High Yield Strategy

The Fed Forays Into Leveraged Credit

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A slate of new programs announced to support lending

The Federal Reserve has taken further unprecedented steps on Thursday to support the flow of credit. As it relates to leveraged credit, the extent of relevant programs included:

1) **Primary Market Credit Facility (PMCCF)**: will provide funding backstop to corporate debt issuers, with the definition of eligible issuers expanded to include recent fallen angels (issuer must be rated at least BBB-/Baa3 as of March 22, 2020; if rated by multiple agencies, the issuer must be at least BBB-/Baa3 by two or more as of March 22, 2020. Issuers that were subsequently downgraded, must be rated at least BB-/Ba3 at the time of purchase). The issuer limit is set at 130% of max total debt over the past 12mo. The facility will use the leverage of 7:1 for HY exposures. Pricing will be market-based +100bps facility fee.

2) **Secondary Market Credit Facility (SMCCF)**: will purchase corp debt in the secondary market, with the expanded definition also including recent fallen angels, similar to PMCCF. In addition the SMCCF may purchase US-listed ETFs including those focused on HY. Issuer limits are 10% of bonds outstanding over the past 12mo, and ETF limits are 20% of shares outstanding. We are tracking $36bn in AUM of US HY ETFs. This facility will also use a 7:1 leverage for HY assets. The Fed will avoid buying ETFs at prices above the NAV. The combined size of SMCCF and PMCCF will be up to $750bn with the breakdown of 2/3 for primary and 1/3 for secondary facilities.

3) **Main Street New/Expanded Loan Facilities (MSNLF/MSELF)**: will provide loans through US banks to eligible borrowers, which are defined as US businesses with <10k employees or <$2.5bn 2019 revenues and leverage <6x of 2019 EBITDA. The key difference between the two programs is that the Fed will be financing terms loans originated prior to Apr 8 with MSELF, and new loans originated from today with MSNLF. The combined size of both facilities is $600bn, and the Fed will purchase up to 95% of each loan, with the balance remaining on originating bank's balance sheet. Issuer limits will be the lesser of $150mn or 30% of existing facilities whether drawn or undrawn. The proceeds of these loans cannot be used to repay any existing loans. Facility origination fee is 100bps.

4) **Term Asset-Backed Securities Loan Facility (TALF)**: will participate in issuance of ABS securities, including CLOs tranches rated AAA. The constraining elements of this program include requirements for newly issued loans only and static CLO structures only. The overall facility size is $100bn, which will be split among auto/student/card ABS, CMBS, and CLOs.

All facilities are set to expire on Sept 30, 2020, unless extended by the Fed & Treasury.

Refer to important disclosures on page 4 to 6. 12124918

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What do we think here

The Federal Reserve and the US Treasury have taken a set of very important steps to support the flow of credit in the US economy, in our opinion. While the earlier set of programs has provided direct support to the cornerstones of debt markets such as Treasury, CP, IG, and primary dealer funding, this current batch takes a meaningful step in expanding the reach of the support mechanisms, including areas of leveraged finance.

Most critically, we think the inclusion of fallen angels in the PMCCF/SMCCF is going to provide an immediate relief to what was becoming a chokepoint of a functioning US credit market with $125bn of IG downgrades into HY so far and many more likely to come. The fact that the Fed is willing to provide funding to these corporations at the time when market is practically unable to is going to go a long way in normalizing the functioning of corporate credit market. We provide the full list of YTD fallen angels along with their eligibility for the PMCCF/SMCCF facilities in Figure 1 below.

Figure 1: Recent fallen angels (yellow highlights = eligible for SMCCF/PMCCF facilities)

Date	Ticker	Name	Sector	Face	FA Price	FA OAS	BBs OAS	FA vs BBs
			YTD Fallen Angels ex MTD					
1/31/2020	SPR	SPIRIT AEROSYSTEMS INC	Capital Goods	1,300	102	254	217	37
2/29/2020	KHC	KRAFT HEINZ FOOD	Food Producers	21,790	103	288	299	-11
2/29/2020	EQT	EQT CORP	Energy	4,500	77	933	578	355
2/29/2020	EQM	EQT MIDSTREAM PARTNERS L	Energy	3,500	85	676	578	98
3/31/2020	F	FORD/FORD CREDIT	Autos/Financials	34,572	86	715	559	156
3/31/2020	OXY	OCCIDENTAL PETROLEUM COR	Energy	29,059	52	1,696	1,311	385
3/31/2020	WES	WESTERN MIDSTREAM OPERAT	Energy	7,820	49	1,781	1,311	470
3/31/2020	CVECN	CENOVUS ENERGY INC	Energy	4,781	50	1,563	1,311	252
3/31/2020	DAL	DELTA AIR LINES INC	Transportation	4,100	86	793	559	234
3/31/2020	M	MACYS RETAIL HLD	Retail	2,456	67	1,455	559	896
3/31/2020	ZFFNGR	ZF NA CAPITAL	Autos	1,699	88	804	559	245
3/31/2020	UCGIM	UNICREDIT SPA	Financials	1,250	95	674	559	115
3/31/2020	ADAABB	ADANI ABBOT POINT TERMIN	Transportation	500	75	1,613	559	1,054
3/31/2020	MARSPE	MARKS & SPENCER PLC	Retail	300	120	447	559	-112
Total/Average				117,627	81	978		298
			Current Month Fallen Angels					
	CLR	CONTINENTAL RESOURCES	Energy	5,300	72	1,213	1,090	122
	MXCN	METHANEX CORP	Chemicals	1,550	73	985	578	407
	RCL	Royal Caribbean Cruises	Services	1,450	71	1,442	578	864
	UCGIM	UNICREDIT SPA	Financials	1,000	97	506	578	-72
	KORS	Michael Kors (USA) Inc	Retail	450	75	1,076	578	498
Total/Average				9,750	78	1,044		364
			Fallen Angel Watchlist (split-rated, remaining in IG index)					
	APA	APACHE CORP	Energy	7,095	56	1,047	1,090	-44
	MTNA	ARCELORMITTAL	Metals	3,620	95	554	578	-25
	TPR	TAPESTRY INC	Retail	1,600	80	820	578	241
	PTEN	PATTERSON-UTI ENERGY INC	Energy	875	41	1,770	1,090	680
	HI	HILLENBRAND INC	Capital Goods	375	102	359	578	-219
Total/Average				**13,565**	**75**	**910**		**127**

Source: BofA Global Research

The next most important step was the inclusion of HY ETFs on the list of eligible instruments for SMCCF. While the amounts may be relatively small in the grand scheme of things – we estimate $36bn of AUM in US focused funds, so roughly $7bn of firepower, what important here is the signal. The Fed said it is willing to step in provide support to this critical component of US corporate funding landscape, and the expectation is that the market will do the rest and operate under the assumption that the Fed could do more, if circumstances require.

The Main Street lending facilities (MSNLF and MSELF) are not directly targeting leveraged credit issuers, but many of such borrowers are eligible to participate nevertheless. Our estimates show that about 45% of leveraged credit issuers by count and 30% by dollar value of debt outstanding are eligible for participation in these programs. The key limiting characteristics are going to be $150mn maximum loan size and inability to use proceeds for repayment of existing loans. Nevertheless, again, we think the signaling element of this new step is more important than its immediate size/scope. We estimate that US leveraged credit issuers employ about 18mn people in the United States, or roughly 30% of total private payrolls away from small businesses. Ensuring continued access to credit for this critical segment of US employment landscape is likely to remain in focus of future government crisis response measures.

Lastly, our structured finance strategists believe the inclusion of outstanding CMBS and newly issued CLOs is a move in the right direction but, in order to be as effective as the 2008 TALF program, the 2020 program need to be expended to include secondary position of CLOs. In addition, the limitations on CLOs – static and newly originated loans – likely means the impact on CLOs will be limited.

Overall, we think the Fed and Treasury have taken very important steps in the right direction today by providing further support to the most affected parts of the US corporate credit markets. These actions help support our existing view that there will be a policy response to combat the unprecedented set of challenges facing the US and global economies. This was the primary factor behind our thinking that it is too early to assume defaults will exceed earlier records, and we remain comfortable with our existing view for HY issuer weighted defaults at 9% over the next 12mo. Following an extremely strong market reaction today which could push HY spreads into 700s, we think the market is now trading at the tight end of our expected range for coming months.

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