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U.S. Municipal Bond Market

Fed Drops Municipal Backstop Pricing by 50 Basis Points, Still Very High

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U.S. Federal Reserve Drops Municipal Liquidity Facility Pricing by 50 Basis Points
Yesterday, the U.S. Federal Reserve announced in a press release it reduced the interest rate spread charged to qualified issuers to access its Municipal Liquidity Facility (MLF) by 50 basis points. In the release, the Fed indicated, "Today's changes will ensure the MLF continues to provide an effective backstop to assist U.S. states and local governments as they weather the pandemic." This lower interest rate spread still remains steep relative to the current market. The change really only lowers the program costs to "very high" from "extremely high" compared to current market pricing.

This program adjustment may have appeared necessary because Congress failed to come to an agreement on a fifth phase of COVID-19 last week. It also may have seemed necessary so the Fed can appear as though it is not out of touch with what has been happening in the municipal market since the beginning of March. After all, the 10 year AAA municipal benchmark has dropped 77 basis points since the beginning of May. This number is even larger if you go back to the beginning of April or middle of March.

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The 10 Year AAA Municipal Benchmark Fell 77 Basis Points Since May 1

Date	Yield
May 1	1.35%
Aug. 11	0.58%
Difference	**0.77%**

Source: Thomson Reuters MMD and HilltopSecurities.

The program adjustment reduces interest costs for qualified issuers and it is possible some could utilize the program before it expires at the end of the year, but at this point we are still not expecting a wave of MLF use. Illinois is still the only issuer so far that has used the Fed's MLF program, and if they were to sell debt now, the state very well might end up accessing the capital under better financing terms than it saw with the Fed's MLF program.

That being said, the Fed from the beginning has noted that the MLF is supposed to act as a "backstop" and not as a primary source of financing. This is one of the reasons that the pricing has been expensive relative to the market. We continue to believe that while the Federal Reserve has offered tremendous support to most other markets, the support to the municipal bond market has been underwhelming.

Please see disclosure starting on page 2.

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