Why I’m not a fan of the Fed buying corporate bonds

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In March, the U.S. Federal Reserve moved to prevent a coronavirus-induced downturn by promising to set up an entity to buy corporate bonds and ETFs, including junk bonds and junk bond ETFs. My concern is that the Fed has simply created another time bomb that future generations will have to defuse.

It’s worth remembering the idea embodied in the aphorism, ‘Wall Street will sell what Wall Street can sell’. But just because an investment product exists doesn’t mean you should invest in it.

What the GFC taught us

The Global Financial Crisis taught us that packaging up tranches of subprime mortgages diversified by geography into Collateralized Debt Obligations (CDOs) didn’t make them any less risky. Trillions were lost in the aftermath of the GFC and the financial system would have broken if not for the creation of emergency quantitative easing (QE) by central banks.

You might have thought investors would have learned their lesson so that even if Wall Street came knocking again with a ‘great’ investment idea, their wallets would have been zipped up. Sadly, the lessons weren’t learned, or were forgotten, and now the US Federal Reserve will lead a conga line of central banks into ‘QE infinity.’

To help explain how we arrived here (again), a brief history lesson is first required.

How we arrived here again

Following the GFC, and to avoid an apocalyptic catastrophe, short-term interest rates were brought down to zero.

Realising however that zero short-term rates weren’t stimulating the necessary animal spirits, central banks lowered long-term rates and flattened the yield curve through the purchase of government bonds. When bonds are purchased, their prices rise and because of the inverse relationship between prices and yields, yields fall. When the yield curve is flat, and close to zero, there is little incentive to save short or long-term.

In order to purchase those bonds, the central bank has to pay cash, which is then injected into the financial system. Of course, the cash has to be printed first and in normal circumstances this would put downward pressure on the currency being over-supplied. But when all the world’s central banks are engaging in the same behaviour, the currencies aren’t adversely influenced relative to each other.

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Now, because nobody wants to hold the cash, which is earning zero, it finds its way into speculative endeavours fuelling asset bubbles. Houses, stocks, collectibles, corporate bonds, bitcoin and even junk bonds all appreciate as the cash migrates, first to better returns and then to the less safe versions.

Of course, as the flow of cash starts inflating asset prices, owners of those assets are lured out of hibernation to sell those assets. In financial markets, however, assets are created to meet the demand. One particularly asset class that emerged was the leveraged loan.

Putting all the euphemisms created by rating agencies aside, a leveraged loan is one extended to the riskiest companies with considerable debt already or a poor credit history or both. Another development has been the covenant-lite (Cov-lite) loan, which is exactly what it sounds like.

With a market full of buyers looking for higher returns and willing to adopt more risk, Wall Street had a ready band of idiots who had forgotten CDOs. Wall Street bundled up (securitized) all the leveraged loans, structuring them into Collateralized Loan Obligations or CLOs. Sound familiar?

CLOs became the biggest 'owner' of leveraged loans, holding an estimated 60 per cent at the beginning of 2020. Between 2013 and 2020 the holders of leveraged loans looked like geniuses. The S&P/LSTA US Leveraged Loan 100 Index rose from 1750 in 2013 to 2300 by February of this year.

One month that wiped out the gains from 2013

But never mistake a rising market for genius. Within one month between February 22, 2020 and March 23, 2020 all of the gains since 2013 were wiped out. As at March more than a quarter of the loans within CLOs had been downgraded and more than 1000 tranches of loans within CLOs were under review for a potential downgrading. Another financial market meltdown was emerging and another chapter in a long history of financial folly was being written.

This time, however, the US Federal Reserve didn't take a year to work out how to 'save' the world. With a carbon copy of the GFC now underway, the Fed pulled outs its playbook and on 23 March announced it would begin buying corporate bonds, for the first time in its history.

Crisis averted.

I wonder however how many lessons have been learned? And if QE 1.0 kicked the proverbial can down the road, what has the QE rescue package 2.0 done?

Economists now embrace Modern Monetary Theory (MMT) as an explanation for what is going on here. MMT suggests that cornerstone sovereign countries like the U.S., U.K. and Japan do not need to constrain their money printing and spending by referring to their revenues from taxes or borrowing. They can print as much money as they need or want because they are monopoly issuers of reserve currencies.

Hmmmm. The piper never needs to be paid.

But is such a development, one which results in the destruction of 'price discovery' evidence of an evolution in sophistication of financial markets? Here's the problem: if something cannot go on forever, it must stop. If the US continues to print money with gay abandon and without limit, it could help it finance military and economic domination, which in this environment is probably wise to support. But if the money

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is instead used to support low interest rates for rubbish, Triple C-rated, junk companies, something less desirable will probably emerge. And when it does, the volatility will be sharper and the pain deeper than anything we have experienced.

It might not happen in my lifetime, but my kids will probably know something about it whether they study economics or not.

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