The Fed is on 'wartime' footing and still may be asked to do more

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With a series of moves that take it still deeper into uncharted waters, the Federal Reserve has shown that its work in supporting the economy through the coronavirus is far from finished.

What additional steps the central bank will take are unknown.

But with its most recent measures, which include forays into small business loans and junk bonds, the Fed has displayed a whatever-it-takes willingness to use all the tools at its disposal, then come up with some new ones necessitated by an economic crisis the nature of which the U.S. has never seen.

The moves announced Thursday were "stunning in [their] scope, expanding support broadly and deeply across" financial markets and small and medium-sized business lending, said Krishna Guha, head of global policy and central bank strategy for Evercore ISI.

"The Fed is at war against the virus and this is a wartime degree of commitment to credit policy," Guha added.

What's happened so far

To recap: The Fed on Thursday not only announced details of the much-anticipated Main Street lending program it is undertaking with the Treasury, but also detailed a slew of other measures aimed at boosting various parts of the markets and economy.

There was a move to provide support for loans made to small businesses, another measure that adds to existing credit facilities that will buy up business debt beyond the investment-grade sphere and into "fallen angel" territory that includes recently downgraded companies, and a bold move to loan directly to states and municipalities.

Taken together, the programs are designed to add up to $2.3 trillion in loans. That doesn't even count the previous initiatives: Near zero interest rates, open-ended asset purchases that already have increased the Fed's holdings by nearly $2 trillion, and a host of other credit facilities aimed at everything from providing overnight financing for banks to ensuring the supply of U.S. dollars to central banks around the world, a move that by itself has added more than $300 billion to the Fed's balance sheet.

The moves go beyond anything the Fed did during the financial crisis in 2008-09 — both in scope and speed. Guha called it "an incredibly broad deployment of new generation virus era" programs "that seek to address the specific nature of the shock as it impacts financial markets and credit supply on an all-out war footing."

What's to come

With all of this done, though, the tough work may be yet to come.

"The Fed has gone both bigger and broader if not cheaper," Guha wrote in a note to clients. "Huge implementation tasks lie ahead. Market participants should recognize that it will be weeks – in some cases more than a month – before new programs are up and running."

The moves reflect a commitment from the Fed to attack the economic issues at their roots for a public that had a recession forced on it due to virus protection measures. For now, there's little concern being expressed about consequences down the road.

"People undertaking these sacrifices for the common good, we need to make them whole," Chairman Jerome Powell said Thursday. "These are programs that we're developing at a high rate of speed. We' don't have the luxury of taking our time the way we usually do."

The Fed's efforts are getting mostly applause on Wall Street.

Despite a raft of horrifying economic data and even worse forecasts ahead, the stock market is coming off its best week since 1974.

With the outlook for unemployment and gross domestic product worse than even the financial crisis and approaching Great Depression-like numbers, investors have been willing to bet that the Fed's historically aggressive stance will pull the economy back on its feet after the coronavirus crisis passes.

"I give Powell four gold stars. They had to do a lot of things at once," said banking industry veteran Christopher Whalen, founder of Whalen Global Advisors. "The markets are OK, and I think the Fed gets a big pat on the back for doing that."

Still, there are challenges ahead.

Cato Institute senior fellow George Selgin notes that enforcing the rules of the programs will be difficult and the banks that will be making the loans may not be willing to do that on their own.

And as the true nature of the economic damage becomes known, the Fed may be called on to do still more.

The central bank already has taken unprecedented steps out on the risk curve by agreeing to buy "fallen angel" corporate debt at a time when S&P estimates that $650 billion worth is in the at-risk category. Any further tumult could see a demand for the Fed to start buying equity ETFs, in the mode of what the Bank of Japan has been doing.

Still more damage might show that loans aren't enough, particularly for smaller companies.

"When you look at mid-caps, 85% of them are over-indebted. They don't have debt because they invest, they have debt because they struggle," said Kerstin Braun, president of the Stenn Group, a nonbank finance company based in the U.K. "We think in two to three months, we will know better how this will go. It will all depend on how long the country is closed, how big is the output gap. The larger the output gap, the deeper the economic damage."

Braun said companies are indicating an increased interest in alternative finance, showing that "possibly the banks are tapped out."

The Fed now is trying to step into that financing gap as it grapples with multiple challenges at once.

"Free money is what the economy needs now, not a helping-hand loan that needs to be paid back," said Chris Rupkey, chief financial economist at MUFG Union Bank. "Fed officials need to be careful otherwise they may be loading up too much debt on us to weather the economic storm that the country will never be able to pay off and will drag down economic growth for years to come."