
'We Are Going To Buy Your Bonds Whether You Want Us To Or Not'

By Tim Duy *Thu, Jun 18, 2020*

'The Fed appears to be taking actions that are not obviously necessary to meet its stated objective of smooth market functioning,' writes Duy, an economist and Fed-watcher at the University of Oregon.



This week the Federal Reserve announced it is expanding its corporate bond-buying program. Via [Victoria Guida at Politico](#):

The Fed is going to create an index of U.S. corporate bonds that it will purchase on the open market as long as they meet eligibility standards — an approach that will spare the companies from having to seek aid directly from the central bank.

The goal of the \$750 billion emergency lending program is to keep cash flowing in the markets and support “the availability of credit for large employers,” the Fed said on Monday. Stocks rose on the news, reversing sharp losses earlier in the day.

The announcement represents a shift in strategy for the central bank, which was previously only going to buy individual bonds issued by companies that approached it directly. Now the Fed will buy bonds of all eligible companies, whether they ask or not.

[Brian Chappatta at Bloomberg](#) wonders why the Fed is doing this at all:

The most surprising part of this is there is virtually no evidence that the corporate-bond market needs this kind of intervention — it has been working nearly flawlessly for months.

This does create a bit of a problem for my narrative (not that it's all about me). I have typically described the Fed's asset purchase program and lending program in terms of market functioning. The Fed identifies a gap in the credit market and tries to bridge that gap. In some cases, bridging the gap might be possible by simply being a credible backstop to a credit market. This appeared to be the case in the corporate debt market.

Just the willingness of the Fed to prevent a liquidity crisis from becoming a solvency crisis

was enough to revive the corporate debt market. As Chappatta noted, the market appeared to be functioning just fine. So why the extension of the program? Isn't the best case scenario the one in which the Fed can stabilize credit markets without actually buying anything?

This isn't the first time the Fed has done something like this. Last week, the Fed put a floor under the asset purchase program by holding it "at least at the current pace to sustain smooth market functioning." Heather Long at the *Washington Post* quickly [eyed the logical conundrum](#):

Hi, good afternoon, Chair Powell. I'm struggling with two things that I'm hoping you can provide some clarity on. The first is the ongoing bond buying program. You say that it's needed to continue the smooth functioning of markets, but I guess most of us aren't really seeing instability in markets right now. So, if you could kind of give us some clarity of what you're seeing that needs to continue to be smooth at that level and that pace.

Powell responds:

CHAIR POWELL. There have been gains in market function, although not fully back to where you would say they were, for example, in — in February, before the pandemic arrived. We don't take those gains for granted though. This is a — this is a highly fluid situation and we're we're not taking those for granted. And in addition, as I pointed out in my — in my statement, those purchases are clearly also supporting highly accommodative — or accommodative financial conditions, and that's — that's a good thing, so that's why we're doing that.

It is not a particularly satisfying answer. It doesn't fully embrace that asset purchases are increasingly less about market functioning and increasingly more about accommodative financial conditions. In other words, quantitative easing does not just allow for the transmission of accommodative interest rate policy, but is accommodative policy by itself. I [discussed this Monday in my Bloomberg column](#).

The Fed did a stealth easing last week and it kind of flew under the radar. After this week's

bond market news, I am more convinced that the Fed is rapidly moving beyond market functioning but not being very direct about that move. It is fairly easy to conclude that the Fed is working to push down interest rates (or push up prices) across a range of financial assets but not directly saying this is the Fed's objective. I understand why they want to pursue such a policy. I don't understand why they don't just say they are pursuing such a policy.

The Fed's behavior this past week does give us a clue on how yield curve control is going to work. In theory, an advantage of yield curve control is that the Fed could control interest rates by just promising to purchase debt at a certain price. The promise alone should be effective with minimal actual purchases. Just as the Fed's promise was enough to stabilize the corporate debt market.

A risk management focused policy that maybe didn't quite know which was more important, the price or the quantity, might choose to do both. In that world, the Fed set interest rates at zero along the one, two, etc. year horizons while at the same time expanding the quantity of assets purchased. I think that's how it would work. At least that what I am thinking tonight.

Bottom Line: The Fed appears to be taking actions that are not obviously necessary to meet its stated objective of smooth market functioning. It looks like the Fed is trying to enhance the portfolio balance effect of asset purchases. I am not opposed to that, but I am wondering why they don't just say it.

One reason could be that they fear Congress will limit the amount of fiscal support should the Fed push monetary policy further now. I am at a loss for another reason. The implication is that, short-term psychological shift aside, even if the economy just limps ahead it looks like the Fed is providing support for a wide range of asset classes.

This post originally appeared on Tim Duy's [blog](#).