AS CORONAVIRUS SURGES, TREASURY CLAWS BACK FUTURE CARES STIMULUS MONEY FROM FED

Market psychology can change quickly -- will we miss the safety of a financial backstop?

By Scott Colbert, CFA®

The U.S. Treasury has asked the Federal Reserve for some money back at the end of the year. The Treasury would like the Fed to essentially return the unused portion of the "risk-based capital" (about $455 billion) that Congress appropriated from the $2.8 trillion Coronavirus Aid, Relief and Economic Security Act signed into law last spring.

While this program was always intended to close at year end, is this a good idea for the financial markets during a surging pandemic?

Risk-based capital is a fancy name for money set aside to absorb potential losses the Fed might incur after going on its bond-buying spree earlier this year. The U.S. Treasury is looking for any unspent "old" stimulus money to repurpose and close the gap on funding a new stimulus package, stalled somewhere between the Republicans, Democrats and the lame duck administration. With the economy potentially facing an impending wave of coronavirus-inspired shutdowns, the sense of urgency for an additional stimulus bill is intensifying.

This cash cushion the Fed was holding onto was in place to act as a future "loss absorber" to afford our central bank the flexibility to buy more fixed income securities (mostly high quality corporates, some municipals and a modest amount of junk bonds) and make direct loans to municipalities, state and local governments and middle market businesses if the economy needed a further boost.

The Fed having the power to buy bonds that were distressed during the initial months of the coronavirus recession was just what the doctor ordered to keep credit markets liquified and working. Credit markets healed faster than most expected, and this backstop program was a big contributor to help keep markets free-flowing and compress credit spreads when we needed it most. Even better, all the Fed had to do last April was point its "monetary bazooka" at the frozen bond market to break it loose. The Fed used little of its ammunition with the free markets and investors took care of the rest...spurred along by this Fed backstop.

While the Treasury Secretary is correct that most of the risk-based capital is unused today, we are surprised Treasury would ask for the money now just as the economy confronts what is hopefully the last wave of the coronavirus before material availability of the vaccine.

In fact, we think it's possible the United States might experience modest negative growth sometime over the next four winter months. As such, we would prefer to see the Fed keep ammunition at the ready, until we know the coronavirus threat has truly passed.

To be fair to the Treasury, having this money returned to Congress would afford the administration more flexibility in crafting an additional stimulus bill. It could be argued since we are not using this capital today there are other more pressing imperatives to address now that the financial markets have largely healed. And there is clearly some truth and logic in that approach, as we address how to fairly allocate the country's limited capital and resources to gain the most economic bang for the buck.

The problem with asking for the money back now is we have no idea when it might be redeployed, how it's going to be used, or even if it is ever coming back. So, from our perspective, cash in the Fed's hand today is likely more valuable than a nebulous stimulus package in the future.

The immediate impact of returning the unused monies is likely to be minimal, but the psychology of markets can change quickly. Our Treasury Secretary knows this better than most based on his experience as a bond trader at Goldman Sachs. While any near-term damage is nearly non-existent, down the road, credit spreads could likely be a lot more volatile than they would have been if the Fed still had ammunition in its pocket to limit the extent of any credit spread-widening.

Looking back historically, credit spreads peaked in our last "Great Recession" in March of 2009 at twice the levels they did during this recession largely because the Fed was provided this capital to quickly buy bonds with credit risk.

An analogy can be gleaned looking back at the much-maligned TARP program, when Congress allocated nearly three-quarters of a trillion dollars to inject capital in the banking system back in 2008 as our financial system was collapsing. The Fed only had to use half those monies appropriated back then to start the recovery of our bank and credit markets. Ultimately, all of that TARP money and interest was returned to U.S. taxpayers.

This time, the Fed used less than 20% of the monies allocated to it, and all this outlay will also likely be fully returned to taxpayers…with interest.

While we understand there could be other uses for this stimulus money near term, we think the capital the Fed still has in its back pocket should be maintained. The Fed can use these funds to help buttress the last span of the bridge we are building to get our economy to the vaccine waiting on the other side. There just doesn't seem to be an urgent or compelling reason to pick the Fed's pocket just yet before we cross this bridge and the all clear is ultimately signaled.

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ABOUT THE AUTHOR

SCOTT M. COLBERT, CFA®

Executive Vice President, Chief Economist and Director of Fixed Income Management

Scott is the chief economist and director of fixed income management with Commerce Trust Company. He joined Commerce in 1993 and has investment responsibilities for over $19 billion in fixed income assets. Scott directly manages the Commerce Short-Term Government and the flagship Commerce Bond strategies. Scott received his Bachelor of Science degree in nuclear engineering from the University of Cincinnati in 1986 and received his Master of Business Administration from Xavier University in 1988. He has been both a director and president of the Chartered Financial Analyst Society of St. Louis.