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The Fed Enters the Municipal Bond Market to Lend Cities a Hand, but Will It Be Enough?

On Monday, the Federal Reserve went all-in to support America's shuttered economy. Among its most remarkable moves was its backstop of the $3.8 trillion municipal bond ("muni") market, a critical source of financing for states, counties, and municipalities. The Fed hopes this will keep credit flowing to states and localities as their revenues—and the market for their debt—reel in the wake of the global coronavirus pandemic. As investor dollars rush out of the muni market, it is revealing troubling debts as well as questions about the role of fiscal federalism in a time of crisis.

State and local debt is facing its largest monthly drop in value since 1987, sending yields soaring nearly a full percentage point to 2.6% this week. Investors withdrew more than $12 billion from municipal bond funds last week, the highest weekly outflow on record, with some funds posting their largest one-day drop in a decade. Many funds now trade below the value of their assets, including those for New York State, suggesting that investors fear surging defaults.

Munis are normally considered among the safest of assets. Just a few weeks ago, investors were scooping up this debt in a flight to risk from markets roiled by the coronavirus. This is continuing the trend since the Great Recession of strong investor demand for state and local debt, culminating in more than $100 billion in inflow last year. Muni's tax-exempt status has made them especially popular following the 2017 tax law.

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MARCH 25, 2020