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U.S. Municipal Bond Market

Watching How U.S. Fiscal and Monetary Policy Impacts the Municipal Bond Market

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Summary

- Fiscal policy steps already approved by Congress in response to the COVID-19 pandemic total over $3.5 trillion;
- U.S. monetary policy specific to the municipal bond market that was enacted in response to COVID-19 was highlighted by the creation of the Municipal Liquidity Fund. So far only Illinois and NYMTA have used the MLF. New Jersey is said to be considering the MLF;
- It still does not seem that Washington lawmakers are close to a fifth phase of COVID-19 relief. Conversations seemed to have been jump-started last week by White House COS Meadows, but a compromise is still not imminent;
- Senate majority leader Mitch McConnell said this morning the Senate will vote on a slimmed down version of targeted COVID-19 relief this week. This abbreviated version amounts to only about $500 billion and is not guaranteed to pass in the Senate. This illustrates the extent of the rift and why it has been so difficult to get another round of aid completed. This smaller version does not include state and local government aid;
- Without aid, state and local governments will likely enact a combination of deep budget cuts impacting personnel and service delivery. We are also expecting to see more tax and fee increases incorporated this time around, compared to past economic downturns.

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Summary of U.S. COVID-19 Fiscal Policy Reponse, Phase 5 Talks Stopped in August

Phase	Became Law	Legislation	Details	Amount (billions)
Phase 1	March 6, 2020	Coronavirus Preparedness and Response Supplemental Appropriations Act	Research and deveopment, health-care services and supplies	$8.30
Phase 2	March 18, 2020	Families First Coronavirus Response Act	Testing funds, paid leave, food stamp funding	$192.00
Phase 3	March 27, 2020	Coronavirus Aid, Relief, and Economic Security (CARES) Act	Expanded unemployment, PPP, Fed Reserve & industry loans, payroll tax credits, created MLF, other	$2,700.00
Phase (3.5 or) 4	April 24, 2020	Paycheck Protection Program and Healthcare Enhancement Act	Expanded PPP, hospital & testing funding	$733.00
Total Fiscal Policy Response Cost To Date				**$3,633.30**
Phase 5	Sept. ?, 2020	Unknown	Negotiations for a Fifth Phase of COVID-19 relief stopped during the first week of Aug. Congress returns to D.C. Tuesday, Sept. 8, House leaves Oct. 2, Senate leaves Oct. 9.	Reps: $1T; White House: $1.3T Democrats: $2.3T
Potential Fiscal Policy Response Cost (High-end, at $2T)				**$5,633.30**

Source: HilltopSecurities.

Please see disclosure starting on page 6.

Unprecedented U.S. Fiscal Policy in Response to COVID-19 Pandemic

Lawmakers returned to Washington this week, which is the last time they will be in session before the Nov. 3, 2020 elections. Last weekend, the White House tried to jump-start COVID-19 relief negotiations. As of now there is a lot of ground to cover and the White House, Senate Republicans, and House Democrats are still far apart on a compromise. The White House raised its total package number to $1.3 trillion and House Democrats lowered their "ask" to $2.2 trillion from $3.5 trillion. Senate Republicans still have not officially passed legislation; Their number seems to be as far below $1 trillion as possible, possibly even as low as $500 billion.

In 2020, there has already been an unprecedented amount of fiscal and monetary policy introduced to support the economy. Some of those policy moves by Congress and the Fed have been specifically targeted to the municipal bond market.

As we await the fifth phase of COVID-19 relief talks to evolve, it is important to acknowledge what has already been accomplished by fiscal and monetary policy in 2020. Even though the potential for a fifth phase of COVID-19 relief remains up in the air, we should reiterate there has already been an unprecedented amount of fiscal and monetary policy introduced to support the economy. Some of those policy moves by Congress and the Fed have been specifically targeted to the municipal bond market.

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act)

There were four distinct phases of Congressional or "Fiscal Policy" that came about in March and April of this year related to COVID-19. The third phase of this fiscal support was the most significant by far, which featured the $2.7 trillion Coronavirus Aid, Relief, and Economic Security Act, or what most refer to as the CARES Act.

The CARES Act was a record-setting fiscal relief package that came together in only a matter of weeks. This quicker than normal timeline was good and bad, because it left little room to really consider policy options but at the time it seemed lawmakers were assigning a premium to getting funds out the door as opposed to weighing policy effectiveness.

Public Finance Elements of the CARES Act

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There were several components to the CARES Act, but some of the major parts of it expanded unemployment benefits, created the Paycheck Protection Program (PPP), funded Federal Reserve support, and offered some direct assistance to public finance entities. For example, it funded:

- The $150 billion COVID-19 relief fund for state, tribal, and local governments;
- Created the $31 billion Education Stabilization Fund for states, school districts, and higher education institutions;
- Allocated $10 billion for the Federal Aviation Administration's Airport Improvement Program;
- Earmarked $25 billion for transit providers; and
- Assigned $454B for use by the Federal Reserve.

For more information, please see our March 25 commentary, Agreement on the $2+ Trillion CARES Act; Not Nearly Enough for State and Local Governments. Page 2 includes a more detailed description of the public finance elements included in the CARES Act.

To date, only about 25% of the COVID-19 relief fund dollars allocated to state and local governments have been spent. We do not think this low spend rate is an indication of a lack of need, but due to restrictions of how the funds could be spent and because it takes time for programs such as this to get up and running and for proceeds to be disbursed. Please see more on this topic in pages 2-9 of our July 30 commentary, COVID-19 Spending to Date Not an Accurate Indicator of Need.

HEROES Act and Moving Forward Act

In recent months additional legislation has been proposed and passed through the U.S. House that is relevant to the legislative conversations going on right now. The HEROES Act is important because even though it is not law, it is known as the opening proposal

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- The Health and Economic Recovery Omnibus Emergency Solutions Act, or HEROES Act, was the $3+ trillion of federal relief passed by the House which included almost $1 trillion of aid for state and local governments.
- The $1.5 trillion Moving Forward Act, or H.R. 2, was the infrastructure focused legislation passed by the House that included some municipal bond friendly elements such as a:
    - Permanent reinstatement of a Build America Bond (BAB)-like infrastructure bond program that would be exempt from sequestration;
    - Permanent reinstatement of tax-exempt bonds for advance refundings.

We included more details about the HEROES Act in our May 12 commentary, The HEROES Act: The House Democrats' Opening Proposition, and included a more in-depth overview in our June 22 commentary, The Moving Forward act in $1.5T for Infrastructure in Proposed "Moving Forward" Act, Municipal Friendly Elements Included.

HEROES Act Proposed Fiscal Relief

Type	Amount ($ in billions)
State Governments	$500
Local Governments	375
U.S. Territories	20
Tribal Governments	20
Total State & Local Relief	**$915**

Source: Summary of legislation and HilltopSecurities.

The Fed has been extraordinarily active since the very beginning of the COVID-19 pandemic.

Again, neither the HEREOS Act nor the Moving Forward Act has become law, but they could continue to be referenced in the coming months and they are important to be aware of moving forward. References to the HEROES Act could arise during conversations regarding future talks about COVID-19 relief. We expect details from the Moving Forward Act could surface during infrastructure-related debate.

On the Monetary Policy Support Side

The Fed has been extraordinarily active since the very beginning of the COVID-19 pandemic. Federal Reserve chair Jerome Powell said, "The effect of the coronavirus will weigh on economic activity in the near term and pose risks to the economic outlook" during an unscheduled press briefing held on Sunday March 15. The Fed had already dropped the Fed Funds rate 50 basis point back on March 3 and made a statement by cutting its target to zero on the March 15. Also on March 15, the Fed announced several quantitative easing measures, encouraged a more active use of the discount window, eased bank capital requirements, and coordinated international cooperation on U.S. dollar liquidity swap arrangements. Only a few days later the Fed began to announce the first of its many emergency lending programs and facilities. On Tuesday, March 17, the Fed announced and described the creation of its Primary Dealer Credit Facility and its Commercial Paper Funding Facility.

Timeline of COVID-19 Related Federal Reserve Emergency Lending Facilities

Date Announced	Operational Date (or Proposed)	Name of Program or Facility	Funded by CARES ($ Amount)
March 17, 2020	March 20, 2020	Primary Dealer Credit Facility	None
	April 14, 2020	Commercial Paper Funding Facility	None
March 18, 2020	March 23, 2020	Money Market Mutual Fund Liquidity Facility	None
March 23, 2020	June 29, 2020	Primary Market Corporate Credit Facility	$50 billion
	May 12, 2020	Secondary Market Corporate Credit Facility	$25 billion
	June 17, 2020	Term Asset-Backed Securities Loan Facility	$10 billion
April 9, 2020	April 16, 2020	Paycheck Protection Program Liquidity Facility	None
	June 15, 2020	Main Street Lending Program	$75 billion
	May 1, 2020	Municipal Liquidity Facility (MLF)	$35 billion

Source: Federal Reserve and HilltopSecurities.

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There was a significant amount of monetary support from the U.S. Federal Reserve in recent months. Other Fed programs and facilities followed in later days and weeks. Fed programs specific to the municipal bond market included expansions to both:

- Money Market Mutual Fund Liquidity Facility; and
- Commercial Paper Funding Facility.

On March 23, the Fed extended asset eligibility requirements to these programs to include some short-term municipal securities.[1] We wrote about the pressure on the municipal variable rate demand obligation market in our March 18 commentary, A Focus on the Significant Pressure in the VRDO Market.

Since its inception, the MLF has been meant to be used only as a liquidity backstop for short-term purposes. So far, only Illinois and the NYMTA have used the MLF.

The Municipal Liquidity Facility

Then, on April 9 the Fed announced the initial details about its Municipal Liquidity Facility (MLF). Since its inception, the MLF has been meant to be used only as a liquidity backstop for short-term purposes. So far, only Illinois in June ($1.2 billion) and the NYMTA at the end of August ($450 million) have used the MLF. New Jersey is considering using the MLF at this time. Even though the Fed lowered the MLF pricing by 50 basis points two weeks ago, we still see it as expensive and do not believe eligible issuers will use it to a large degree unless the market takes a significant turn. As of now the municipal bond market is working as efficiently and effectively as ever. To date, there are no 2020 liquidity issues like those we saw in March and into the beginning of April.

There have been several updates to the Fed's MLF over the past several months. For more details about the MLF and other Fed related topics please see our following 2020 publications:

- 8/19: The Fed Backstops $451 Million of NYMTA notes Despite Efficient Market Conditions
- 8/12: Fed Drops Municipal Backstop Pricing by 50 Basis Points, Still Very High
- 7/23: Fed Expands Main Street Lending Program Eligibility to Include Nonprofits
- 6/30: Another Corporate Facility Launched, Fed Chair's Prepared Comments are Stale, PPP Expires
- 6/19: Fed Pledge to Buy Corporates Underway; Nothing New for Municipals
- 6/15: Fed Launches Main Street Lending Program, Mulls Expansion to Non-Profits
- 6/3: Illinois Taps Fed's Municipal Liquidity Facility, Fed Expands Eligibility
- 5/11: Updated Pricing Detail: Federal Reserve's Municipal Liquidity Facility
- 4/29: Fed Expands Municipal Liquidity Facility, Provides Details
- 4/9: More Good News than Bad This Week, which includes the details from the initial announcement of the Fed's MLF

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Status and Potential for a Fifth Phase of COVID Relief

The potential for a fifth phase of COVID-19 relief was big news back in July and many, including us, were expecting a total federal relief package of something between $1-3 trillion of federal aid that would include spending on things like an expansion of unemployment benefits and aid for state and local governments. It seemed after the reopening rollback occurred at the end of June another phase of relief was "almost ensured."

Trump's Aug. 8 executive actions sent a message that the White House was able to do what Congress was not, most notably an extension of unemployment benefits.

Congress returned from their July 4 break on Tuesday, July 21, and the expectation was that they had three weeks, or until Friday, Aug. 7 to finalize details for a Phase 5 relief package. Negotiations broke down completely by the first week of August. Then, just a day after Congress failed to come to an agreement on COVID-19 relief, on Saturday, Aug. 8, President Trump put into place four different executive actions, detailed in our Aug. 10 commentary, Something is Better Than Nothing As President Attempts to Assist But Offers No Adequate Alternative to Congressional Action.

In essence, the message was that the White House was able to do what Congress was not. Most notable was an extension of unemployment benefits in the amount of $300 per week that would most likely last until about the middle of September, replacing the $600 a week benefit that expired on July 31.

At the beginning of the week of Aug. 24, it seemed a fifth phase agreement was not going to be considered by lawmakers. However, White House Chief of Staff (COS) Mark Meadows seemed to have pushed the importance of relief to the front burner. At the end of the week, the president noted he supported a total relief package up to $1.3 trillion.

Then over the rest of the weekend and into the beginning of last week, White House negotiator Meadows began to unveil more of the president's hand as it related to what President Trump is envisioning should be included in a fifth phase of federal relief. Over the Aug. 29-30 weekend, COS Meadows appeared on "Meet the Press" and specifically noted the White House is on board with unemployment benefits, aid for small businesses, and help for daycare, hospitals, and schools all at levels Speaker Nancy Pelosi would "agree with."

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At the beginning of last week, COS Meadows went a step further during a morning interview on CNBC, stressing progress is being made on negotiations but highlighted that a key roadblock to negotiations was the unrealistic amount of aid the Democrats were asking for to help state and local governments. See our coverage, State and Local Aid is Key Roadblock, Says COS Meadows, But Offers $300 Billion. In a statement posted following a conversation with Treasury Secretary Steven Mnuchin, Speaker Pelosi made it clear that the Democrats were not going to give in. Pelosi's statement ended with:

> "Sadly, this phone call made clear that Democrats and the White House continue to have serious differences understanding the gravity of the situation that America's working families are facing.
>
> "House and Senate Democrats have repeatedly offered to compromise. Over a month ago, we said that we would be willing to cut a trillion dollars from the HEROES Act if the White House would add one trillion to the Senate bill. Last week, we said we would be willing to go down to $2.2 trillion."[2]

It seems Senate Republican do not share the White House's enthusiasm for another phase of relief, either. Senate Republicans are said to be constructing a $500 billion plan; a level much lower than the Democrats' ask and more than half of what the White House said it is willing to approve. Last week, Senate Majority Leader Mitch McConnell said, "I don't know if there will be another package in the next few weeks or not." Leader McConnell also said that any appetite for bipartisanship has "descended."

In a statement posted following a conversation with Treasury Secretary Steven Mnuchin, Speaker Pelosi made it clear that the Democrats were not going to give in.

Phase Five Still Not Close to Imminent

So, a phase five relief package is still not close to imminent. It might not even be possible before the election. We did raise the potential risk of no relief back in April when we highlighted political risk as a real possibility in our commentary, Three Key Atypical Credit Risks and Market Update.

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Congress returned to Washington today, following the Labor Day holiday. What kind of ground can be made before members of the House leave Friday, Oct. 2 or members of the Senate leave on Friday, Oct. 7 is uncertain at this point. One thing that is certain is whatever the federal government is able to get done absolutely has a direct and meaningful impact on the credit quality of every single outstanding municipal bond. The impact may be more meaningful to some compared to others, but the impact of action or inaction will be significant for sure. Federal government relief is the second most important credit related item to be watching currently, after the trajectory and spread of COVID-19.

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[1] *Please see Municipal Debt Markets and the COVID-19 Pandemic; Liberty Street Economic form the Federal Reserve Bank of New York; June 29, 2020.*
[2] *Werner, Erica; Twitter Post; Sept 1, 2020; 8:12pm; https://twitter.com/ericawerner/status/1300964771035054086.*

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Readers may view all of the HilltopSecurities Municipal Commentary here.