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Fleeting Opportunity Seen as Swap Index Spikes.

A combination of pricing pressure due to seasonal weakness, new regulations on money market funds, and the scarcity of short-term paper is creating a unique buying opportunity in one of the municipal market's most actively-used benchmarks for swap transactions.

After 19 consecutive weeks unchanged at 0.01%, the rate on the weekly reset municipal swap index overseen by the Securities Industry & Financial Markets Association spiked in March and currently remains at 0.39% as of April 13.

The 52-week range is 0.01% to 0.40%, according to SIFMA.org. Analysts said it's the first such opportunity to boost yield on the short end of the curve in two years.

"This is a technical condition of the market that acts in favor of investors because it pushes rates higher, but they won't stay there very long," said Phil Fischer, managing director of credit research at Bank of America Merrill Lynch & Co.

Money market fund rules passed July 2014 by the Securities and Exchange Commission triggered $20 billion of outflows and created a structural "disequilibrium" that's now affecting the market, Fischer said.

The most critical of the regulatory changes involve floating net asset value and fees and gates amendments, many of which will be implemented on Oct. 14, and some of which go live on April 14. Some of the minor tweaks have already been implemented.

This year, the SIFMA municipal swap index rate has surged from 0.01% to 0.40% in a matter of weeks, Fischer said.

"We normally have weak technicals through tax time caused by outflows," he said. "But we are not supposed to have seven-day muni rates at 0.01% when comparable taxable rates are on the order of 0.40% basis points."

Created in 1992 by SIFMA to both accurately reflect activity and boost liquidity in the VRDO market, the index is comprised of hundreds of actual issues that represent the universe of VRDO securities.

Fischer said the index is gospel to the MMF industry because it provides the average rate for several hundred VRDOs that purchased aggressively by money market funds.

Issuers typically sell long-term bonds that – depending on the liquidity and put features – allow them to reset as weekly interest rate swaps at rates determined by the level of the SIFMA index.

Prior to April 13, the rate of the index spiked to as high as 0.40% on March 30. It was calculated at 0.29%, 0.13%, 0.06%, and 0.02% in the prior four weeks before March 30 after remaining unchanged at 0.01% consecutively each week from Oct. 21, 2015 to March 2 when it crept up to 0.02%.

The rate had been at 0.02% for the previous 12 consecutive weeks, and prior to that it largely hovered under 0.10% dating back to August 20, 2014, according to SIFMA.org data.

Investors who are seeking respite from the relatively low absolute yields in the municipal market, yet want to remain defensive to hedge against potential interest rate volatility, can reap the best of both worlds as a result of the rare, higher than usual short-term yields, analysts said.

They describe the price spike as an anomaly because of its arrival and availability amid individual income tax season, the debut of new regulations imposed on municipal money market funds later this year, and a scarcity of short-term paper, which has been largely declining since 2008.

“It’s a good opportunity for people who want to invest or reinvest at the higher rates” before the normalization of supply and demand at the short end of the curve in month or two ahead of the June 1 and July 1 rollover season, Fischer said.

Others agreed that the swift increase in the SIFMA municipal swap index is a positive for yield-starved investors, though they said its timing is uncharacteristic.

“This is a good event for investors … they are collecting more interest,” said Mike Craft, managing director of credit at Lumesis, Inc., a financial technology company focused on providing business efficiency, regulatory and data services to the municipal bond marketplace.

He said even though the higher-than-usual spike in the SIFMA index is occurring earlier this year, it is still a positive market event given the overall low absolute yields.

“In previous years, the tax time spike came later, usually the middle of April,” Craft said. “If taxpayers own MMFs and owe the IRS, they tend to wait to file, redeem funds, and pay near the deadline.”

Craft isn’t certain if the anomaly is a structural shift due to the recent money market fund reform, but if so, he said it can shrink that market further, not to mention possible unknown impacts in the municipal market in the future.

The MMF reform requires a floating NAV for institutional prime money market funds, and allow MMFs to impose a liquidity fee of up to 2%, or temporarily suspend redemptions – also known as a gate.

These fees and gates give non-government money market fund boards new tools to address runs and stem heavy redemptions and avoid the contagion that occurred in the 2008 financial crisis.

While retail prime and retail municipal money market funds are able to continue transacting at a stable $1.00 NAV under the reform, this option is not available to institutional investors. They will be eligible to use government money market funds and institutional, non-government money market funds, which will have a floating four-decimal NAV.

Fischer said the opportunity to earn higher yields is likely to be short-lived and investors should take advantage of the spike in rates now rather than waiting.

“It’s an anomaly but it’s going to head back toward the equilibrium in a month or two,” Fischer predicted.

Issuance of VRDO paper has contracted to $1 billion so far this year, down from the $116 billion in all of 2008. Austerity at the state and local levels has contributed to the decline as the outstanding volume of traditional notes maturing in less than 13 months has dropped to $30 billion from $100 billion in 2002, according to Fischer.

“We don’t have a lot of short-term paper directly as notes or synthetic VRDNs and what that means is that the municipal market is chronically short of enough short-term paper,” Fischer said. “As states get more surplus money the need to borrow is less.”

Part of the decline has stemmed from inefficiencies and market changes, he said.

“The cost of these bank facilities has gone way up and the issuers found it cheaper to place some of that as bank loans,” he said.

That further compounds a supply–demand imbalance already affecting the short-term market, according to Fischer.

“That’s why you see that the municipal market is always upward sloping and the very short end has lots and lots of demand from individuals and institutions and not a lot of supply,” he added.

That supply-demand imbalance is what kept the SIFMA index at 0.01% since October of 2015, Fischer noted.

He said investors were willing to accept almost no return in exchange for the low risk of the Federal Reserve Board suddenly raising short-term rates before December 2015.

Fischer said the bias toward higher short-term rates, in part a result of the implementation of these regulations, could last through the end of April. Afterward, there could be a new precedent once the impacts of the new MMF regulations sink in and tax season passes, he said.

Typically, the rates on the SIFMA index have been equivalent to 70% of one month of the London Interbank Offered Rate, or LIBOR.

“To have SIFMA index at 0.01% for this length of time is an extreme anomaly,” despite the seasonal effects, regulatory changes, and ongoing shortage of short-term municipal paper, Fischer said.

The Bond Buyer

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