easing (QE), the Fed also announced and formally implemented the following:

- A Primary Market Corporate Credit Facility (PMCCF) and a Secondary Market Corporate Credit Facility (SMCCF) to support investment grade companies' funding needs;
- A new Term Asset-Backed Lending Facility (TALF) to support consumers and businesses who can issue asset-backed securities. This was used effectively after the 2008 crisis;
- Last week the Fed announced a Money Market Mutual Fund Liquidity Facility (MMLF) to help money market funds with redemption requests. Today, the Fed expanded allowable securities to include high quality municipal debt;
- Also last week, the Fed announced a Commercial Paper Funding Facility (CPFF) to aid a market that effectively shut down. Today, the facility was expanded to include high quality municipal debt.
- The Fed also announced plans for a facility to support small businesses through the Small Business Administration.

The Fed has no ability to take direct credit exposure so most of these facilities are structured through Special Purpose Vehicles (SPVs) with support from the Treasury. For now, the Treasury is using the Exchange Stabilization Fund (ESF) to support the SPVs. The fiscal package likely to emerge from congress includes additional funding for the ESF that will provide additional capital for the SPVs. Separately, as part of the March 15th announcement, the Fed agreed to supply virtually unlimited funds to the repo markets, which successfully brought overnight rates down to the Fed's target near zero.

Altogether, the facilities and lending commitments ease the stress faced by both the banking system and corporations as they harness cash to deal with the period of economic inactivity. Given the circumstances, we believe these actions are appropriate and timely to stem a freeze in financial markets, and ensure the economy's access to capital.

The Virus and the Economy

Global infections seem to have exploded last week. According to Johns Hopkins University Center for Systems, Science and Engineering, the number of reported cases globally increased from about 197.2 thousand to 354.7 thousand between March 16 and March 23, 2020. The weekly increase is greater than all of China's reported cases (81.5 thousand), and an approximately 140% increase in the non-Chinese infections. It is evident by now, the world was woefully unprepared for an outbreak like COVID 19, and the protocols to stem contagion are immensely difficult to implement.

However, as challenging as the virus' evolution appears, it seems to follow a similar pattern once serious efforts are put in place to test and isolate. Successful Asian nations followed three key protocols to avoid mass contagion:

- Quarantine hotspots
- Offer extensive and accessible testing;
- Control new outbreaks.

Europe and the U.S. were caught unprepared to identify hotspots or offer reliable tests. Those deficiencies have been or are being addressed with the logical consequences that infirm people are now being counted and fear of contagion is personalizing social distancing. While not perfect, severely affected areas like New York, California and Italy are taking the hazard seriously with glimmers of hope emerging. In Italy the number of new cases has begun to decline. In fact, the rate of growth in Europe has eased suggesting the region's new infections may soon slow. Even in New York City, a U.S. hotspot, more widespread isolation will likely ease contagion within days. Elsewhere in the U.S., testing has improved and shut downs are deployed suggesting the cycle experienced by the successful nations is underway. In all likelihood, new cases grow uncomfortably over the next few days as test results are released, but after a week or two the rate of growth should subside.

As for the economy, the effects of the demand destruction are still unquantifiable. Suffice it to say, we will likely witness unprecedented numbers of unemployed and significant quarterly GDP erosion in the second quarter. The Fed's actions go a long way to alleviating the liquidity stresses that could otherwise get out of control. The fiscal package being discussed in Congress should help some of the most vulnerable individuals and industries by providing the bridge they need to get through the shutdown. Ultimately, we believe demand recovers in the second half of the year, and applaud the authorities for recognizing the importance of helping consumers and industries survive this debilitating period.

Financial Markets

After yesterday's announcement, investment grade companies were able to borrow about $17 billion in the primary market. In fact, the new issue market was tapped for $100 billion during March, a sizeable amount given the lack of liquidity. High quality companies had to pay up as spreads widened nearly 270 basis points during March, but access was more important than pricing after many had to repay their commercial paper. High yield borrowers do not yet have access, but we believe the Fed's efforts to keep credit flowing include the maintenance of bank facilities for less creditworthy borrowers.

An industry suffering a "double-whammy" is energy. Along with collapsing demand, companies face a price war between Saudi Arabia and Russia. Oil prices declined about 60% year-to-date and about 54% in March after conversations between OPEC and Russia broke down. Energy companies have taken quick and drastic action to reduce capital expenditures, dividends (if they had them), and unprofitable production. Rating agencies already began to downgrade industry participants and some may be forced to restructure. The high yield energy index is down about 39.3% month-to-date reflecting that eventuality. While the industry may suffer meaningful harm, a silver lining for consumers and the economy is that low oil prices will offer appreciable assistance as we emerge from the virus.

As in prior episodes of liquidity-driven dislocation, we continue to focus on opportunities to upgrade our holdings and take advantage of market dislocations.

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