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How the Fed's Expanded Support Can Help the Muni Market.

Analysts warn, however, that downgrades and negative outlooks could nevertheless increase.

The Federal Reserve has stepped in once again to help a part of the economy suffering from the coronavirus-fueled recession while it waits on more support from Congress.

It is expanding its $500 billion municipal liquidity facility (MLF) to include more cities and counties as well as multi-state entities.

U.S. counties with at least 500,000 residents and cities with a population of at least 250,000 residents will now be eligible for the Fed backstop. The comparable requirements were 2 million and 1 million residents previously, when the Fed first announced the MLF earlier in the month.

"The new population thresholds allow substantially more entities to borrow directly from the MLF than the initial plan announced on April 9," the Fed explained in a statement.

The facility was created to help states, cities and counties that cannot meet their financial needs through the capital markets because their spending rose sharply while their tax revenues fell substantially due to the COVID-19 pandemic.

"The Fed is effectively providing a guarantee on the ability for these issues to borrow," explained Matt Fabian, partner at Municipal Market Analytics, an independent research firm.

It will purchase eligible notes from municipal issuers that can prove they could not borrow in the capital markets without paying much higher interest rates than "normal" and can provide confirmation of that so long as they meet other requirements, said Fabian.

"It's unclear to us how the Fed will determine 'normal' pricing," wrote analysts at Morgan Stanley. The Fed said pricing guidance "will be forthcoming" and it is also considering extending the use of the lending facility to municipal entities that issue revenue bonds.

The municipal notes available for the Fed backstop include tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), and other similar short-term notes from eligible issuers. They also must have a term no longer than 36 months, an increase from the 24-month limit the Fed originally announced, and must be rated investment grade as of April 8.

The expansion of the municipal liquidity facility "will help states and localities "get through immediate liquidity issues," Fabian said.

Current liquidity in the muni market is thin but better than it was in late March and early April before the Fed announced its municipal lending facilities. But it could be tested as downgrades and negative outlooks increase.

In the last two months, Illinois, New Jersey, New York, Alaska, Connecticut, Hawaii and the New York Metropolitan Transportation Authority have been hit by downgrades or negative watches from the major rating agencies, and many more could follow as a result of the current economic downturn.

But even in the midst of the developments, there are opportunities for muni investors, says Fabian.

MTA bonds, which have been downgraded by major credit agencies to the equivalent of A or A-, are yielding 6% for a 10-year term. On a tax-equivalent basis that's around 12% for New Yorkers in the highest bracket for federal, state and local taxes. Investors, however, "have to assume that debt will be downgraded to BBB, but that the MTA will survive the current crisis. You're effectively betting it's too big to fail," said Fabian.

The agency has seen its ridership fall by over 90%, which has hurt revenues, leading the MTA to seek federal and state aid to help close a $8.5 billion budget deficit this year.

No matter what the municipal issue, advisors need to alert clients to the fact that municipal bond servicing is subordinate to local governments providing health and welfare services.

"Clients have to understand that there could be issues [with munis] that they haven't had to deal with before," Fabian said.

Morgan Stanley analysts said the Fed's latest move was "an additional boost to high grade" muni bonds. The high-yield muni market, in contrast, will remain "weak for the foreseeable future," according to the analysts.

They expect the municipal bond issuers will tap the majority of the $500 billion muni lending facility from the Fed, but the Fed could eventually provide even more support "if market conditions deteriorate further, at least until the broader economy is clearly healed."

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