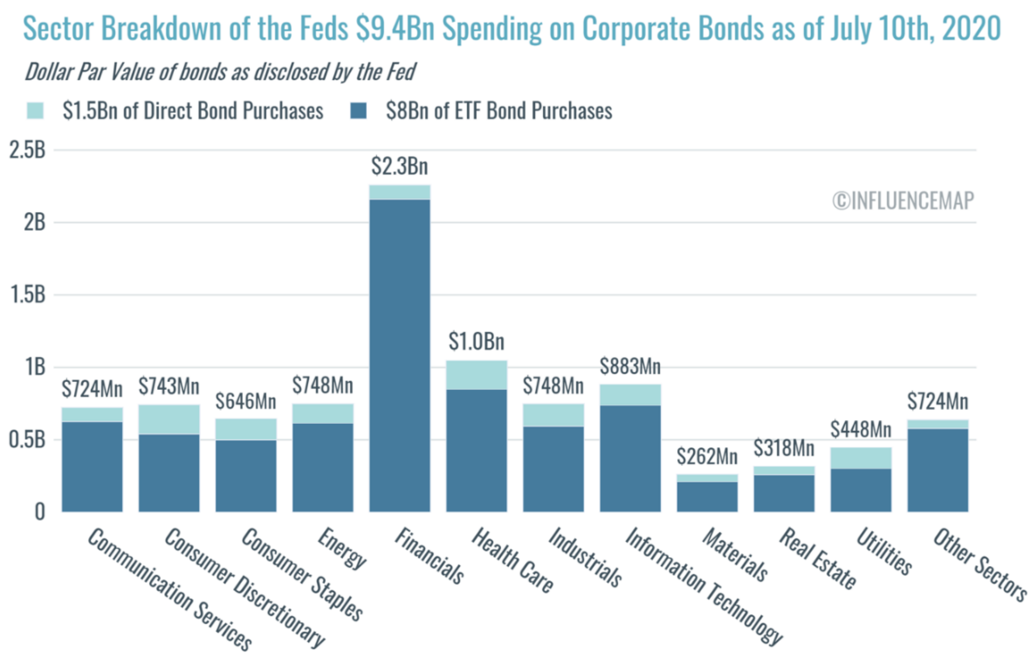
July 2020

Is the Fed Being Sector Neutral?

A Sector Weighting Analysis of the US Federal Reserve's Corporate Bond Market Interventions

Introduction

InfluenceMap released Necessary Intervention or Excessive Risk? in June 2020 to examine the US Federal Reserve's COVID-19 related Secondary Market Corporate Credit Facility (SMCCF) activity from a risk viewpoint. It was designed to trigger better disclosure from the Fed and central banks globally as to their strategies during these unprecedented interventions in real economy debt markets. It found long term secular declines in certain sectors in which the Fed was investing (notably Energy, which contains oil/gas and coal value chain companies exclusively), posing issues of excessive risk-taking by the US government and market distortion. Whether the Fed's corporate bond buying is market neutral and the extent to which it is hedging positions is not clear. However, the sector-weightings of the Fed's purchases can be

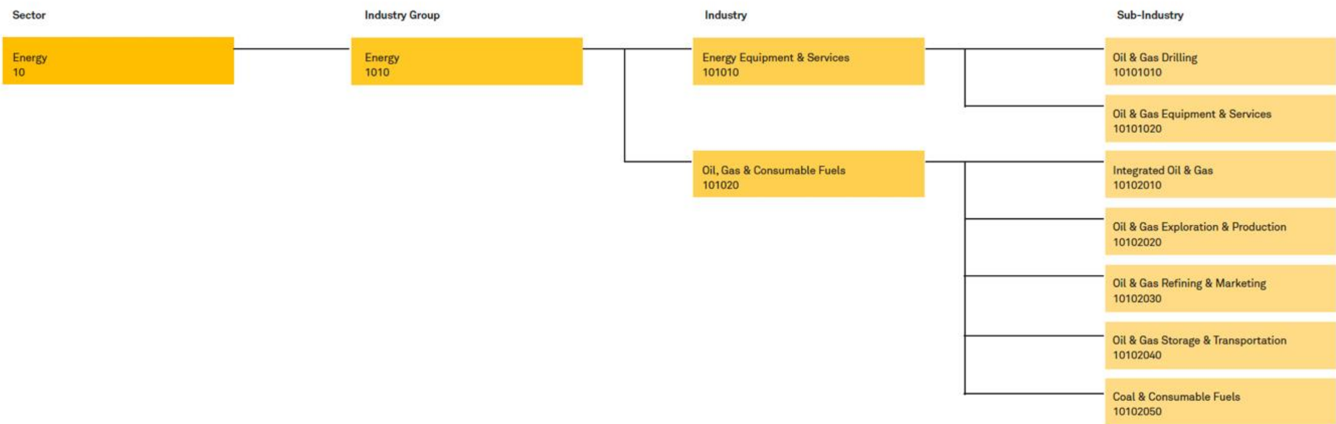


assessed using financial databases and analysis of the Fed's disclosures. The results are outlined in this paper with the Fed's bond purchases by sector noted below as of July 10th, 2020.[1]

Sector-Neutrality

The Global Industry Classification Standard (GICS) is an economic taxonomy developed in 1999 by MSCI and S&P for use by the global financial community. It consists of 11 economic sectors and a hierarchy of further sub-categories. This analysis looks at three indicators as comparison benchmarks of weightings by sector: corporate debt outstanding, equity values and employment. During the financial crisis a decade ago, the Emergency Economic Stabilization Act of 2008 allowed the Fed to extend its mandate and intervene to support the financial sector. Thus, financial-sector bias during the current intervention may not be considered a large deviation of Fed policy. In terms of the real economy sectors, the following discusses the extent of sector-neutrality within the Fed's interventions against the three indicators of debt outstanding, equity values and employment. The S&P1500 is taken as representative of listed US corporations.

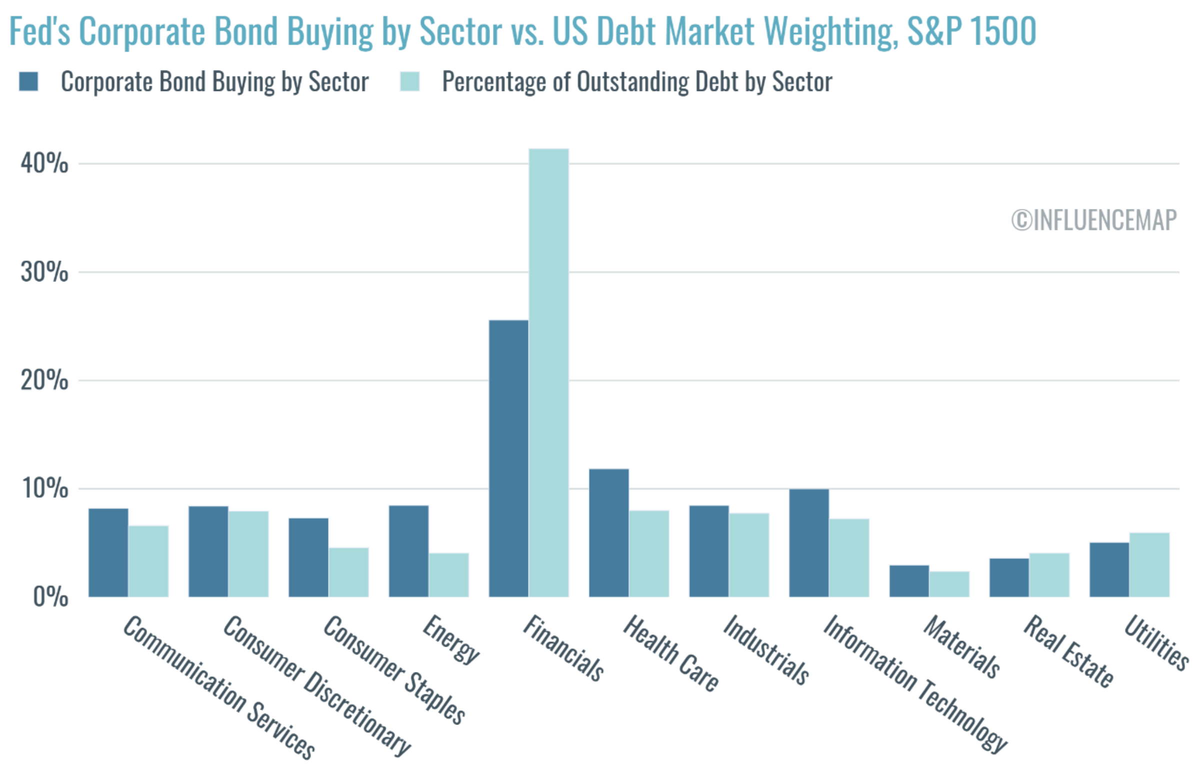
The research finds that the ***only*** *sector where the Fed is consistently overweight on all three indicators (debt outstanding, equity values and employment) is the GISC Energy sector, which contains oil/gas and coal value chain companies exclusively. Against a corporate debt outstanding indictor, it is more than* ***2X*** *overweight. Against equity values, it is over* ***3X*** *overweight, and against employment, more than* ***4X*** *overweight.*



[1] Around 6% of the bond issuers in the Fed's $9.4Bn purchases are not matched to GICS sectors in the financial database used for this research. These are indicated as "Other Sectors" in the chart above and are not included in the analysis that follows.

Sector-Neutrality by Corporate Debt Outstanding

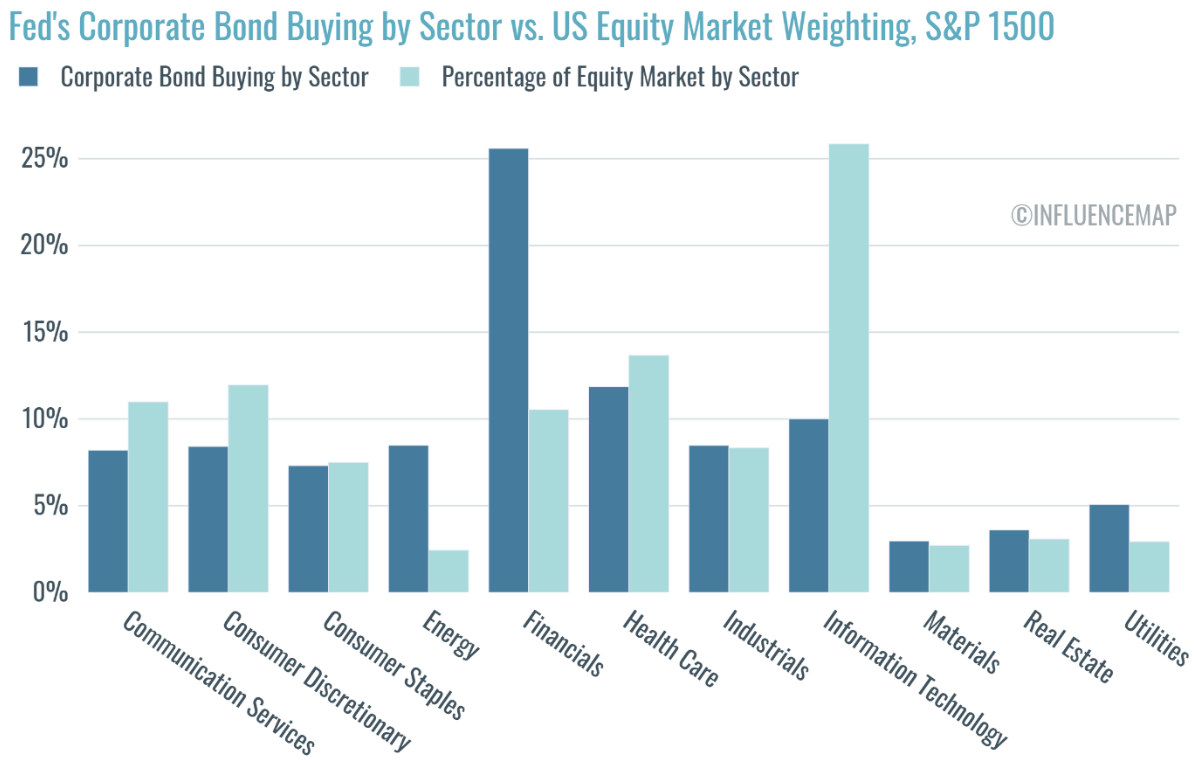
As the Fed is purchasing corporate debt, it might be expected to be sector neutral on the indicator of S&P1500 corporate debt outstanding.[2] The following chart suggests that the Fed's corporate bond purchases are more than twice overweight in the Energy sector compared to the US corporate debt market overall as defined by the S&P1500 constituents. The Fed is overweight in Energy by this indicator to the greatest extent by far in all sectors of the economy (including Financials).



[2] Data taken from financial databases, dated 31/12/2019

Sector-Neutrality by Equity Values

The following chart suggests that the Fed's corporate bond purchases are more than three times the S&P1500 equity values weighting for the Energy sector (data as of July 2020). As with the debt outstanding indicator, the Fed is overweight in Energy to the greatest extent by far in all real economy sectors.

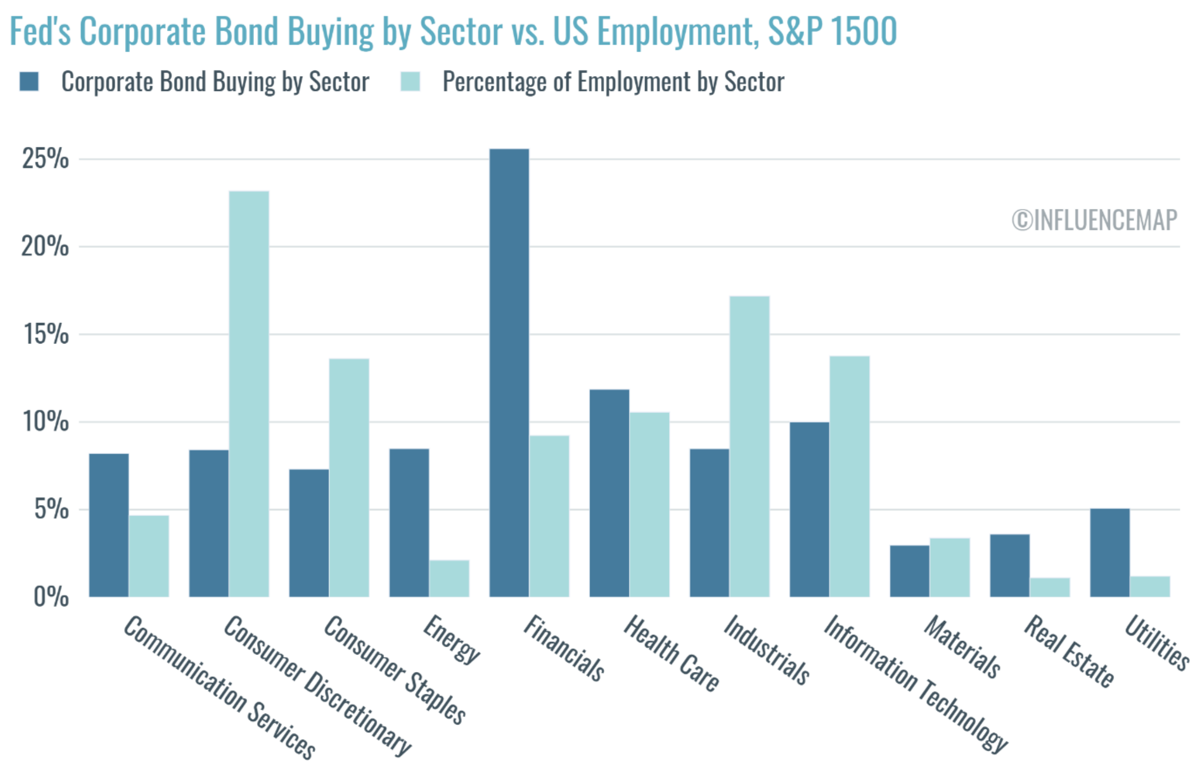


Sector-Neutrality by Employment

Adopting a sector-neutral by employment approach may ally with the Fed's commonly referred to "dual mandate", one of which is maintaining maximum sustainable employment. The following chart suggests that the Fed's corporate bond purchases within the S&P1500 are more than four times overweight Energy on the employment indicator.[3] Real Estate and Utilities also show similar overweighting. It is likely COVID-19 related unemployment did **not** impact the Energy, Real Estate or Utilities sectors as much as others based on the US Bureau of Labor Statistics' guidance on the most exposed sectors. It is likely Consumer Discretionary (which includes hotels, airlines & consumer facing sub-sectors) is far more impacted, yet the

[3] It is noted the employment data refers to all employees of the S&P1500 companies and totals 33mn people, including likely non-US employees. A full analysis of total employment in the US would include small/unlisted businesses, self-employment and the public sector.

Fed's bond purchases to date are more than three times underweight in this sector, contrasting sharply with the significant overweighting of Energy, Real Estate and Utilities.



Summary

The Federal Reserve's COVID-19 related SMCCF purchases (as of July 10th, 2020) are heavily overweight in the Energy sector (containing oil/gas and coal value chain companies exclusively) based on indicators of corporate debt outstanding, equity values and employment numbers. No other sector exhibits this extent of overweighting. Roughly 8% (or $748Mn) of the Fed's $9.5Bn worth of bond purchase issuers to date are in Energy, with $134Mn of this being direct purchases (out of total $1.5Bn), and the rest being via ETFs. It is not clear whether the Fed in practice intends to be sector neutral in its real economy bond portfolio, and if so, how it intends to achieve this given the current pace of buying.