CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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The Fed Backstops Everything

The Fed's actions in this crisis have been swift, radical and, in important ways, very effective. Liquidity has been restored to markets that ceased to function for a period in mid March. It provided dollars around the world to meet the unmet demand. It is acted in a series of moves to bolster credit of almost every kind.

One suspects we will see more from the Fed in the weeks ahead.

By

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In these increasingly frequent letters, I have tried to explain what appears to be unfolding in our new world. In this *Core Comments*, since we are now in the Paschal season, let me wish everyone a good Easter and Passover. Passover Seders, in the midst of this plague, have redoubled meaning.

My aim is to explain what the Federal Reserve is doing and the effects its amazing actions have on every asset class under the sun. So far, we have not seen the benign effects of the huge $2 trillion legislation recently enacted. One hopes we will soon. On April 9th, the Fed announced another heretofore unimagined policy, the effect is to extend the credit of the Fed to almost all credit markets in America. Given the Fed's US dollar actions, discussed below, one realizes that the Fed's actions are global in scope. If we ever doubted that the Fed is the central bank for the world and that the US dollar is the world's currency, its actions dispel those doubts.

March witnessed extraordinary disruptions in bond markets, including the market for US Treasury bonds, the deepest and most liquid market in the world. At the same time, the US dollar sustained a period of extraordinary volatility, first falling by about 5%, then surging higher by 17% in the space of nine days, before again falling back to where the roller coaster ride began. The dollar is the world's reserve currency; much more than half of all the world's trade is denominated in dollars. Its gyrations were exceptional and indicated the extreme need that foreign banks, foreign countries and foreign businesses had for dollars and the difficulties of obtaining those dollars. In a five-day period beginning on Sunday, March 15, the Fed announced three huge programs to increase access to dollars around the world, entering into dollar swap agreements at very low rates with its six long-standing swap partner central banks--those for the Euro, the Swiss Franc, the Japanese Yen, the Canadian Dollar, the Pound Sterling and the Swedish Krone. Four days later, it extended similar terms to the central banks of Australia, Brazil, Korea, Mexico, Singapore, Denmark, Norway and New Zealand. On the next day, it increased the frequency of its dollar-funding operations. To date, nearly $550 billion have been drawn by these central banks. In their turn, those central banks offer dollar facilities to their domestic banks, which then lend the dollars on to domestic business. The Fed ended the dollar-funding crisis.

In its blizzard of policy undertakings in March, the Fed also sought to end the disruption of the high-grade US corporate debt market. In the *Core Comments* of February 27, I noted in passing that I had sold our high-grade corporate bonds, remarking that there was no reason to hold those bonds, which had very little credit risk, while we held our Treasuries that present no credit risk. Little did I know then that credit markets would fall shortly thereafter, along with the volatility in the dollar. The fund through which we held our corporate bonds (symbol LQD) fell by 22%--an unheard of amount—in the dreadful mid-March period. The Fed, along with its many other efforts, promised liquidity to high-grade bonds and it worked. Bond prices began to recover; this week, we purchased a new position in LQD, now yielding a rather handsome 3.8% and on its way back in price to the levels of early March.

Then yesterday came what is the most radical policy yet. The Fed will support--with $2.5 trillion--a huge range of personal, small business, municipal and state credits, as well as commercial mortgages, leveraged loans, equipment loans and leases, and corporate bonds (even including some 'junk bonds'). This has been never ventured before. Prior to the financial crisis of 2008 - 2009, the Fed only held US Treasuries. In its 'quantitative easing' in response to that crisis, it expanded its balance sheet five fold, but only added more Treasuries and US government-backed mortgage securities. Now the Fed underpins essentially every aspect of credit markets except for distressed debt. (How long will it be before the Fed buys distressed debt and US stocks? Just a rhetorical question.)

The Fed guarantees liquidity in credit markets. I take this to mean that we may invest in credit markets--bonds and other fixed income securities--based upon our views of what the future holds. We need not concern ourselves that the credit markets will turn upside down and become utterly incomprehensible, as they were for two weeks in mid March. If I am right in drawing this conclusion then, for me, it points the way for Core's investments in the period just ahead. That is, we can analyze the credit markets in terms that we understand, e.g., what will the economy do in the months ahead? What are the inflationary or deflationary pressures? We need not concern ourselves with the question of liquidity in these markets; the Fed provides the lubricants to ensure their functioning.

By avoiding stock investments this year and with our large investments in long-term US Treasury bonds and in gold, we have earned good returns, while the stock market crashed around us.

Core's investments. As mentioned above, we took a position this week in US high-grade corporate bonds. We had sold our similar position in late February; with the benefit of hindsight, this looks to have been shrewd trade. It was not that I foresaw the huge decline that lay ahead; I simply acted to further reduce risk in our portfolios. I had been concerned since the autumn of 2018 that things would unravel. Economic growth was weakening; the strong stock market in 2019 was not sustained by growing corporate earnings. Corporate profits fell all through 2019. Stocks were boosted higher by a series of Fed actions. First, in response to the sharp sell off of stocks in November and December 2018, the Fed stopped raising the Fed funds rate and stopped reducing the assets on it balance sheet. (This is now known as the 'Powell pivot.') Then, as 2019 rolled on, the Fed cut the Fed funds rate, after a failed experiment to 'normalize' short-term rates. Finally, early last autumn, the so-called repo market went haywire. The repo market (short for 'repurchase market') refers to overnight lending between banks to meet their demands for credit. Suddenly repo rates increased enormously. (This was something of a mystery then; now it seems to have been the canary in the coal mine foreshadowing last month's amazing disruptions in fixed-income markets.) In response to repo ructions, the Fed took hundreds of billions of new short-term Treasury bills on to its balance sheet, pointedly declaring that this was not quantitative easing. Nevertheless the stock market took it as the 2019 version of QE and moved higher in price, despite declining profits. Don't fight the Fed, as they say.

As with the Treasury market and many others, the stock market has rallied from the fierce mid-March selling. Stocks clearly like the news of the latest Fed actions, putting some $2.5 trillion into more or less everything in the credit markets. Although this bear market in stocks was the fastest ever, in that it declined by 35% from intra-day high in mid February to intra-day low in late March, it will still, in my view, follow the long-established patterns of bear markets. After this initial decline, it has rallied back quite strongly making up some half of what it lost just recently. Reflexive bear market rallies are often sharp and strong, as is this one. What follows usually is a long period of further declines, further rallies, and deeper lows than in the first round of selling. Thus I think it will be this time, as well. Because we have all made a good return so far this year with our Treasuries and gold while stocks crumbled, we have the luxury to wait, to observe, and to pick our point to buy stocks again.

CORE Comments

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