U.S. Municipal Bond Market

Municipals Shrug Off Reopening Rollback

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Summary

- The reopening rollback began at the end of June and has gained steam.
- Municipal investors have moved $12.7 billion into municipal funds over the last nine weeks. Last week, a little over $1 billion flowed into municipal funds.
- It seems municipal investors have shrugged off the reopening rollback and other negative indicators or trends.
- This could be because investors are relying on monetary and fiscal policy that has occurred and may yet still materialize.

Investors Have Shrugged Off the Reopening Rollback

Early indications are that municipal investors have shrugged off the increase in confirmed COVID-19 cases in the U.S. and the resulting reopening rollback. We review the landscape and offer a few reasons why this might be occurring, mostly related to monetary and fiscal policy.

Rising Daily Cases, Rollback Intensifying, MEI Falls

The national number of new daily confirmed COVID-19 cases in the U.S. ranged from 15,000 to 30,000 from the middle of May to the middle of June, according to Centers for Disease Control and Prevention (CDC) data.[1] When the amount of confirmed cases began to rise at the end of June, certain states like California, Florida, and Texas began to rollback their reopenings. The national number of new cases has continued to rise since then, despite the rollbacks. Over just the last three days, the CDC numbers for July 10-12 showed over 60,000 confirmed cases each day.

In response to the rising numbers of cases at the end of June, policymakers began to rollback reopenings. The rollback has continued this week, as California announced another level of reopening plans were reversed, for example. Another question that will continue to impact state and local government and economic activity has to do with whether or not schools open for in-class learning in fall 2020. In just the last week or two, speculation about whether or not primary, secondary, and higher education students will physically return to classrooms rose to prominence. At this point, the expectations still seem to be uncertain, despite some plans being drawn up that call for students physically in classrooms. New York Governor Andrew Cuomo noted New York schools can reopen in a region that is in Phase 4 and if the daily infection rate is below 5%.[2]

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Another headwind to investor sentiment could have been from the reversal of the Dallas Federal Reserve's national Engagement and Mobility Index (MEI), which fell again. This indicates that national economic activity and indicators are likely to follow.[3] But, the shift does not seem to have swayed investor opinions.

Investment Dollars Flowed in Municipal Funds for Nine Straight Weeks

We saw a little over $1 billion flow into municipal mutual funds, per Lipper data released last week, despite the worldwide pandemic and the fact that COVID-19 related trends in the U.S. are worsening, not getting better.

We have observed $12.7 billion of flows into municipal funds since the middle of May. There have been positive flows into municipal funds for nine straight weeks. Municipal fund flows will be net positive after only another $2 billion flows back into municipals.

Please see disclosure starting on page 3.

This is quite a reversal in municipal investor sentiment compared to just a few months ago. For six weeks in March and April, we saw $31 billion flow out of municipal funds.

Why are Municipal Investors So Confident?

Part of why municipal investors remain so confident in the face of uncertainty could be because in March Congress and the Federal Reserve sent a message early on that the economic might of the U.S. would be brought to bear in order to minimize the negative impact from the pandemic. It could also be because investors are assuming Washington, D.C. lawmakers are likely to deliver another round of COVID-19 relief by the end of July/beginning of August.

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The confidence could also be because an increased amount of Federal Reserve support for the municipal bond market is being assumed. The Fed's Municipal Liquidity Facility (MLF) has only been utilized by one issuer so far, the state of Illinois. And if Illinois went to market today, the pricing would most likely be better than the MLF. Fed MLF pricing is high, as the program is meant to be a last resort.

There has been extensive Federal Reserve support of other markets to date, and we do not think the support for municipals in the form of the MLF comes close to what has been provided in those other cases. More could and should be done by the U.S. Federal Reserve now to prepare for a municipal market dislocation from liquidity concerns or anxiety over credit. Investors could be assuming that because there is room for the Fed to act in support of the municipal market, that it could act, and make up ground in comparison to the support for other markets.

Our Expectation of Congressional Relief and More Federal Reserve Support

At this point, we want to reinforce our expectation that federal government relief for state and local governments is almost certainly going to materialize by the end of July or beginning of August. A consensus for another round has been building.

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In contrast, it does not seem like the Federal Reserve is likely to expand or create new programs for state and local governments or in support of the municipal bond market in the near term. This stance could change, certainly. But, the fact that the Fed has prepared substantial corporate bond programs for deteriorating scenarios and the Fed has not done that for municipals tells us that the MLF could be as good as it gets.

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[1] *Cases in the U.S.; Centers for Disease Control and Prevention; Data updated July 13, 2020.*

[2] *New York Governor Andrew Cuomo, @NYGovCuomo. Twitter Post. July 13, 2020, 11:09 AM. https://twitter.com/NYGovCuomo/status/1282708662134493185*

[3] *Kozlik, Tom; President Cannot Cut Public School Funding; Schools, State and Local Governments Likely to See Aid in July/August; Jobless Claims Remain Elevated, At Risk; National MEI Index Falling Again; Hilltop Securities; July 9, 2020.*

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