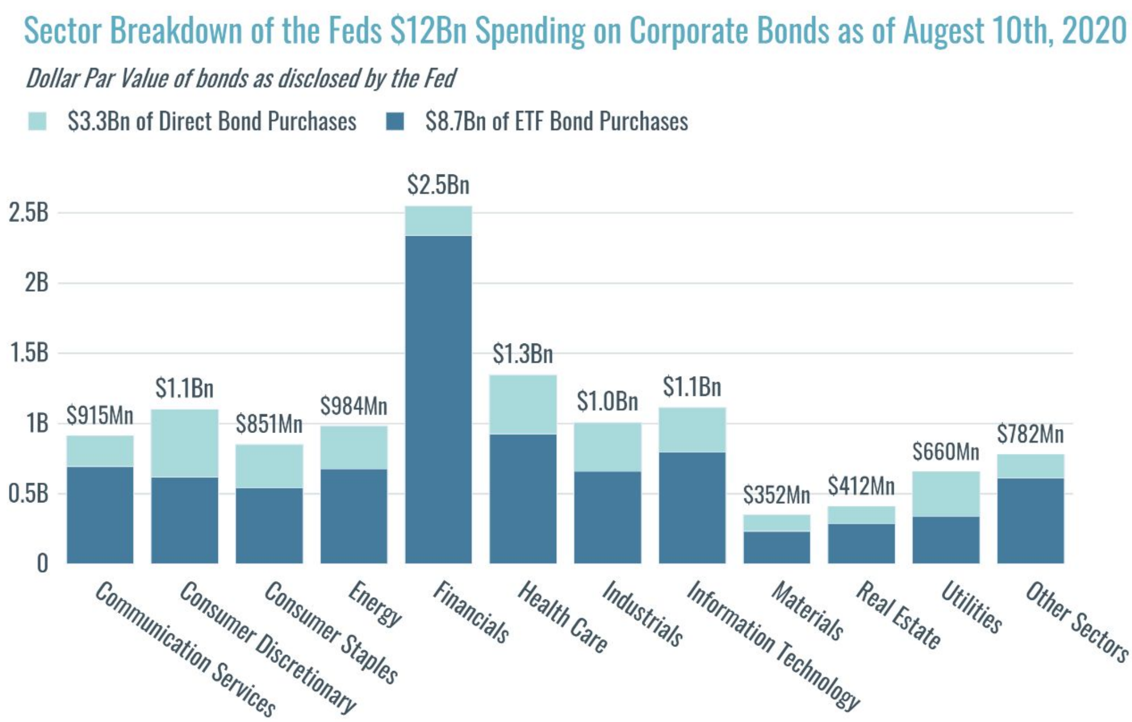
The US Federal Reserve & Corporate Debt

The following is an update to InfluenceMap's July report Is the Fed Being Sector Neutral? based on August 2020 disclosures from the US Federal Reserve.

Introduction

In March 2020, US Congress authorized the Federal Reserve to establish the Primary and Secondary Market Corporate Credit Facilities (PMCCF and SMCCF) to increase capital flow to US companies suffering as a result of the COVID19 pandemic. As reported in *Necessary Intervention or Excessive Risk*, the Fed's plans to purchase corporate debt marked a major foray into the real, as opposed to financial, economy.

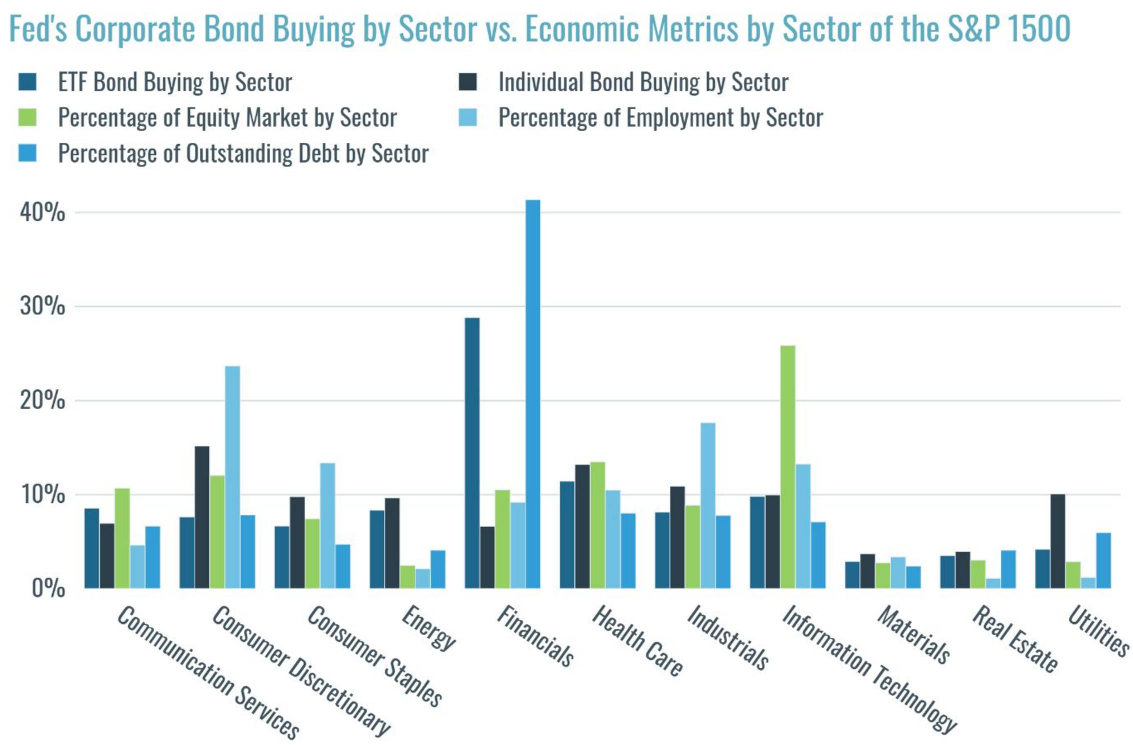
All Fed disclosures to date (August 2020) refer to the SMCCF component of the Federal Reserve's corporate debt buying program, which remains the smaller of the two (the SMCCF has a potential ceiling of $250Bn vs. $500Bn for the PMCCF). Primary market activity is vastly more significant for any beneficiary companies as it introduces new capital into the company as opposed to supporting the market for existing debt in the case of the SMCCF. Thus far, the Fed has not disclosed any activity through the PMCCF. It is also noteworthy that while US equity markets (as of August 20th, 2020) have returned to all-time highs, the Fed's SMCCF purchases ($12Bn) remain a small fraction of the potential upper limit of the program (less than 5%).



InfluenceMap released *Is the Fed Being Sector Neutral?* in July 2020 to examine the extent to which certain sectors may be overrepresented in the Federal Reserve's real economy corporate bond portfolio. The report analyzed the Fed's disclosures through the SMCCF. It found that the GICS Energy sector, composed exclusively of oil, gas, and coal value chain companies, was the only sector consistently overweight across three key indicators of weightings by sector: corporate debt outstanding, equity values, and employment. Using the same financial databases and benchmarks for comparison, this paper offers an update to these findings as of August 10th, 2020. The results are outlined below, with the plot above showing the Fed's cumulative bond purchases by sector.

Sector Neutrality

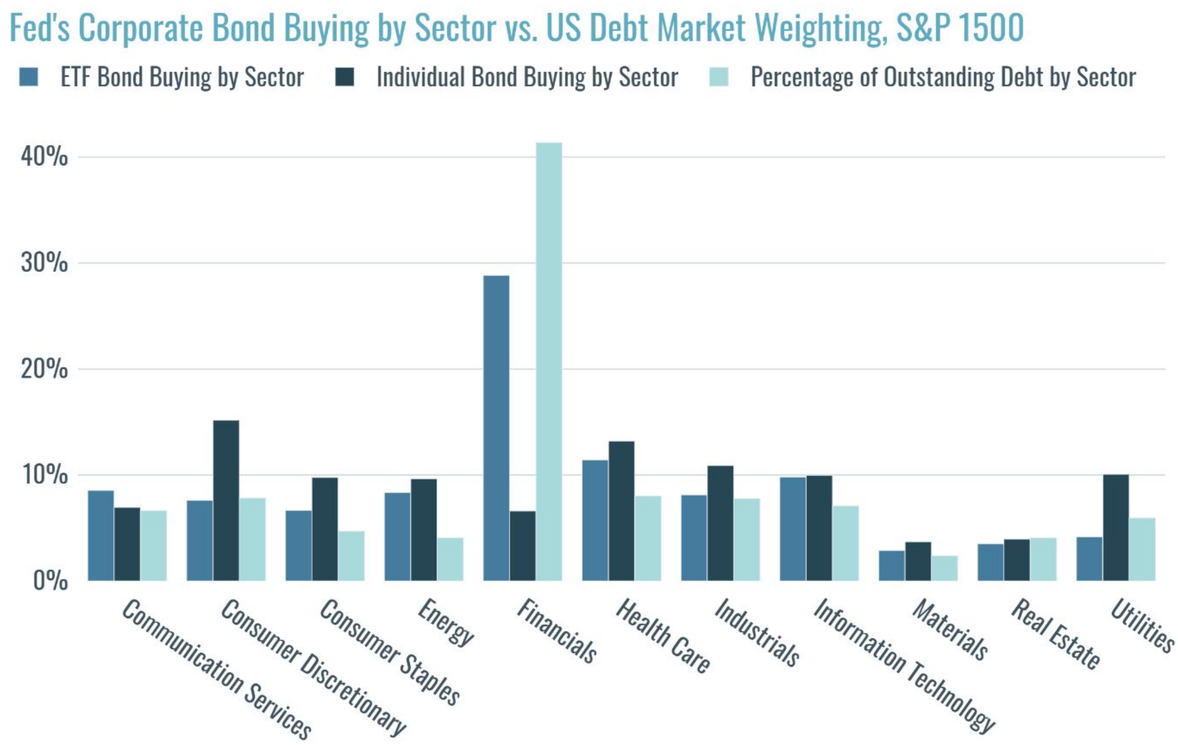
The first round of SMCCF purchasing began in May 2020 through a selection of 15 bond ETFs. In June 2020, the Fed expanded to individual corporate bonds in addition to bond ETFs. (RecoveryMap - a project of InfluenceMap - details all bond purchases disclosed by the Fed since May 2020, including whether they were acquired individually or through ETFs). The Fed has since announced its intention to further increase its focus on individual bonds though the SMCCF. Given that individual bond purchases represent a more active approach with greater discretion on the part of the Fed, this briefing distinguishes between individual bond and ETF purchases. *It finds that the GICS Energy sector is the only sector overweight on three economic benchmark indicators: corporate debt outstanding, sector employment, and market value - in* both *purchasing categories.* When looking at individual bond purchases only, the fossil-fuel intensive Utilities and Materials sectors are also overweight on all three indicators. In this case, Materials is only slightly overweight on the three indicators, while the Utilities sector is overweight by 1.7 times in outstanding debt, 3.5 times in market equity, and 8.5 times by number of employees.



The Energy sector makes up 8% of the Fed's bond ETF purchases through the SMCCF and 10% of its individual bond purchases through the SMCCF. By contrast, the sector benchmarks for Energy - as defined by the S&P 1500 constituents - are 4% for outstanding corporate debt, 3% for market value, and 2% for employment.

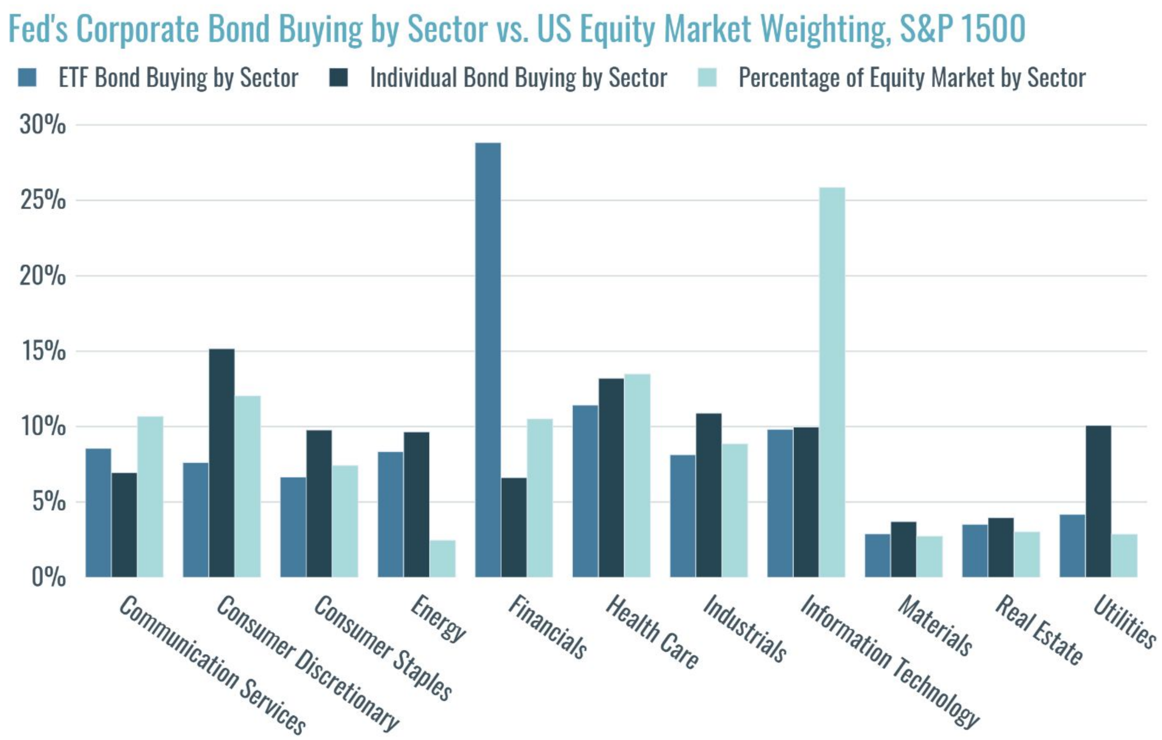
Sector Neutrality by Corporate Debt Outstanding

Given the central aim of the SMCCF to increase cash flow to US companies by purchasing corporate debt, the Fed might be expected to reflect the indicator of S&P 1500 corporate debt outstanding. However, the following chart suggests that the Fed's bond purchases remain overweight on Energy when measured against the S&P 1500 corporate debt market overall. Energy is 2.0 times overweight in bond ETFs and 2.4 times overweight in individual bonds.



Sector Neutrality by Equity Values

As reflected in the following graph, the Fed's corporate bond purchases within the S&P 1500 are 3.4 times overweight in Energy on the Equity indicator in ETFs, and 3.9 times overweight in individual bonds. The Fed's purchases of bonds might be expected to reflect the proportion of the US economy each sector inhabits; however, this data shows a large overweighting of the Energy sector in a metric designed to represent economic size.



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Sector Neutrality by Employment

The Fed's corporate bond purchases are 4.0 times the S&P 1500 employment weighting for the Energy sector bonds purchased through ETFs and 4.6 times overweight for individual bond purchases. While a sector neutral by employment approach might align with the Fed's dual mandate to stabilize prices and maximize employment, the following chart suggests that Energy is most overweight on employment of all three indicators, continuing a trend noted in July.