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Broken Arrow!

The Muni Market is Overrun

Baird Advisors: Duane McAllister, CFA and Lyle Fitterer, CFA

Baird Funds

During the Vietnam war, the military term "broken arrow" was universal code meaning a ground unit was being overrun by the enemy; an urgent call to send all available assets to help. Now!

Unprecedented liquidations from municipal funds and ETFs last week overran the ability of dealers and traditional investors to manage redemptions. The result was the sharpest one-week decline in municipal bond prices since at least 1981. The technical selling pressure completely overran fundamental valuations. According to Lipper data, municipal funds saw net redemptions of $12.3B, nearly three times the previous outflow record. Over 40% of the redemptions were from high yield municipal funds/ETFs, where credit and liquidity concerns were most acute. But investors sold what they could, which to a large extent was higher-quality, short-term maturities, which then negatively impacted the entire municipal investor base.

This is not the time to elaborate on the illiquidity causes, but suffice to say it was a combination of an immediate demand for cash – even intra-day needs for the ETFs – at a time when liquidity providers (banks/dealers) are highly restricted from taking on risk. Add in record volatility in U.S. Treasury yields, which makes hedging difficult and costly, and the result was a tax-exempt market that completely disengaged from its normal reference point, U.S. Treasury yields.

Because the banks/dealers were not able to offer liquidity when needed, a "broken arrow" distress signal is now being sent to Congressional leaders, hoping they will grant the Fed the ability, with its unlimited balance sheet, to purchase long-term municipal bonds for the first time ever in an effort to stabilize the market. If granted, it would most likely involve only large state and local general obligation issuers, and perhaps essential service revenue bonds. But even a modest amount of Fed capital would likely help enhance market liquidity.

Until then, investors with cash to deploy have an incredible opportunity to buy tax-free bonds at unprecedented valuations. For example, a 2yr AAA tax-free bond now trades for a 2.80% yield, which is nearly 10X the yield of a *taxable* 2yr Treasury note of 0.30%. If you assume a "normal" 80% tax-free-to-taxable yield relationship between these two maturities, then the 2yr Treasury yield could rise to 3.50%, and the 2.80% yield on the tax-free municipal would still be fairly valued. Similar undervaluation comparisons can be made along the maturity spectrum (see chart below).

Extreme Cross-Market Valuations: Tax-Free Municipals to Taxable Treasuries

Maturity	Treasury	AAA Muni	Muni/Treasury Ratio	1 Week Change
2Y	0.317%	2.802%	884%	650%
5Y	0.462%	2.684%	581%	401%
7Y	0.736%	2.734%	371%	217%
10Y	0.850%	2.880%	339%	166%
30Y	1.424%	3.411%	240%	85%

Source: Bloomberg as of 3/20/20

Health concerns over the coronavirus are real and no one knows how long the economic shutdowns around the country may last. But during periods of economic decline, even less extreme than this, interest rates on high-quality bonds generally fall, not rise. The opposite has occurred in the municipal market offering investors a rare opportunity. In addition, the Fed has returned to their target range of 0% - 0.25% for the federal funds rate, where it remained for seven years after the financial crisis. The gravitational pull of the zero-interest rate policy will be a strong force over time to pull all yields lower as well.

While credit concerns are likely to emerge, higher-quality municipal issuers will survive this crisis. Most municipalities entered this period in strong financial position and credit ratings have been on the rise for the last several years. After more than ten years of economic growth, reserve funds are well above levels prior to the 2008 Great Recession. In addition to the Fed's recent moves demonstrating that they are "all-in" with monetary policy support, unprecedented fiscal support is also on its way. Aid to the states is a federal priority, since a well-functioning government sector has never been more necessary. Unlike corporations, which can lay off workers at the first sign of economic weakness, demands on the public sector rise. Federal stimulus will help assure that the necessary resources are available to meet the evident needs – and a stable municipal market is critical in this process. Municipalities will need access to capital and investors need to know if they lend money, not only will they get paid back, but that normalized pricing and trading activity will also return.