On my mind: More heavy lifting from the Fed—while Congress squables

Sonal Desai, Ph.D.
Chief Investment Officer,
Franklin Templeton Fixed Income

MARCH 23, 2020

The Federal Reserve (Fed) today raised its response to the coronavirus crisis to a whole new level, announcing open-ended quantitative easing (QE) as well as purchases of short-dated investment-grade (IG) corporate debt and exchange-traded funds (ETFs), measures that had not been adopted even at the height of the global financial crisis just over a decade ago.

The decision to buy corporate debt takes a page from the European Central Bank's playbook, and disproves market concerns that this step might be beyond the Fed's institutional reach; the fact that purchases will target the whole investment-grade spectrum and not be limited to AAA issuers is bold.

The decision to purchase ETFs follows the Bank of Japan's example, and expands the purchase of IG debt to longer maturities. Together, these measures show that the Fed understands the need for a creative, decisive and adaptive strategy to fight the current crisis.

The Fed announced a raft of new measures and facilities aimed at: (i) providing targeted relief to affected households and businesses; (ii) giving broad support to economic activity; and (iii) ensuring the smooth functioning of money and credit markets. These include:

- Open-ended QE. On March 15, the Fed had launched $700 billion in asset purchases. Today, it announced it will purchase Treasuries and agency mortgage-backed securities (MBS) "in the amounts needed" to keep markets functioning smoothly and ensuring monetary policy can do its job. The sky is the limit, in other words.
    - The scope of purchases is now broadened to encompass agency *commercial*.
- New facilities to support credit to households and businesses with up to $300 billion in new financing, seeded with $30 billion in equity by the Treasury:
    - A Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance; this will provide four-year financing to investment-grade companies, and borrowers will be able to defer interest and principal payments for the first six months (extendable at the Fed's discretion). The PMCCF will extend loans through a Special Purpose Vehicle (SPV) seeded by the Treasury.
    - A Secondary Market Corporate Credit Facility (SMCCF) for outstanding corporate bonds across the investment-grade spectrum as well as ETFs; this will also work via a Treasury-seeded SPV.
    - A Term Asset-Backed Securities Loan Facility (TALF) to support the issuance of asset-backed securities (ABS) based on student, auto, credit card loans and loans guaranteed by the Small Business Administration.

- Expansion of the Money Market Mutual Fund Liquidity Facility (MMLF) and the Commercial Paper Funding Facility (CPFF) to a wider range of securities.
- Planned launch of a Main Street Business Lending Program to support lending to small- and medium-sized businesses.

Three crucial things to note, in my view, to assess the likely impact on the economy and markets.

First: The Fed has essentially pledged unlimited firepower to support the broad economy and stabilize markets; it has launched a decisive, creative and adaptive strategy which suggests it stands ready to do whatever it takes to fight the current crisis. I would expect a flexible approach both in terms of the size of the programs and potentially the eligible securities.

Second: The Fed will provide targeted support so that businesses and households can get the credit they need to survive through the crisis.

Third: The Fed now needs to quickly follow through to provide clarity on how the new facilities can be accessed by the relevant private institutions. Preliminary indications from the markets are that liquidity is improving on the margin, but anything more needs much more clarity on the operational aspects of the new facilities. This is understandable; the new facilities have just been announced and there is a lot of new information to process—but the focus now must quickly switch to the operational aspects.

Surviving the shock

Will it work? I think the Fed's support can help the US economy survive the shock and set the stage for a strong recovery in the second half of the year, on two conditions:

One: that the draconian government-mandated shutdown of large parts of the economy is sufficiently short-lived. We are entering the second of extreme social distancing and business closures in a number of US states. If containment measures prove effective, in the coming weeks the data should provide reassuring evidence that contagion is being contained, that we are "flattening the curve;"' this should allow for a gradual relaxation of the preventive measures, outside of the worst-affected areas. With the right monetary and fiscal support, the majority of affected businesses should be able to survive and then ramp-up operations as the situation normalizes.

Two: that Congress gets its act together and launches a package of fiscal measures in the next few days. Fiscal policy needs to step in to provide direct cash payments to individuals, extended unemployment benefits and emergency paid leave, as well as some form of rent/mortgage payments forbearance for impacted small- and medium-sized businesses and financial assistance to corporates in the hardest hit sectors.

The bill currently in Congress would also boost the reach of the newly announced Fed lending facilities: it would allow Treasury to allocate an additional $425 billion in equity to the Fed's SPV, which would translate in an additional $4 trillion of potential lending.

The fiscal support package currently in Congress amounts to about $2 trillion, or 10% of US gross domestic product. In synergy with the Fed's array of measures, it would allow a large share of businesses and households to weather the storm. The damage to the economy—and to the livelihood of countless individuals—will still be substantial, but this combination of fiscal and monetary policy would allow the majority of businesses to avoid bankruptcy and to rehire/pay their workers as the emergency ends.

A combined "shock and awe" fiscal and monetary support is also needed to reassure financial markets while we still face significant uncertainty on the duration of the crisis. Without the fiscal component, monetary policy cannot do it on its own—and investors clearly realize this.

It's time for Congress to set aside partisan disputes and provide the support that US households and businesses urgently need. Concerns about bailouts and moral hazard should also be set aside, in my view. Airlines, carmakers and retailers are not in trouble because they did anything wrong; they are not guilty of any reckless behavior that would be condoned and incentivized by a bailout; no viable business strategy could have insured them against a shock of this magnitude. Financial assistance to households and small- and medium-sized businesses should be time-bound, limited to bridge them through the crisis—but it should start as soon as possible.

The Fed has made its move; it's still the biggest and quickest player in town—but it can no longer be the only game in town. Congress must stop squabbling and act now.

Sonal Desai

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. Actively managed strategies could experience losses if the investment manager's judgment about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired result.

IMPORTANT LEGAL INFORMATION

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as of March 23, 2020 and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FTI affiliates and/or their distributors as local laws and regulation permits. Please consult your own professional adviser or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction.

Issued in the U.S. by Franklin Templeton Distributors, Inc., One Franklin Parkway, San Mateo, California 94403-1906, (800) DIAL BEN/342-5236, franklintempleton.com—Franklin Templeton Distributors, Inc. is the principal distributor of Franklin Templeton Investments' U.S. registered products, which are not FDIC insured; may lose value; and are not bank guaranteed and are available only in jurisdictions where an offer or solicitation of such products is permitted under applicable laws and regulation.

Australia: Issued by Franklin Templeton Investments Australia Limited (ABN 87 006 972 247) (Australian Financial Services License Holder No. 225328), Level 19, 101 Collins Street, Melbourne, Victoria, 3000. **Austria/Germany:** Issued by Franklin Templeton Investment Services GmbH, Mainzer Landstraße 16, D-60325 Frankfurt am Main, Germany. Authorised in Germany by IHK Frankfurt M., Reg. no. D-F-125-TMX1-08. Tel. 08 00/0 73 80 01 (Germany), 08 00/29 59 11 (Austria), Fax: +49(0)69/2 72 23-120, info@franklintempleton.de, info@franklintempleton.at. **Canada:** Issued by Franklin Templeton Investments Corp., 5000 Yonge Street, Suite 900 Toronto, ON, M2N 0A7, Fax: (416) 364-1163, (800) 387-0830, www.franklintempleton.ca. **Netherlands:** FTIS Branch Amsterdam, World Trade Center Amsterdam, H-Toren, 5e verdieping, Zuidplein 36, 1077 XV Amsterdam, Netherlands. Tel +31 (0) 20 575 2890. **United Arab Emirates:** Issued by Franklin Templeton Investments (ME) Limited, authorized and regulated by the Dubai Financial Services Authority. Dubai office: Franklin Templeton Investments, The Gate, East Wing, Level 2, Dubai International Financial Centre, P.O. Box 506613, Dubai, U.A.E., Tel.: +9714-4284100 Fax:+9714-4284140. **France:** Issued by Franklin Templeton France S.A., 20 rue de la Paix, 75002 Paris France. **Hong Kong:** Issued by Franklin Templeton Investments (Asia) Limited, 17/F, Chater House, 8 Connaught Road Central, Hong Kong. **Italy:** Issued by Franklin Templeton International Services S.à.r.l. – Italian Branch, Corso Italia, 1 – Milan, 20122, Italy. **Japan:** Issued by Franklin Templeton Investments Japan Limited. **Korea:** Issued by Franklin Templeton Investment Trust Management Co., Ltd., 3rd fl., CCMM Building, 12 Youido-Dong, Youngdungpo-Gu, Seoul, Korea 150-968. **Luxembourg/Benelux:** Issued by Franklin Templeton International Services S.à r.l. – Supervised by the Commission de Surveillance du Secteur Financier - 8A, rue Albert Borschette, L-1246 Luxembourg - Tel: +352-46 66 67-1- Fax: +352-46 66 76. **Malaysia:** Issued by Franklin Templeton Asset Management (Malaysia) Sdn. Bhd. & Franklin Templeton GSC Asset Management Sdn. Bhd. **Poland:** Issued by Templeton Asset Management (Poland) TFI S.A.; Rondo ONZ 1; 00-124 Warsaw. **Romania:** Issued by Bucharest branch of Franklin Templeton Investment Management Limited ("FTIML") registered with the Romania Financial Supervisory Authority under no. PJM01SFIM/400005/14.09.2009,, and authorized and regulated in the UK by the Financial Conduct Authority. **Singapore:** Issued by Templeton Asset Management Ltd. Registration No. (UEN) 199205211E. 7 Temasek Boulevard, #38-03 Suntec Tower One, 038987, Singapore. **Spain:** FTIS Branch Madrid, Professional of the Financial Sector under the Supervision of CNMV, José Ortega y Gasset 29, Madrid, Spain. Tel +34 91 426 3600, Fax +34 91 577 1857. **South Africa:** Issued by Franklin Templeton Investments SA (PTY) Ltd which is an authorised Financial Services Provider. Tel: +27 (21) 831 7400 ,Fax: +27 (21) 831 7422. **Switzerland:** Issued by Franklin Templeton Switzerland Ltd, Stockerstrasse 38, CH-8002 Zurich. **UK:** Issued by Franklin Templeton Investment Management Limited (FTIML), registered office: Cannon Place, 78 Cannon Street, London EC4N 6HL Tel +44 (0)20 7073 8500. Authorized and regulated in the United Kingdom by the Financial Conduct Authority. **Nordic regions:** Issued by Franklin Templeton International Services S.à r.l. , Contact details: Franklin Templeton International Services S.à r.l., Swedish Branch, filial, Blasieholmsgatan 5, SE-111 48, Stockholm, Sweden. Tel +46 (0)8 545 012 30, nordicinfo@franklintempleton.com, authorised in the Luxembourg by the Commission de Surveillance du Secteur Financier to conduct certain financial activities in Denmark, in Sweden, in Norway, in Iceland and in Finland. **Offshore Americas:** In the U.S., this publication is made available only to financial intermediaries by Templeton/Franklin Investment Services, 100 Fountain Parkway, St. Petersburg, Florida 33716. Tel: (800) 239-3894 (USA Toll-Free), (877) 389-0076 (Canada Toll-Free), and Fax: (727) 299-8736. Investments are not FDIC insured; may lose value; and are not bank guaranteed. Distribution outside the U.S. may be made by Templeton Global Advisors Limited or other sub-distributors, intermediaries, dealers or professional investors that have been engaged by Templeton Global Advisors Limited to distribute shares of Franklin Templeton funds in certain jurisdictions. This is not an offer to sell or a solicitation of an offer to purchase securities in any jurisdiction where it would be illegal to do so.

Please visit www.franklinresources.com to be directed to your local Franklin Templeton website.

FRANKLIN TEMPLETON