

Bond Case Briefs

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The Treasury Is Asking the Fed for Its Money Back. Here's What It Means for Markets.

The Federal Reserve will likely be forced to close five pandemic facilities on Dec. 31 and return unused funds unless Congress acts. And while Wall Street watchers say the move could undermine confidence, markets had a muted response Friday.

Treasury Secretary Steven Mnuchin declined to extend the facilities in a late Thursday letter to Fed Chairman Jerome Powell, saying that they had done their job and highlighting that much of their capacity remains unused. What's more, he said, the only facilities slated to close are those financed with Treasury funding appropriated by Congress in the Cares Act. Mnuchin asked the Fed to return unused funds and extend the four programs that don't have that funding.

The Fed, for its part, came out with a statement saying that it "would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy."

Markets' responses were muted on Friday. The S&P 500 was down 0.3%, while the iShares iBoxx \$ Investment Grade Corporate Bond exchange-traded fund was down 0.3% and the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG) was down 0.2%. And the iShares National Muni Bond ETF (MUB) gained 0.1%.

Still, many Wall Street strategists appear to agree with the Fed.

"While the amount of debt purchased so far isn't necessarily significant relative to the size of the market, we view the signaling of the purchases as important as the purchases themselves," strategists at CreditSights wrote in a Nov. 20 note.

They were writing on investment-grade debt, but strategists in other markets have echoed the sentiment.

"US credit markets will have to get through the winter months in which the surging new wave of the virus and exhaustion of savings from prior fiscal stimulus threaten a loss of economic momentum without a Fed backstop, though with support from vaccine prospects," Evercore ISA economists Krishna Guha and Ernie Tedeschi wrote in a Nov. 19 note. "Mnuchin's move will tighten financial conditions and removes a safety net for markets at the wrong moment."

Vikram Rai, a municipal-market strategist with Citigroup, wrote in a late October note that the "Municipal Liquidity Facility (MLF) MUST be extended beyond year-end 2020."

To get a more detailed idea of the implications of the facilities' closings, it may help to run down what specific facilities are expiring, the markets they were created to support, and their uptake:

The Primary- and Secondary-Market Corporate Credit Facilities:

These two vehicles were created to buy up to \$750 billion in corporations' bonds, either directly or indirectly through exchange-traded funds. In the primary market facility, the Fed could buy four-year bonds directly from companies. In the secondary market facility it bought up to five-year maturity bonds that companies have already issued, with their selections based on a broad-based investment-grade market index. The secondary-market facility also bought corporate bond ETFs.

While the Fed hadn't bought any bonds in the primary-market facility, it owned \$4.8 billion of bonds and \$8.6 billion of ETFs in its secondary-market facility, totaling more than \$13 billion.

That is a relatively small sum compared to the maximum \$750 billion purchase amount, not to mention the overall size of the \$9.6 trillion corporate bond market. Yet corporate bond markets across the quality scale have recovered to their pre-pandemic levels. According to ICE Indexes data, investment-grade bonds are yielding 1.9%, down from 4.7% at the height of March's selloff, and high-yield bonds are yielding slightly less than 5%, down from their 11% pandemic peak.

The Term Asset-Backed Securities Loan Facility, or TALF:

This facility was created to support the market for securities backed by loans, specifically: credit-card loans, automobile loans, student loans, certain types of business and insurance loans, and leveraged loans.

As of Oct. 31, the Fed had lent out \$3.7 billion of cash with the TALF, in the form of three-year loans with AAA-rated asset-backed securities as collateral. The asset-backed securities market is about \$1.7 trillion, according to the Securities Industry and Financial Markets Association, or Sifma, though a significant amount of those loans are backed by commercial mortgage-backed securities, which are included in the \$10.3 trillion mortgage market.

In his letter to the Fed, Mnuchin highlighted steep declines in consumer-loan-backed security yields since the pandemic, indicating a rebound in prices—for both AAA- and A-rated securities. Credit-card asset-backed security yields are only slightly higher than pre-pandemic levels, as are auto loans.

The Main Street Lending Program:

This bundle of facilities was meant to help small-to-midsize businesses and nonprofits access cash. The program—five facilities all managed under a common umbrella—was created to purchase a large proportion of new or expanded loans of at least \$100,000 from these entities' lenders. The facilities were created to purchase five-year loans with deferred principal and interest payments.

As of Oct. 31, the MSLP had purchased \$4.2 billion of loans, from 419 businesses across the U.S. and one nonprofit. In his letter to the Fed, Mnuchin said that the financial system can now provide credit to businesses, citing a National Federation of Independent Business survey that found only 2% of small and medium-sized firms reported that they had unsatisfied borrowing needs.

The Municipal Liquidity Facility:

This facility was created to lend directly to state and local governments, but was one of the most controversial programs in the Fed's stable, as market participants said its costs were prohibitively high—even after a reduction—and strategists said the Fed didn't want to get too involved with a market that it saw as more Congress's area of focus.

The Metropolitan Transportation Authority and the state of Illinois have used the facility, as the MTA grapples with cratering revenues and Illinois' recent budget trouble threatens the state's credit

rating. The MTA has borrowed \$450.7 million from the MLF and plans to borrow an additional \$2.9 billion by the end of this year, while Illinois has borrowed \$1.2 billion.

Even so, the broader municipal market hasn't taken the coming expiration too hard yet, as mentioned above. The worst of the pandemic-related trouble has so far been experienced by regions with high population densities and/or tourism revenues, such as New York and Hawaii, or among issuers that were struggling already with structural deficits. And many of the most embattled issuers say they would rather have grants than loans.

Still, with a divided government likely after January's runoff elections the question of federal aid is still up in the air. And UBS strategist Tom McLoughlin told Barron's in an interview last week that he believes there could be an uptick in the number of municipalities using the MLF in coming weeks if they believe it will soon expire.

In his letter, Mnuchin cited recent months' declines in municipal bond yields as evidence of the facility's success, even though that market hasn't recovered as strongly as corporate debt markets have.

And broadly, the programs' success appear to be a major reason that Mnuchin feels comfortable shutting them down.

But it is not yet clear how markets will fare this winter, with surging coronavirus case counts and a divided government that looks likely to persist into the new administration in January.

Even so, there is another reason that investors don't seem pessimistic about the facilities' closing at the moment: The possibility that the closing of the facilities will prompt more fiscal support from Congress. In an interview with CNBC on Friday morning, Mnuchin said that fiscal support is a more important factor in coming months, and said he would be working with Congress on Friday to attempt to push forward a deal.

"With lockdowns increasing, though hopefully mitigated by COVID vaccines in the coming months, now is a perfect time to get at least a [small] deal done," wrote Academy Securities strategist Peter Tchir in a Friday note. "So maybe Mnuchin has figured out a way to get the money out directly or is betting that this forces the hand of Congress. I think this might be what the economists who are harshly criticizing this move are missing."

Barron's

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Nov. 20, 2020 12:31 pm ET