
Fed Treads Cautiously Into Muni Market With Loan Lifeline.

- **Central bank isn't making open-market buying, as some sought**
- **Fed leaves the door open to more steps if they are needed**

The Federal Reserve is treading carefully into the $3.9 trillion municipal-bond market.

The central bank announced on Thursday that it would lend as much as $500 billion to states and the biggest local governments to cover massive tax shortfalls brought on by the swift slowdown in the economy, preventing a wave of short-term debt sales from hitting the public markets. But it stopped short of swooping in to buy long-term debt to head off another sell-off like the one that erupted last month, as it is doing with corporate bonds, collateralized loans and commercial mortgage-backed securities.

"The Fed is throwing a lifeline to municipal governments," said Gary Pollack, head of fixed income at DWS Investment Management. "This will provide them time to get through this difficult period."

The step will ensure that states and the most-populous cities can raise money to keep operating as tax collections dry up while their economies grind to a virtual halt and annual filing deadlines are pushed back. Wall Street analysts had predicted that such sales would jump in the coming months, which could have put pressure on a segment of the market where interest rates surged sharply last month when money managers dumped the shortest-dated securities to raise cash.

The lending program is somewhat limited in scope, however, since it is open to states and the 10 cities and 16 counties that are big enough to meet the minimum population requirements, according to Census figures. While states would be allowed to borrow money for smaller governments that don't qualify on their own, it's not clear how willing they would be to do so on behalf of financially struggling municipalities.

"While today's action helps the largest cities, it completely misses the mark for those cities, towns, and counties across our country that fall under the population minimums," Chris Iacovella, the chief executive officer of the American Securities Association, a lobbying group for regional firms. "These areas represent the heartbeat of America and for some reason the Fed and Treasury have chosen to exclude them while backstopping the largest cities, which doesn't make any sense."

The Fed's move comes after the municipal-bond market went through an unprecedented sell-off in March as investors pulled record amounts out of mutual funds and governments began to forecast huge deficits from the virus-related shutdowns in activity. That rout stopped after Congress reached agreement on the $2.2 trillion economic stimulus measure, which gave the central bank the power to lend to states and cities and fostered speculation that it would start buying already-issued bonds in order to backstop the market.

"I am a bit disappointed in that the Fed will not be buying muni bonds in the secondary market, something they are doing for investment-grade corporate bonds," RJ Gallo, senior portfolio manager at Federated Hermes. "Perhaps that may evolve in the future if this program fails to provide sufficient capital and liquidity support."

Bond prices gained after the Fed's announcement Thursday, driving the yield on 10-year top-rated securities down 10 basis points to 1.24%, less than half what it hit in March. Even risky securities that feel steeply during last month's sell-off joined in the gains, with Ohio tobacco-settlement bonds due in 2055 climbing to as much as 97.5 cents on the dollar from about 91 cents Wednesday.

The Fed's special purpose vehicle will purchase so-called tax, revenue and bond anticipation notes, which governments sell when they're facing temporary shortfalls in revenues or waiting to sell long-term debt. The notes that the entity purchases must mature in 24 months or less.

That will prevent a massive amount of short-term securities from being issued at a time when the municipal-debt market is only slowly reviving from last month's turmoil, which has starkly reduced the pace of new bond sales as many large deals are put on hold.

John Mousseau, the chief executive officer of Cumberland Advisors, said the Fed's direct lending will help guaranty that the "market will not seize up," which could in turn take pressure off of longer-dated securities as well.

The Fed said in a statement Thursday that it would continue to watch conditions in the municipal market to see if further action is needed. That fits with the central bank's typical approach to wading into new asset classes, said Sean Simko, head of global fixed-income management at SEI.

"What we've noticed from the Fed is that they do like moving in steps — they're taking it in a measured pace," Simko said. "It wouldn't surprise me if they would come into the market with a step two or step three if needed."

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By Amanda Albright, Fola Akinnibi, and Danielle Moran

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— With assistance by Alexandre Tanzi