16 June 2020
Article

Fed now purchasing corporate bonds

The Federal Reserve will begin purchasing individual corporate bonds under the secondary market corporate credit facility. We think this is a positive for USD credit

Source: Shutterstock

So far, the secondary market corporate credit facility (SMCCF), one of several emergency facilities recently launched by the Federal Reserve to improve market functioning in the wake of the coronavirus pandemic has only been purchasing exchange-traded funds (ETFs), where they have utilised roughly US$5.5bn of the US$250bn currently available for the programme.

The SMCCF will initially compile a portfolio of USD corporate bonds that tracks a broad market index and the index will be recalculated every 4-5 weeks, with constant updating of the eligible list of bonds. As it stands, the facility will be active until 30 September this year, unless of course, the board decides to extend the programme.

This is positive for US investment-grade corporates that have eligible debt for purchasing. An issuer must have significant operations in the US and have the majority of its employees US-based to be eligible. This makes it unlikely any European corporates can find a work around to become eligible. The maximum amount the facility will purchase of an eligible issuer is 10% of the total outstanding bonds of said issuer. Additionally, the maximum amount the facility, combined with PMCCF, will purchase of an eligible issuer is 1.5% of the total combined size of SMCCF and PMCCF. Furthermore, the index will be under the basis of sector weights, which the Fed's purchases will track closely.

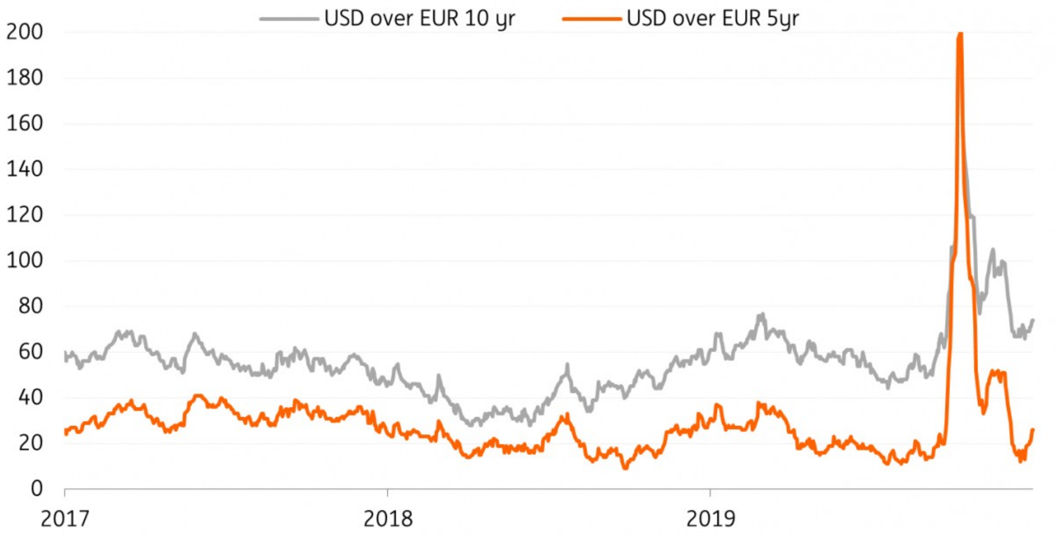
The Fed identifies 12 sectors:

- Basic industry
- Capital goods
- Communications
- Consumer cyclical
- Consumer non-cyclical
- Energy
- Insurance
- Non-bank/Insurance financials
- Real estate investment trusts
- Technology
- Transportation
- Utilities

The Fed is limited to a remaining maturity of five years or less. With the support limited to the short end, we will continue to see consistent steepening on USD credit curves.

This may amplify the recent trend we have seen in USD/EUR corporate credit spread differential. As seen in the below figure, the long end of the USD curve is significantly wider than the long end of the Euro curve, this is due to the ECB purchasing across all maturities. The higher USD over EUR differential in the long end may offer an attraction for US corporates to issue in Euro (reverse yankee issue).

EUR USD spread differential



Source: ING, ICE

Depending on how the corporate credit curves in both EUR and USD develop (in addition to cross-currency basis swaps), we may even see a scenario whereby it could be attractive for Euro corporates to issue short tenor USD bonds and USD corporates to issue long tenor EUR bonds.

All in all, we consider the Fed purchasing under the secondary market corporate credit facility as a positive.

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