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As Fed Exits Credit, Investors See 'Helicopter Parent' Close By

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The Federal Reserve's plan to begin unwinding its unprecedented backstop of corporate debt is rekindling an idea that many have warned about: that investors are now convinced that the central bank will bail them out again if needed.

From Neuberger Berman to Invesco Ltd., investors say that the Fed's intervention at the depths of the Covid-19 pandemic provides a model to follow for future crises, which isn't necessarily what the central bank wanted to communicate.

Chairman Jerome Powell has said the Fed would only act as a backstop in once-in-a-generation type emergencies. Yet risk premiums barely moved after the central bank said it's going to gradually shed those investments, and companies are still selling bonds after a relentless rally over the past 14 months that's driven borrowing costs to all-time lows and debt issuance to record highs.

"The Fed is a bit like a helicopter parent when it comes to the bond markets," said Nicholas Elfner, co-head of research at Breckinridge Capital Advisors. "Their involvement in the bond market is assumed at this point."

The Fed has insisted that its emergency lending program was closely tied to its objective of keeping employment stable by preventing a systemic collapse of corporate funding. Since the emergency facilities were first announced last March, companies with even the highest default risk have sold debt to willing buyers, and U.S. corporations have sold trillions of dollars of bonds at rock-bottom rates.

The Fed's history as a lender of last resort was aimed at protecting small savers and making sure the banking system had backstop credit when liquidity was tight. It moved more in the direction of market support during the financial crisis and the pandemic, where it also bolstered municipal credit, money market funds and the commercial paper market.

"Systematically, that guarantee was extended to all creditors and is now extended to the corporate credit market," said Peter Ireland, an economist at Boston College. "You have to wonder if that is necessary and desirable, and it opens the issue of credit allocation."

Making Assumptions

The bailouts of American International Group Inc. and Wall Street banks in the great financial crisis were so eye-opening that Congress moved to constrain the Fed's power. Under 13.3 of the Federal Reserve Act, the Fed in "unusual and exigent circumstances" with a vote of five governors and approval of the Treasury Secretary can open a credit facility with "broad-based" eligibility.

In order to reopen it, the Fed would have to establish and agree that another set of market conditions warranted emergency action, and the Treasury Secretary would again have to approve it.

A Federal Reserve spokesperson declined to comment.

Still, the assumption in the bond market that Fed aid will be there "has to be taken very seriously because it does suggest that moral hazard is rearing its ugly head," said George Selgin, director of the Center for Monetary and Financial Alternatives at the Cato Institute in Washington. "That doesn't mean they are unaware of 13.3 requirements. It means that they believe the Fed and Treasury will quickly approve those facilities again."

Senator Pat Toomey, the top Republican on the Senate Banking Committee, is adamant that the credit programs cannot be restarted or replicated without congressional approval, as per a government spending bill passed in December.

"The Secondary Market Corporate Credit Facility was created to temporarily address the market turmoil and liquidity crunch experienced in the early months of the pandemic," Toomey said in emailed comments to Bloomberg. "This facility was not intended to undercut or replace the private market, or act as a mechanism for bailouts or a substitute for fiscal policy."

Muted Response

The central bank said Wednesday it plans to start selling around $13.7 billion of corporate debt and exchange-traded funds in its Secondary Market Corporate Credit Facility, which was launched last year to help limit the damage to the U.S. economy by the coronavirus pandemic. They'll begin with ETFs on June 7. A measure of credit risk, the high-grade CDX, weakened Thursday morning in New York, but pared back losses as strategists expect the exit to have little impact on spreads and valuations.

The selling should represent a minuscule portion of secondary trading volumes between now and year end, and shouldn't have "any material impact on spreads whatsoever," according to JPMorgan Chase & Co. strategists led by Eric Beinstein. The exit is also unlikely to change overall valuations in the junk-bond market, Barclays Plc strategist Bradley Rogoff said.

Bank of America Corp. strategists aren't so sure. The Fed's move will push spreads wider, as it should take "very little selling to convince investors the tightening cycle is underway," strategists led by Hans Mikkelsen wrote in a report Wednesday. The decision was "100% surprising" and is "very negative" for risk assets, they added.

Still, five investment-grade companies brought bond sales Thursday, as did Bombardier Inc., the embattled train and aircraft manufacturer with some of the lowest debt ratings. For some investors, that's testament to their belief that the Fed isn't going anywhere.

"My takeaway is the Fed has your back," Matt Brill, head of U.S. investment-grade credit at Invesco, said on Bloomberg TV Thursday. "Whether they tell you they have it now or they are going to have it in the future, it's still there and that's permanent."

U.S.

Blue Owl Capital Inc., the newly-formed alternative asset manager from the merger of Owl Rock Capital and Dyal Capital Partners, is tapping the bond market for the first time since the investing giants combined last month.

- Latam Airlines Group SA Chief Executive Roberto Alvo, seeking to stave off an overture from rival Azul SA, said the bankrupt air carrier's Brazilian operations aren't for sale
- For deal updates, click here for the New Issue Monitor
- For more, click here for the Credit Daybook Americas

Europe

There was just one issuer in the European primary market on Thursday as the Corpus Christi holiday in some parts of the continent dampens prospects of new bond sales.

- Looking further ahead, public sector issuers may continue to dominate sales after taking the lead for the fifth month this year, with the EFSF planning a deal next week
- The European Union will also talk to investors next week about its issuance plans under a landmark program to fund economic stimulus
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Asia

High-grade borrowers dominated new dollar offerings in the Asian primary market on Thursday, with only one high-yield name out of five new deals.

- Sichuan Languang's local bonds slumped further Thursday, poised for record lows amid ongoing debt worries about the Chinese developer
- Dan Ivascyn, CIO of Pacific Investment Management Co. said Pimco is favoring those parts of the high-yield market most likely to benefit from an economic reopening, including airlines, hospitality and gaming sectors, and commercial real estate