**CONCISE CAPITAL**

## September 2021 High Yield Market Insights

- During the pandemic the Fed expanded its asset purchase programs, first deployed after 2008
- To ensure liquidity and the functioning of capital markets, the Fed cross the Rubicon of buying corporate bonds
- 'Shock and awe' from the Fed's corporate bonds purchase announcement accounted for most of the impact
- Now that the Fed has included corporate bonds, it has become another tool in its toolbox

Since the Great Financial Crisis (GFC) in 2008, when the Federal Reserve unleashed several Large Scale Asset Purchase (LSAP) programs – otherwise known as quantitative easing (QE) - the market has become accustomed to the Fed playing a dominant role within capital markets. Many investors argue that this intervention has materially distorted pricing and asset allocation. Before the GFC, the Fed's balance sheet averaged well under one trillion dollars. By late 2014, when the Fed decided to allow Treasuries and MBS securities held in the System Open Market Account (SOMA) to wind down, the balance sheet had swelled to $4.6 trillion.

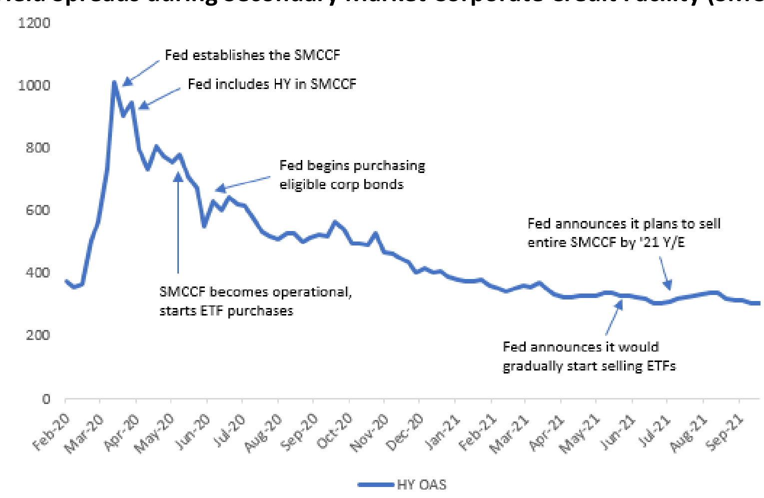
The Fed's response to the pandemic-led market dislocation in 2020 caught the most seasoned Fed watchers by surprise. Last March, Chair Jay Powell and the Federal Open Market Committee (FOMC) announced an asset purchase plan that made even former Fed President Ben Bernanke sit up and take notice. In addition to restarting its dormant QE program, the Fed purchased corporate bonds, including single name investment grade bonds and ETFs, for the first time. In early April 2020, the FOMC expanded the corporate bond purchases to include eligible high yield bonds and high yield ETFs.

The inclusion of corporate bonds within the asset purchase program caused consternation among investors. The corporate bond market being much smaller than the treasury market, participants were concerned about price discovery, liquidity and an exit strategy for the purchases.

However, corporate bond purchases turned out not to be disruptive to IG or HY bond markets, amounting to less than $500 million per week. The Secondary Market Corporate Credit Facility (SMCCF) topped out at $14 billion. The corporate debt purchases had a strong psychological impact, yet had little practical imprint. While its inclusion raised eyebrows, high yield represented an inconsequential, sub-5% of total SMCCF holdings.

Figure 1 illustrates the impact on high yield spreads following various Fed announcements about the SMCCF rollout – notably even before actual asset purchases started.

**Figure 1: Evolution of High Yield Spreads during Secondary Market Corporate Credit Facility (SMCCF)**




*Source: Bloomberg, Concise Capital*

On March 23rd, 2020, just after the global economic shutdown, the Fed announced two corporate debt buying facilities. While a Primary Market Corporate Credit Facility was announced alongside the SMCCF, the Fed only utilized the SMCCF. The HY market's knee-jerk reaction was a -144bp decline of the credit spread over Treasuries, which had topped out at 1,087bp on March 23rd. Then, on April 9th, the Fed announced the inclusion of HY corporate bonds, driving spreads lower by -65bp over the following week and down to 731bp on April 17th.

With spreads oscillating over the next month, on May 12th, the Fed announced that it would purchase bond ETFs. That announcement led to another dramatic decline in spreads, which fell -228bp to 550bp through June 5th.

Finally, the HY market received yet another psychological boost following the announcement on June 16th that the Fed would begin purchases of eligible corporate bonds directly, including eligible BB rated issues and select "fallen angels". The announcement, along with several fiscal policy initiatives, boosted performance throughout the rest of 2020 and into 2021.

Fears over the eventual unwind of the program proved unfounded. The HY market took the announcements on June 3rd, 2021 that the Fed would begin gradually selling ETFs, and on July 8th that it would begin selling eligible corporate bonds, in stride. The entirety of the SMCCF portfolio was liquidated by the end of September 2021 without noticeable impact.

The Fed's inclusion of corporate bonds within the SMCCF program proved to be symbolic yet effective. The extent to which such tools may be utilized in future crises is unknown. Some central banks, such as the Bank of Japan, have included nearly all asset classes in their asset purchase programs, including stocks. If the corporate bond market begins to view the Fed as the buyer-of-last resort, it may price a ceiling for spreads below historical levels.

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