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Muni Market Support for Federal Reserve Intervention Grows.

- **Groups call on central bank to buy more munis amid selloff**
- **Congressional approval needed to purchase long-term muni-bonds**

The Federal Reserve is wading into the $3.9 trillion municipal-bond market. But the central bank still has more levers it could pull in the asset class that's been stung with the worst monthly rout on record.

Last week, the Fed expanded its emergency lending program to provide liquidity to money market funds so it would include purchases of short-term municipal bonds, and on Monday, it tacked on support for variable-rate demand notes. Despite the rare intervention, the chorus of calls for more help is getting louder. In the last week, lawmakers, state officials and lobbying groups have all advocated for the unusual move of the central bank buying municipals, at least temporarily.

The state and local debt market is in the midst of its worst rout in history due to a wave of selling by mutual funds and exchange-trade funds that's led to a liquidity crunch. For issuers, the soaring borrowing costs could make it more expensive for them to raise money in both the short- and long-term. Meanwhile, the coronavirus outbreak is wreaking havoc on government finances as revenue is falling at the same time costs are skyrocketing.

"States and issuers are being faced with other matters right now — it'd be nice not to deal with this one," said David Erdman, who handles debt sales for the state of Wisconsin.

The Federal Reserve is authorized to buy short-term municipals maturing in six months or less. But lobbying groups like the Bond Dealers of America, which represents banks and dealers, have said they would support the central bank going further than that and buy longer-dated securities temporarily. But that would likely require congressional or Treasury funding to backstop the Fed against credit risk.

Quantitative Easing

"Given the significant role that states are playing at the forefront of the response to the Covid-19 virus, we want to make sure the resources are available financially for states as this progresses," said Shawn Wooden, who oversees debt sales for the state of Connecticut. Wooden is among a group of Democratic treasurers who last week called on the Fed to intervene.

Allowing the Fed to buy municipals through quantitative easing is likely "quite difficult" because it would require Congress to change its charter, Morgan Stanley strategists said in a report last week. Lawmakers' effort to pass a stimulus bill — which a lawmaker said would expand the Fed's ability to buy municipals — sputtered over the weekend.

But the Morgan Stanley strategists said that the Fed still had the authorization to buy revenue anticipation notes, which are sold by governments waiting for tax collections to come in. They said it would give governments access to liquidity in a "worst-case scenario."

The Fed on Monday moved to address a municipal-bond market niche that's been hit hard with much higher borrowing costs for issuers. The bank will include variable-rate demand notes as eligible collateral as part of its lending program to money-market funds, which may help reduce yields on those securities, according to Barclays Plc. Yields on a closely-watched index of variable-rate debt hit 5.2% last week, the most since 2008.

Still, the entry of the Fed could be a slippery slope in a market with millions of bond CUSIPs and varying credit ratings, said Kyle Gerberding, director of trading for Asset Preservation Advisors.

"Which ones do they buy? Which ones do they not?" he said.

Citigroup's Vikram Rai said he believed that the Fed's involvement would help as banks face limits on how much more they can step in to alleviate the selling pressure. Dealer inventories of municipals excluding variable-rate debt rose to $14.5 billion as of March 11, up from just $11.4 billion in mid-January, according to the most recent Federal Reserve Bank of New York data.

"It seems like an extreme suggestion, but we're in uncharted waters," Rai said. "This is the only way to temper the volatility in the market."

Bloomberg Markets

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March 23, 2020, 10:49 AM PDT

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