Vanguard Muni Chief Says Death of Liquidity Greatly Exaggerated.

In the $3.7 trillion municipal-bond market, dealers have cut inventories and trading has been on the decline. But the man who oversees tax-exempt debt for the world's largest mutual-fund company isn't worried the market will freeze up.

Chris Alwine, the head of state and local-government debt for Vanguard Group Inc., said even if buyers rush for the exits and bond prices slide, Wall Street will still be there, willing to step in to make a profit.
"The Street doesn't go in there and say I'll lose on the next 50 trades to make sure the market is really tranquil," Alwine, who oversees $120 billion of municipal bonds for the Valley Forge, Pennsylvania-based company, said in an interview Wednesday in New York. "They're in the business to make money, plain and simple."

Wall Street has been awash with speculation that a bond-price rout could be exaggerated by a exodus of capital from U.S. fixed income markets when the Federal Reserve raises interest rates for the first time since 2006. While concern that dealers won't buy during a sell-off has largely focused on the corporate and Treasury market, then Securities and Exchange Commissioner Luis Aguilar in February said the drop in liquidity could foist steep losses on municipal investors once rates climb.

The municipal market, which is divided among more than 50,000 issuers and is dominated by individual investors, has long been less liquid that the Treasury and corporate markets, and it weathered the turmoil since the recession without seizing up. When mutual funds dumped holdings of Puerto Rico bonds as the island's debt crisis escalated, hedge funds snapped up the securities, which continue to trade frequently even as the government edges closer to a record-setting default.

The average daily trade volume for municipal bonds is less than 2 percent of what it is for Treasuries and less than half that of corporates, according to Securities Industry and Financial Markets Association data. Last year, $2.7 trillion of municipal debt changed hands, a decline of 16 percent decline from 2011, according to Municipal Securities Rulemaking Board statistics.

Such trading is handled between dealers, rather than on centralized exchanges, which can make it harder for investors to shop for bids to buy and sell.

Alwine said liquidity is best gauged by the cost of trading, the ease of doing so and the ability to buy and sell large blocks of bonds without affecting their price. None of those factors are easy to measure with official statistics, he said.

Positive Sign

By one indicator, the money manager said, there's little sign of liquidity drying up: Bid-offer spreads, or the difference between where an investor offers to sell and another to buy, are less than they were before the 2008 credit crisis.

That comes despite a withdrawal by securities dealers, which have been keeping fewer bonds in their inventories in hope of selling them later. Dealers' holdings fell to about $19 billion at the end June from $40 billion in 2010, according to Federal Reserve data, as regulations and narrower profits due to low interest rates led banks to devote less capital to the market.

That doesn't mean they won't come back. The firms are waiting until there's more money to be made, Alwine said. After Chicago's credit rating was cut to junk by Moody's Investors Service in May, the price swings made dealers active traders in the city's debt, he said.

"Credit was hit, the bond traded down, volume spiked and all the dealers were much more active in that name once there was a potential to make more money," he said.

Another example: The "taper-tantrum" of 2013, when speculation that the Fed would raise interest rates pushed yields on top-rated 30-year municipal bonds to as much as 129 percent of comparable Treasuries. "Waves of demand" came in as AAA rated bonds were yielding the equivalent of 8 or 9 percent on other debt, once the tax break was factored in, he said.

To take advantage of opportunities when the market sells off, Vanguard ensures that it has enough cash and holds higher-rated bonds from states such as California and New York, where demand for tax-exempt bonds is strong. These securities can be more easily traded during times of market stress, he said.

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