HilltopSecurities
A Hilltop Holdings Company

U.S. Municipal Bond Market

More Good News than Bad This Week

Tom Kozlik
Head of Municipal Strategy & Credit
214.859.9439
tom.kozlik@hilltopsecurities.com

Good News

- Dr. Anthony Fauci announced today that COVID-19 death projections in the U.S. are now at 60,000 and not going to be in the 100,000 to 240,000 range announced last week;
- Today, the Federal Reserve offered sparse, but at least some details about its highly anticipated $500 billion Municipal Liquidity Facility program. We review some specifics and offer some opinions below;
- The Dow Jones Industrial average gained 285 points (or 1.22%) today partly based on the news of $2.3 trillion of additional stimulus programs from the Federal Reserve. The $500 billion Municipal Liquidity Facility program was part of that Fed announcement;
- A fourth phase of federal relief is being considered by Washington, D.C. lawmakers which could amount to another $100 billion for hospitals and $150 billion for state and local governments; that is if politics do not get in the way; and
- The primary municipal bond market continued its healing this week, and the entire negotiated calendar and some of the day-to-day calendar successfully priced.

Bad News

- Another 6.6 million jobless claims were filed, which makes 16 million over three weeks or 10% of the U.S. workforce;
- There is some bad COVID-19 news as deaths in New York are still peaking;
- Although human testing for a COVID-vaccine began, it is not likely Americans will be able to consider themselves completely safe until fall of 2021, according to Bill Gates; and
- Illinois' outlook lowered to "Negative" by Moody's and S&P.

It seems like the social distance guidelines for the majority of the country are doing the job. Many expected this and next week to be a significant peak in COVID-19 deaths, especially in NYC.

Among the Good News

COVID-19 Update

It seems like the social distance guidelines for the majority of the country are doing the job. Many expected this and next week to be a significant peak in COVID-19 deaths, especially in NYC. Last weekend, the White House's Coronavirus Task Force forecast total U.S. casualties could be between 100,000 and 240,000.[1] President Trump said the U.S. is, "In the midst of a great national trial unlike any we have ever faced before" and that the next two weeks would be "painful."[2]

Just today, Dr. Anthony Fauci (director of the National Institute of Allergy and Infectious Diseases) cut the White House's estimate of projected COVID-19 deaths to 60,000.[3]

There have been a total of 435,780 coronavirus cases reported in the U.S., 14,865 deaths, and 22,941 recoveries to date.[4]

Please see disclosure starting on page 7.

Mostly Good News from the U.S. Federal Reserve, Again

The U.S. Federal Reserve continues to be as in front of the curve as much as it can be. It added to its considerable menu of programs and revealed details about its ability to purchase municipal debt, which the market has been anticipating since the 2020 CARES Act was signed into law.

The Federal Reserve added to its considerable menu of programs and revealed details about its ability to purchase municipal debt, which the market has been anticipating since the 2020 CARES Act was signed into law.

The big picture announcement about $2.3 trillion in Fed programs focused on money for small businesses, payroll protection, and short-term cashflow support for state and local governments made by Fed Chairman Jerome Powell at the Brookings Institution.

Anticipated Details on Fed's Municipal Liquidity Facility

Today, the Federal Reserve announced the creation of its Municipal Liquidity Facility. Please see the Federal Reserve's announcement here, and the term sheet with some, but not much detail of the Municipal Liquidity Facility here. In the below section, text in quotations is directly from the Fed's term sheet.

We view this as a program that is being put into place for scenarios more likely to present themselves in two to four months from now when the cashflow crunch state and local governments are likely to experience will surface. What will be the cause? Tax day is being delayed in many states, which could present cashflow challenges. Other revenue sources are tanking and are likely to continue to take a hit in the near term because of social distancing measures. The significant deterioration of the labor market is further complicating the near-to-medium term situation for state and local governments.

Other revenue sources are tanking and are likely to continue to take a hit in the near term because of social distancing measures. The significant deterioration of the labor market is further complicating the near-to-medium term situation for state and local governments.

This announcement may be considered a disappointment by some market participants who were expecting the Fed might announce that they would be buying longer term bonds in the primary and secondary market.

Let's keep in mind it is very possible that this could just be the first of different parts of a Federal Reserve multi-point plan for the municipal market. Just because the expected or hoped for announcement did not come today, it does not mean it will never come. It is important to remember that the Federal Reserve has been significantly providing liquidity in other markets when needed, and the Fed has in the past few weeks added municipal market-related items to programs as needed. This may not be the end of the Fed's help to municipals. Let's get to the details of what we do know about the $500 Billion Municipal Liquidity Facility.

Description of the $500 Billion Municipal Liquidity Facility

The Federal Reserve Bank will commit to lend to a special purpose vehicle (SPV) on a recourse basis. The SPV will purchase up to $500 billion Eligible Notes directly from eligible issuers. We define these terms below. This stipulation in the Fed's term sheet points to only primary market activity and not secondary market activity, as allowable.

The Fed activity will be secured by all the assets of the SPV. The Department of the Treasury, using CARES Act funds, will make an initial equity investment of $35 billion in the SPV. This clarifies the role the $35 billion plays.

Type of Support to Eligible Issuers

Eligible issuers include: U.S. states, the District of Columbia, U.S. cities with a population exceeding one million residents, and U.S. counties with a population exceeding two million residents. The Federal Reserve describes an Eligible Issuer as a, "State, City, or County (or an instrumentality thereof that issues on behalf of the State, City, or County for the purpose of managing its cash flows), in each case subject to review and approval by the Federal Reserve."

The Federal Reserve Bank will commit to lend to a special purpose vehicle (SPV) on a recourse basis. The SPV will purchase up to $500 billion Eligible Notes directly from eligible issuers.

The term sheet also highlights: Only one issuer per State, City, or County is eligible. So, coordination among different levels of government and types of issuers is going to be key.

Our Opinion on Support to Eligible Issuers

This is very limiting. There are only 10 cities and 16 counties that would be eligible because of this population restriction. This criteria could severely limit participation in select cases to only states, because there are some states that have few or zero cities with a population over one million or counties with a population over two million. This criteria is a drawback. We believe this may need to be revisited and/or expanded. Although, below we note an exception can be made from the state for the revenue limitation, perhaps something similar is coming for this category as well. More clarification is needed here certainly.

This criteria could severely limit participation in select cases to only states, because there are some states that have few or zero cities with a population over one million or counties with a population over two million. This criteria is a drawback. We believe this may need to be revisited and/or expanded.

The Eligible Notes (Structure)

According to the Fed, they are considering tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), and other similar short-term securities. The maturity of the notes is limited to 24 months from date of issuance. Eligibility is subject to review by the Federal Reserve and relevant legal opinions and disclosures are required. We do not have additional details about this yet.

Our Opinion on Eligible Notes Criteria

This is likely going to be considered a short-term disappointment to the market, generally, but we believe this program is being put into place to alleviate circumstances likely to develop, not to help market liquidity now.

Percent of Revenue Limitation

The Fed indicates that there is a par amount limitation based on a percentage of FY17 general revenue.

There are going to be cases, and perhaps many cases, where this limitation is not going to meet the needs of state and local governments.

The term sheet indicates the Fed, “May purchase Eligible Notes issued by or on behalf of a State, City, or County in one or more issuances of up to an aggregate amount of 20% of the general revenue from own sources and utility revenue of the applicable State, City, or County government for fiscal year 2017.”

There is also an exception: “States may request that the SPV purchase Eligible Notes in excess of the applicable limit in order to assist political subdivisions and instrumentalities that are not eligible for the Facility.”

Our Opinion on this Revenue Limit of Federal Support

There are going to be cases, and perhaps many cases, where this limitation is not going to meet the needs of state and local governments. Much will be driven on the length the economy remains impaired, the depth of the labor market fall, and the credit status of issuers beforehand. We suspect this limit may need to be revisited and expanded.

Eligible Use of Proceeds

The proceeds can be used, “To help manage the cash flow impact of income tax deferrals resulting from an extension of an income tax filing deadline; potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic; and requirements for the payment of principal and interest on obligations of the relevant State, City, or County.”

“An Eligible Issuer may use the proceeds of the notes purchased by the SPV to purchase similar notes issued by, or otherwise to assist, political subdivisions and instrumentalities of the relevant State, City, or County for the purposes enumerated in the prior [above] sentence.”

There appears to be some flexibility here, but more details are still needed. Because it says, “resulting from the COVID-19 pandemic,” and this could be read as very restrictive depending upon the detail. The second part of the term sheet also refers to a situation, potentially, where larger entities could be supporting smaller entities.

Our Opinion on Eligible Use of Proceeds

There appears to be some flexibility here, but more details are still needed. Because it says, “resulting from the COVID-19 pandemic,” and this could be read as very restrictive depending upon the detail. The second part of the term sheet also refers to a situation, potentially, where larger entities could be supporting smaller entities. This may be a way for states to issue on behalf of smaller entities not eligible because of population limitations.

More details are promised on Pricing, and they are certainly needed.

Pricing
"Based on an Eligible Issuer's rating at the time of purchase with details to be provided later."

Our Opinion on Pricing
More details are promised, and they are certainly needed.

Origination Fee
"Each Eligible Issuer that participates in the Facility must pay an origination fee equal to 10 basis points of the principal amount of the Eligible Issuer's notes purchased by the SPV. The origination fee may be paid from the proceeds of the issuance."

Call Right
"Eligible Notes purchased by the SPV are callable by the Eligible Issuer at any time at par."

Termination Date
"The SPV will cease purchasing Eligible Notes on September 30, 2020, unless the Board and the Treasury Department extend the Facility. The Reserve Bank will continue to fund the SPV after such date until the SPV's underlying assets mature or are sold."

U.S. Equities Gained Ground on Fed News
The Dow Jones Industrial average gained 285 points (or 1.22%) today partly based on the news from the Federal Reserve. The potential for an agreement from Russia and Saudi Arabia to cut oil output was also being considered by the market today. HilltopSecurities' Scott McIntyre and Greg Warner wrote more on this in [Stocks Gain on Broadening Fed Support].

The Dow Jones Industrial average gained 285 points (or 1.22%) today partly based on the news from the Federal Reserve. The potential for an agreement from Russia and Saudi Arabia to cut oil output was also being considered by the market today.

Potential Phase Four of Federal Government Relief
It should be considered pleasing that Congress is considering another $100B for hospitals and $150B for state and local governments (this should not be restricted to COVID-19 only items; this is important. It needs to be used for budget and cashflow purposes too).

However, a quick release of a potential phase four hit a partisan snag, unsurprisingly. Now conflicting ideas of what a fourth phase should look like are being considered.[5] There is no timeline set as of now of when this could be potentially agreed upon.

In summary, we get the impression that the release of this information may have been rushed. As you can see there are still many missing details. How will this work in practice? How do Eligible Issuers apply? We will certainly be on the lookout for answers to these questions and more and will communicate them as they are released.

Primary Municipal Market Healing
We saw benchmark AAA MMD yields fall across the board this week as primary municipal market demand strengthened and healing continued day to day. Sentiment strengthened throughout the week. The market is closed tomorrow for a holiday. Although the details of the Fed's Municipal Liquidity Facility were disappointing to some, the program is still supportive of the market overall and disappointment was not apparent in market activity today (Thursday).

We saw benchmark AAA MMD yields fall across the board this week as primary municipal market demand strengthened and healing continued day to day. Sentiment strengthened throughout the week.

2 year AAA MMD
- Monday: 1.10%
- Thursday: 0.93%

10 year AAA MMD
- Monday: 1.48%
- Thursday: 1.20%

30 year AAA MMD
- Monday: 2.29%
- Thursday: 2.01%

This week's competitive sales gained heightened attention from dealers. We saw seven-plus bids on even some of the larger issues, and the difference between the top and bottom bids were not as significant this week as they have been in the past. This means there was more of a focus and understanding of true market levels this week.

This week's competitive sales gained heightened attention from dealers. We saw seven-plus bids on even some of the larger issues, and the difference between the top and bottom bids were not as significant this week as they have been in the past. This means there was more of a focus and understanding of true market levels this week. Examples of this week's competitive sales include a $223 million Memphis, Tenn., $65 million Lancaster, Penn. School District, and a $75 million Plano, Texas offering. It appears market interest and participation is likely moving closer to normal than we have seen in some time. This participation is also a good indicator because dealer involvement can make up for a lack of initial buyer feedback on levels.

The primary market calendar of almost $4 billion was easily sold this week and some of the volume that was listed as day-to-day was also scooped up by investors. There was a market for both taxable and tax-exempts. This is an important development to note because demand in the taxable municipal market was even slower than it was for tax-exempts in recent weeks.

Next week's calendar is listed as $3.4 billion and should be easily distributed if the same positive market tone continues into next week. The day-to-day calendar has likely fallen to about $8.5 billion down from $10 billion.

Next week's calendar is listed as $3.4 billion and should be easily distributed if the same positive market tone continues into next week. The day-to-day calendar has likely fallen to about $8.5 billion down from $10 billion.

Municipal to Treasury (M/T) ratios remained strong. The 2 year stayed the same and although the 10 year and 30 year M/T Ratios fell, they are still attractive.

2 year M/T Ratio
- Monday: 413%
- Thursday: 413%

10 year M/T Ratio
- Monday: 231%
- Thursday: 166%

30 year M/T Ratio
- Monday: 179%
- Thursday: 150%

SIFMA reset at a 0.74% on Wednesday, April 8.

We continue to see money flow out of municipal funds for the sixth consecutive week. This week, $2.306 billion flowed out of municipal funds, according to Lipper.

Among the Bad News

Near Term Economic Prospects, 6.6 Million More Jobless Claims

The reason Fed Chair Powell is saying that it is time to have a serious public conversation about reopening the economy and what that actually looks like is because it will become more difficult to go about that process with every day that goes by. A longer period of lower economic activity also exacerbates the cashflow scenario state and local governments are going to be facing in the coming months. There is additionally a near-to-medium term issue for the labor market and job

A longer period of lower economic activity also exacerbates the cashflow scenario state and local governments are going to be facing in the coming months. There is additionally a near-to-medium term issue for the labor market and job prospects.

prospects.[6] While the Fed is trying to do what it can to support business, over 16 million workers have lost jobs in just the last three weeks. It could be difficult to ramp back up to a level close to where the economy was two months in short order.

Today, weekly jobless claims came in at 6.6 million, higher than the consensus estimate of 5 million. That means we have lost 16 million jobs, or about 10% of the workforce, in the last three weeks alone.

Today, weekly jobless claims came in at 6.6 million, higher than the consensus estimate of 5 million. That means we have lost 16 million jobs, or about 10% of the workforce, in the last three weeks alone.

Some Bad COVID-19 News, New York Still Peaking

New York Governor Andrew Cuomo announced unfortunate news today that New York's daily death toll reached a third straight record today at 799 deaths. This hints that while numbers may be lower than forecast, there is still much suffering occurring on the health front.[7]

When Can Americans Consider Themselves Completely Safe?

Human testing of an experimental vaccine began, according to the National Institutes of Health.[8] However, it is likely to take over a year to develop, test, and deploy any vaccine. Philanthropist and Microsoft founder Bill Gates said it might not be until fall 2021 that Americans can consider themselves, "completely safe" from COVID-19 as a result.[9]

Moody's and S&P Lowered Outlook on Illinois

The rating outlook for Illinois (Baa3) was lowered to "Negative" from "Stable" by Moody's today citing the negative impact from COVID-19, and the state's financial challenges. SP Global lowered its Illinois (BBB-) outlook to "Negative" a week ago citing similar reasons. Today, S&P lowered its outlook on Illinois Public Universities (range from "A-" to "BB-") to "Negative" from "Stable."

Philanthropist and Microsoft founder Bill Gates said it might not be until fall 2021 that Americans can consider themselves, "completely safe" from COVID-19 as a result.

---

[1] Oprysko, Caitlin; Coronavirus task force presents a bleak landscape with 100k deaths as best-case scenario; Politico; March 31, 2020.
[2] Ibid.
[3] Miller, Kathleen and Jennifer Jacobs; Fauci Slashes U.S. Death Rate Projection, Raising Hope for Re-Opening; Bloomberg; April 9, 2020.
[4] Please see Worldometers.info/coronavirus for data updated hourly, last accessed 4/9/20 9:48am central time.
[5] Carney, Jordain; Senate blocks dueling coronavirus relief plans; The Hill; April 9, 2020.
[6] Lahart, Justin; The Jobs Crisis Will Leave a Mark; Wall Street Journal; April 9, 2020.
[7] Lovelace Jr., Berkeley; Kevin Breuninger; and Noah Higgins-Dunn; New York coronavirus daily death toll reaches third-straight record at 799, Gov. Cuomo says. CNBC; April 9, 2020.
[8] Burton, Thomas M. and Peter Loftus; Human Testing Begins Earlier than Expected for U.S. Coronavirus Vaccine; Wall Street Journal; March 16, 2020.
[9] Clifford, Catherine; Bill Gates: This is how long it may take before Americans 'can be completely safe' from COVID-19; CNBC; April 8, 2020.

Recent HilltopSecurities COVID-19 Municipal Commentary

- Rating Agencies - Assessing Ability and Willingness in the New COVID-19 Normal, April 8, 2020
- Non-Profit U.S. Healthcare - Rising Costs of Care from the COVID-19 Pandemic, April 7, 2020
- Three Key Atypical Credit Risks & Market Update, April 3, 2020
- Mass Transit - From Here to There, April 2, 2020
- Public Higher Education - A Closer Look, April 1, 2020
- Private Higher Education - Impact from Social Distancing, March 31, 2020
- U.S. Airport Sector View - A Month into COVID-19, March 30, 2020
- Four Weeks in March, March 27, 2020
- House Speaker Pelosi Wants More for State and Local Governments in Potential Fourth Phase, March 26, 2020
- Agreement on the $2+ Trillion CARES Act, Not Nearly Enough for State and Local Governments, March 25, 2020
- Still Waiting on Congress, Looking for State and Local Government Stimulus, March 24, 2020
- 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

- 2020 Q1 Economic Recap and Rate Outlook, April 9, 2020
- Stocks Gain on Broadening Fed Support, April 9, 2020
- March Payrolls Plunge, April 3, 2020
- Sifting Through Irrelevant Data, April 1, 2020
- Help is on the Way as Massive Relief Bill Passes the Senate, March 26, 2020
- 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