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U.S. Municipal Bond Market

Still Waiting on Congress, Looking for State and Local Government Stimulus

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Summary, as of Tuesday, March 24

- There have been a total of 51,678 coronavirus cases reported in the U.S., 667 deaths, and 368 recoveries to date;[1]
- Congress is still working out the details of the $2+ trillion CARES Act stimulus package (there may be an agreement by the time this commentary is published);
- We are looking for state and local government stimulus to be included in CARES, and discuss the 2009 Recovery Act as a recent comparison;
- State and local governments could experience "material credit damage" as it relates to rising public pension net liabilities as a result of recent asset losses... that is, if those losses do not quickly reverse, wrote Moody's Investor Service;
- We have been following the municipal VRDO market dislocation closely and saw today that pricings are still reflecting market pressures; and
- AAA MMD yields fell today, potentially because of market engagement.

Congress is Still Working Toward $2+ Trillion Stimulus Package

Congress is still working out the details of the $2+ trillion Coronavirus Aid, Relief, and Economic Stabilization Act (CARES Act). As of the writing of this commentary, there was no vote scheduled but that could be a good indicator because it may mean they are close to an agreement. Early in the afternoon there were signals that a deal could be "hours away."[2]

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In order to manage expectations, we take a look at the timing of the 2009 stimulus legislation. By way of comparison, the House version of the American Recovery and Reinvestment Act of 2009 (Recovery Act) was introduced on January 26, 2009. The Recovery Act was not signed into law until Feb 17, 2009. It's also worth noting there was work being done on this topic prior to the bill's Jan. 26 introduction. The CARES Act was not introduced and work did not begin until last week.

Looking for State and Local Government Assistance in the Stimulus

The Federal Reserve has been doing a substantial job at expanding its programs to include support targeted to state and local governments and the long- and short-term municipal bond market. We know Congress is still working out the details of the $2+ trillion CARES Act. One of the items we did not see in recent versions of the stimulus was the type of financial support for state and local governments like we saw in the previous Recovery Act.

The Recovery Act included $282 billion (out of $831 billion total) of fiscal assistance for state and local governments.[3] Those stimulus funds sent out over a decade ago helped support state and local government budgets. There were also health and medical initiatives, of which universities and schools all benefitted. The U.S. Department of Education noted that 4,400 education jobs were supported by Recovery Act funds in 2009-2010.[4] We have seen estimates of what unemployment claims are likely to sky-rocket to this week. If there ever was a scenario where state and local governments needed a strong stimulus injection, it is now. Under the current circumstances, state and local governments would likely need relatively more than they received in the 2009 Recovery Act. What is facing them now is happening quicker, there is a national

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healthcare crisis to battle, and the economic and financial fallout is likely to be unprecedented.

A report, "How Will the Coronavirus Affect State and Local Government Budgets?" released by the Hutchins Center at Brookings yesterday noted:

> "Unlike the federal government, states and localities can't compensate for lower tax revenues with increased borrowing – they must make up for them with some combination of lower spending, higher tax rates, or fees. After tax revenues declined significantly in 2008 and 2009, state and local governments cut spending sharply."[5]

Under such circumstances, some of the most vulnerable citizens, those who rely on government healthcare, and those individuals who are unemployed could be among those most affected. If states are strapped for cash, they may need to cut programs at the time when those most affected need them the most. Hopefully, federal stimulus can help bridge this gap.

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Market Losses to "Inflict Material Credit Damage" (Moody's Investor Service)

Moody's Investor Service released the report today: 2020 Pension Investment Losses Poised to Inflict Material Damage. Moody's notes the ultimate credit impact on state and local governments depends on several factors, including the pace at how investments recover. Overall, the report concludes:

> "…without a dramatic bounceback of investment markets, 2020 pension investment losses will mark a significant turning point where the downside exposure of some state and local governments' credit quality to pension risk comes to fruition because of already heightened liabilities and lower capacity to defer costs."[6]

The ability to pull back on government contributions is more constrained today by the resulting negative repercussions to the condition of the pension system.

This report had just been released as we were finalizing our commentary, but we want to include a few additional highlights based on Moody's state and local government pension analysis:

- U.S. public pension systems are generally on pace for an average investment loss of about 21% in the fiscal year that ends June 30. This is based on a March 20 snapshot of market indices that we select to generally reflect U.S. public pension system asset allocations;
- While the experience of individual pension systems will vary, adjusted net pension liabilities (also called ANPLs) are generally on pace to rise by nearly 50%;
- As of mid-March market performance, costs for governments to "tread water" are on pace to rise nearly 60% in fiscal 2021; and
- The takeaway is that the ability to pull back on government contributions is more constrained today by the resulting negative repercussions to the condition of the pension system.[7]

Municipal VRDO Pricings

Despite recent Federal Reserve announcements, we are still seeing variable rate demand obligations (VRDOs) price largely in a range of 4.00% to 7.00%. Some are a little under, and some a little over this range. But most are still pricing at levels much higher than we saw before last week when the market dislocation strengthened. We have not seen an impact, considerable or otherwise, in the VRDO market since we began to see pressure build last week after a review of recent resets. Bloomberg reported about the transition in some institutional short-term strategies in a recent article as well.[8] The SIFMA Municipal Swap Index priced at a 5.20% last week, up from a 1.28% a week before, and a recent high of 1.61% before last week. We will continue to watch how this develops as it will be a good indication of how effective the Fed's new program(s) are working. And SIFMA will reset tomorrow.

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MMD AAA Yields Fall a Little on Tuesday – More Engagement

Buyers are continuing to increase engagement, and it occurred even more today. This activity is illustrated in the potential decreases (yes, decreases) in AAA MMD yields. MMD AAA yields fell today at levels ranging from 20 to 25 basis points across the curve today. Yesterday, the 2 year AAA MMD ended at 2.52%, 10 year at 2.79%, and the 30 year at 3.37%.

Recent HilltopSecurities COVID-19 Municipal Commentary

- Congress Working on $2+ Trillion of Stimulus; Fed Provides More Targeted Support for Municipals, March 23, 2020
- Tax Deferrals Could Create a Cashflow Crunch; Market Needs Help With Liquidity; Federal Government Provided Some, Working on More Targeted Support, March 20, 2020
- $12 Billion Flows Out of Municipal Funds,Recent Monetary & Fiscal Policy, March 19, 2020
- March 18 Market Activity – A Focus on the Significant Pressure in the VRDO Market, March 18, 2020
- March 17 Market Activity, March 17, 2020
- March 16 Market Activity: HilltopSecurities Lowers Credit Outlooks Due to Unprecedented Steps Taken to Contain COVID-19, March 16, 2020
- Municipal Market Update: Week of March 16 Playbook, March 16, 2020
- Municipal Market Update: COVID-19 Impact Worsens, March 12, 2020
- Lowered Airport Sector Outlook: Recent COVID-19 Impact, March 11, 2020
- Falling Confidence and No Federal Stimulus Increase to Start the Week, March 9, 2020
- Uncertainty – What the Municipal Market Knows and Doesn't Know About COVID-19, March 4, 2020
- Bracing for the Worst; the Coronavirus Market Effect – Status of the Coronavirus Impact on the US Municipal Bond Market (page 2), Feb 26, 2020

Recent HilltopSecurities COVID-19 Economic Commentary

- Staying Afloat Until the Storm Passes, March 23, 2020
- Government Goes Big on Latest Rescue Plan, March 19, 2020
- Serious Support on the Horizon, March 16, 2020
- Waiting on Fiscal Policy as Aggressive Fed Move Falls Flat, March 16, 2020
- Stocks Rebound as Central Banks Respond, March 13, 2020
- On the Edge of Recession, March 12, 2020
- Central Banks Rush to Mitigate Pandemic Fallout, March 11, 2020
- Untying the Knot, March 10, 2020
- Runaway Markets Ignore Massive Payroll Number, March 6, 2020
- Bracing for Zero, March 5, 2020

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[1] *Please see Worldometers.info/coronavirus for data updated hourly, last accessed 3/20/20 12:06pm central time.*
[2] *Desiderio, Andrew and Sarah Ferris; Negotiators expect deal Tuesday on Massive coronavirus emergency package; Politico; March 24, 2020.*
[3] *State and Local Governments – Knowledge of Past Recessions Can Inform Future Federal Fiscal Assistance; U.S. Government Accountability Office (GAO); March 2011.*
[4] *Maciag, Mike; The Recovery Act Saved Them Public-Sector Jobs, But Can Government Retain Them; Government Magazine; Aug. 12, 2013.*
[5] *Belz, Sage and Louise Sheiner: How Will the Coronavirus Affect State and Local Government Budgets?; The Hutchins Center at Brookings: March 23, 2020.*
[6] *2020 Pension Investment Losses Poised to Inflict Material Damage: Moody's Investor Service; March 24, 2020.*
[7] *Ibid. These bullets are all taken directly from the above mentioned Moody's report.*
[8] *Please see Blackrock, Nuveen Unwind Leveraged Muni Trades Roiled by Havoc; by Martin Braun; Bloomberg; March 23, 2020.*