

The Fed's Further Action to Combat the Virus Fallout

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The following provides some perspective on the Federal Reserve's recent efforts to combat the economic effects of the coronavirus.

1. The Fed continues to follow [its playbook from the global financial crisis](#)—announcing on Sunday a broad-based package of monetary-easing measures. By any historical standard, the scale and scope of these actions was extraordinary. Even so, markets were expecting extraordinary action and have fallen since the Fed's announcement. Notwithstanding today's drop in asset prices, we believe the Fed's moves are significant and will, over time, provide important support to the economy and markets.

2. In terms of conventional policy tools, Sunday's 100 basis point cut in the Fed funds rate, on the heels of the previous 50 basis point inter-meeting move, represents a dramatic easing. With the target for the policy rate now near zero, the Fed is seeking to "get ahead of the problem" and preempt intensified stresses for the economy and markets.

3. The Fed's announcement also included several other important components. Most notably, it not only restarted its Quantitative Easing program, but it also broke new ground in terms of the structure—and flexibility—of the purchases. With the objective of supporting market functioning, the Fed stated that "over coming months the Committee will increase its holdings of Treasury securities by at least \$500 billion and its holdings of agency mortgage-backed securities by at least \$200 billion." This framework gives the New York Fed a sizable pool of essentially unconstrained resources to aid market functioning. In particular, the Fed left the time duration of the program and the ultimate size of the purchases open ended—specifying purchase quantities only as "at least." With this action, the Fed is focusing the full power of its balance sheet on resolving the liquidity disruptions that have occurred in the Treasury market over the past week. This is dramatic action and truly represents a bazooka.

4. The Fed also slashed the borrowing rate at its discount window to just 25 basis points in an effort to make it more attractive for banks to borrow through this facility. If successful, this would help provide funding for a broad swathe of commercial banks and maintain the flow of lending to households and firms. As a related matter, in a joint move with other central banks, the Fed restarted the dollar swap lines and cut the borrowing rate to 25 basis points. This move will help resolve any emerging shortage of dollars in global markets. The Fed also said that it would allow banks to draw on their significant capital buffers to support credit provision through the months ahead. But here there are many uncertainties: Will banks be willing to allow their capital ratios to move down during a time of stress? How much of a reduction might the Fed allow? And will there actually be sufficient demand for credit to drive such a drawdown?

5. Another open question is whether the combined actions will eventually spillover into fixed income credit markets. Given the anticipated easing in overall liquidity conditions, it's reasonable for the Fed to expect its actions to ease conditions in the credit markets as well. However, if conditions in those markets remain severely strained, the Fed will need to follow up with an appropriately tailored facility, likely patterned after the crisis-era Term Asset-Backed Securities Loan Facility (TALF). The implementation of such a facility would require cooperation between the Fed and the U.S. Treasury, probably in conjunction with Congress.

6. Bottom line, this announcement represents a quantum easing of monetary policy. The Fed clearly understands the severity of the situation. The markets, however, will also be looking for two other key markers. First, the Fed has put the onus on President Trump and Congress to respond with a similarly beefed up, fast-disbursing fiscal package. An accompanying fiscal response is critical. Second, markets will also be looking for evidence that the Administration is responding vigorously and effectively to the public health challenges posed by the crisis. Macro policy responses are constructive, but—ultimately—the performance of the economy and the markets will be mainly determined by the severity and duration of the virus' outbreak.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of March 2020.

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