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U.S. Municipal Bond Market

COVID-19 is a National Stress Test; Surprise Record Infections, Policy Shifts Occurring

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Summary

- The Federal Reserve, after performing its annual stress tests, are requiring banks to suspend share buybacks in the third quarter, and the Fed is only allowing dividends to be paid based on an earnings formula.
- The broader backdrop for investors and the financial community at large is that the COVID-19 Pandemic Recession is a national stress test.
- There were 218,248 confirmed COVID-19 cases in the U.S. for the week of June 18; a surprise record.
- Overall, the national coordination and response to the health crisis and Pandemic Recession has been uneven at the very best. It looks like nationally we may have failed the first inning, or the first installment, of the national "stress test." Hopefully, leaders can spark a comeback. Policy shifts are occurring, but still only on a state-by-state basis.
- The response strategy is now changing, along with the narrative. Both Texas and Florida announced changes to their reopening efforts.
- We expect the Dallas Fed's Mobility and Engagement Index (MEI) results in the coming weeks are likely to worsen, which tells us that financial and labor market data are likely to worsen as well.
- We are watching to see if these recent developments spark changes in monetary or fiscal policy targeted toward state and local governments.
- Investors added $1.47 billion to municipal mutual funds as of the week ending June 24. This was the seventh consecutive week of flows into municipal bond funds, totaling $10.6 billion. Investors could begin pulling back, which would threaten an eighth straight week of flows.

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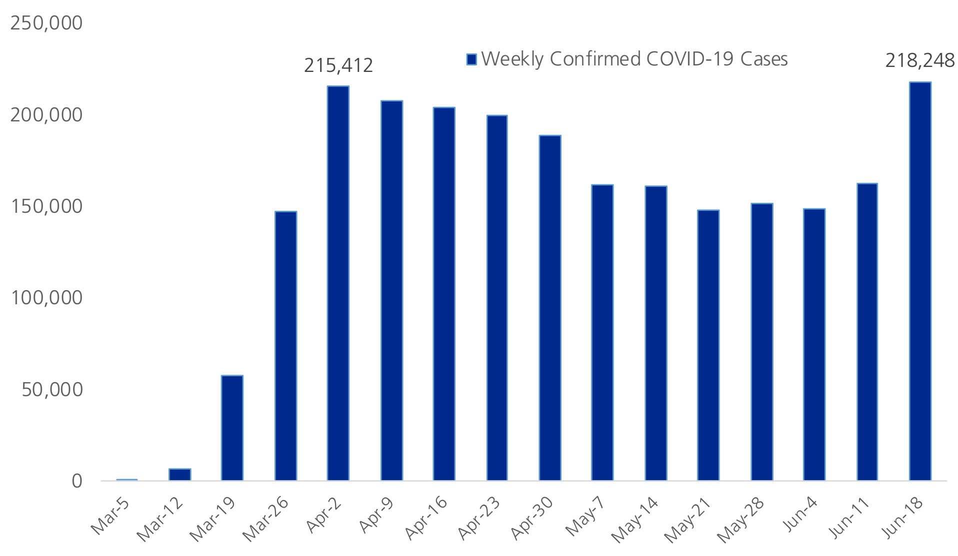
Weekly Confirmed COVID-19 Cases Peaked This Past Week, A Surprise to Many



Source: Johns Hopkins, Bloomberg, and Hilltop Securities.

Fed Announced Results of Bank Stress Tests, COVID-19 is a National Stress Test

The Federal Reserve, after performing its annual stress tests, are requiring banks to suspend share buybacks in the third quarter, and the Fed is only allowing dividends to be paid based on an earnings formula. The bank stress tests included hypothetical scenarios mirroring: a V-shaped recession and recovery; a slower, U-shaped recession and recovery; and a W-shaped, double-dip recession. Unemployment rates peaked between 15.6% and 19.5% during the examinations. The Fed concluded, "Under the U- and W-shaped scenarios, most firms remain well capitalized but several would approach minimum capital levels."[1]

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The broader backdrop for investors and the financial community at large is that the COVID-19 Pandemic Recession is a national stress test. Lawmakers in Washington, D.C. quickly threw $2+ trillion in relief at the problem. Legislators may revisit another round of relief at the end of July. The Fed has done more than its fair share with its menu of programs and interventions, even if we believe the U.S. Central Bank could do more for state and local governments. Overall, the national coordination and response to the health crisis and Pandemic Recession has been uneven at the very best.

After an early "stress test" assessment of governments' responses, we now find, based on the fact that the number of weekly confirmed cases just peaked, government has had an issue cooperating in response to one of the worst pandemics in a century. It looks like nationally the U.S. may have failed the first inning, or first installment, of the national "stress test." Hopefully, leaders can spark a comeback. Policy shifts are occurring, but still only on a state-by-state basis.

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There were 218,248 confirmed COVID-19 cases in the U.S. for the week of June 18, which was a surprise record. While the northeast U.S., which only started to open up in the beginning of June, successfully flattened the curve and seemingly controlled the amount of confirmed cases, spread in the southern and western states has worsened. The daily positive COVID-19 cases in Texas, Florida, Arizona, Georgia, and South Carolina are rising at an alarming pace. The number of cases in California is also high. Part of this is likely because certain states began opening up back at the end of April. Others did not even really close down at all.

Worsening COVID-19 Numbers, Changing Strategy and Narrative

Back at the end of March, Texas Governor Greg Abbott ordered those traveling from high infection areas like New York or New Orleans to self-quarantine for two weeks. He also issued a statewide shelter-in-place order. Only a month later, Gov. Abbott began phasing in a gradual reopening, despite the reluctance of many local officials. The governor proclaimed, "Now it's time to set a new course, a course that responsibly opens up business in Texas. We will open in a way that uses safe standards – safe standards for businesses, for their employees, as well as for their customers. Standards based upon data and on doctors."[2]

But in the last two weeks alone numbers of confirmed COVID-19 cases in Texas have skyrocketed. And on Thursday, New York, New Jersey, and Connecticut announced they are requiring travelers from states with high numbers of COVID-19 cases (including Texas) to self-quarantine for 14 days.

The strategy is now changing, along with the narrative. During the middle of this week, Gov. Abbott was reluctant to issue another stay-at-home order and instead recommended residents stay at home unless travel was absolutely necessary. He later began officially scaling back the Texas reopening process.[3] Friday morning, Gov. Abbott began taking additional official action to scale back businesses and services with a direct link to the COVID-19 spread. Primarily, bars are being required to close.[4]

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Also Friday morning, the Florida Department of Business and Professional Regulation essentially closed bars as well. This order is in stark contrast to Florida Governor Ron DeSantis' comments last week when he said "We're not rolling back" reopening efforts.[5]

The Financial, Municipal Market Impact

The financial markets already began digesting this discouraging news on Friday, June 26. Equity markets retreated and were down by about 2% late in the morning. There was a high amount of Texas municipal bond issuance this week in the primary market and it was easily absorbed. How the newly-issued Texas paper and other municipals trade at the beginning of next week will be a better sign of municipal investor reaction. We expect negative reaction, if any, will not be restricted to Texas, Florida, or to only those states experiencing higher rates of infection. It is more likely investors see this news as a precursor to a second wave and something that could occur nationwide depending on state-to-state timing.

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Strong Investor Sentiment, Seventh Week of Consecutive Municipal Flows

Investors added $1.47 billion to municipal mutual funds as of the week ending June 24, according to Lipper data released Thursday. This was the seventh consecutive week of flows into municipal bond funds, totaling $10.6 billion. Municipal flows are still negative $4.1 billion for the year. We will be watching closely to see if investors are spooked close to a level we saw in April. While an investor reaction of that magnitude is not at all likely, investors could begin pulling back, which would threaten an eighth straight week of flows.

The primary municipal market calendar is set at about $7.7 billion for the week of June 29. This is not necessarily high, but does not indicate the market is suffering from any ability to place debt with investors.

If Social Distancing and Restrictive Orders Increase, Economic and Labor Data Could Worsen

The greater meaning from these recent developments is that while social distancing seemed to be easing in June, this week's numbers and the actions of states like Florida and Texas are indicating that social distancing is likely to increase. An increase in new orders restricting activity and higher levels of social distancing do not bode well for upcoming financial data or the labor market. Three weeks ago, we cited the Dallas Fed's Mobility and Engagement Index (MEI) as a good indicator to watch. Through the week of June 20, the MEI continued to improve and economic activity did as well. We expect that MEI results in the coming weeks are likely to worsen, which tells us that financial and labor market data are likely to worsen as well.

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Could this Motivate Congress to Approve More Relief in July?

It will be informative to see if these new developments light a fire under Congress to pass relief during the last two weeks of July, or if we have to wait until September for them to debate. The $150 billion for state and local governments included in the CARES Act was nowhere near enough to help state and local governments. They are on the front lines of this fight to contain the spread. As a result, their expenses are increasing at a time when revenues are dropping. We still expect more relief at some point.

Relief for individuals rolls off at the end of July, and we do not see how lawmakers can risk a break in benefits for the record amount of those unemployed. This dynamic could rise in importance, especially if financial and labor market data worsen in the coming weeks. State and local government layoffs have been mounting. We believe public sector layoffs will worsen as more cuts are needed to balance budgets.

Potential Expansion to the Fed's Municipal Liquidity Fund

Another item not often mentioned has to do with the very limited nature of the Fed's Municipal Liquidity Fund (MLF). In comparison, the Fed launched its Main Street Lending Program and fulfilled its pledge to buy corporate bonds through its Secondary Market Corporate Credit Facility just last week. However, there is still an extreme imbalance between the lending programs available for private versus public sector borrowers. Sure, the Fed made only small modifications to the MLF, but there is still nowhere the amount of capacity for state and local governments, transportation

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providers, or other related entities via the Fed's lending programs. Perhaps, these recent developments motivate the Fed to expand public sector lending programs. Just as former Treasury Secretary Hank Paulson said at a Senate Banking Committee meeting in 2008, "If you have a bazooka in your pocket, you probably won't have to use it."[6]

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[1] Please see *Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event; U.S. Federal Reserve; June 25, 2020.*
[2] *Toropin, Konstantin and Paul LeBlanc; Texas governor will allow state's stay-at-home order to end on Thursday and open business Friday; CNN: April 28, 2020.*
[3] *Svitek, Patrick; Gov. Greg Abbott recommends Texans stay home as coronavirus cases surge; Texas Tribue; June 23, 2020.*
[4] *Governor Abbott takes executive action to contain spread of COVID-19; Press Release; June 26, 2020.*
[5] *Anderson, Zac; Florida closes bars again as COVID-19 cases spike; Herald Tribune; June 26, 2020.*
[6] *Barr, Colin; Paulson readies the 'bazooka'; CNN Money; Sept 7, 2008.*

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