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GOVERNMENT TARGETS LIQUIDITY AS MARKETS SEEK PATH TO NORMALCY

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Last week, municipal market technical conditions grabbed the investors' attention, as municipal mutual funds endured outflows totaling $12.2 billion in the past week. This was the largest weekly outflow from municipal mutual funds since Lipper began reporting the data in 1992, and nearly two times larger than the previous record of $6.9 billion of outflows set in 2013.[1]

To satisfy the hefty redemptions, fund managers are selling bonds, creating stress on a normally functioning process. The total par amount of bonds out for competitive bid-wanted on Bloomberg alone topped $4 billion at week's end, with the number of items skyrocketing to over 9,000 items, about 1.5 times the previous record for bid-wanted items.[2]

The flurry of sales caused an imbalance of the supply-demand dynamic which challenged liquidity leading to a large move in municipal yields, with the 2-year, 3-year, 5-year and 10-year spots on the AAA MMD curve closing the week up 140bps, 140bps, 136bps and 118bps, respectively, between March 13 and March 20, 2020. The outflows from municipal mutual funds was not the only eye-popping number in the municipal market last week, as the increasing yield caused spikes in the Municipal/Treasury (M/T) ratio, with the 1-year M/T ratio closing the week at 1,755 percent, up from 300 percent on March 13, 2020. This represents increases of 227 percent, 187 percent and 170 percent in the 2-year, 3-year and 5-year M/T ratios, respectively from the 13th.[3]

Much like the prior week, lower quality struggled more than higher quality, as the Bloomberg Barclays High-Yield Municipal Index returned -11.19 percent for the week and -19.09 percent for the month ending March 20, 2020, compared to the Bloomberg Barclays Municipal Index which returned -6.57 percent for the week and -10.32 percent for the month ending March 20, 2020.

TREASURY MARKET COMPOUNDS MUNICIPAL LIQUIDITY CONDITIONS

In addition to the heavy selling mentioned above, disorderly trading in the Treasury market made it nearly impossible for dealers and other non-traditional buyers of municipal bonds to hedge their investments, weakening their bids for bonds that they feared they could end up holding in inventory. Additionally, a crossover bid that usually emerges in the market when municipal bonds are selling off may have found better opportunities in markets that also cratered recently, like equities or corporate bonds. It is important to remember that liquidity is poor across the Treasury, corporate bond and mortgage-backed markets and not just specific to municipals.[4]

CORPORATE MARKETS REFLECTED DISORDER IN OTHER BOND MARKETS

Record-setting outflows were not limited to the municipal space as Investment Grade (IG) mutual funds recorded outflows of $35.6 billion as of March 18, 2020, per Lipper data: nearly seven times larger than the previous record of $5.1 billion from December 2015. Heavy outflows pressured IG spreads, which ended the week at 363bps (up 121bps on the week), 270bps wider year-to-date, and its widest level since May 2009.[5] At the same time, dealer inventories of IG corporates have dropped sharply to less than $1 billion, per Credit Suisse, as brokers are hesitant to add additional credit risk.

Despite the remarkable fund outflows and sharp spread widening, the IG corporate primary market was open for high-quality issuers last week and about $60 billion priced. Blue-chip issuers such as Coca-Cola, PepsiCo, Intel, Verizon, and others brought large deals, which in several cases were utilized to term out commercial paper balances, pre-fund upcoming debt maturities, and/or in anticipation of increased cash needs specific to strains on free cash flows.[6] Although the deals came with price concessions, the fact that supply could come in such a market likely reflects a diverse buyer base relative to other asset classes.

In securitized markets, agency MBS spreads continued to widen over the week with nominal and option adjusted spreads reaching +170bps and +130bps, respectively. Both nominal and option adjusted spreads remain well below 2008 peak levels, but none-the-less the Fed stepped in last week to support the sector, with purchases that include specified pools for the first time to help improve liquidity.

Consumer ABS spreads widened significantly due to pressures on short-term funding markets, with generic, short duration, AAA ABS spreads increasing from +30bps in February 2020, to over +300bps at week's end. While credit fundamentals will undoubtedly suffer as the U.S. economy slows over the next few quarters, the high credit quality of the underlying receivables in the prime auto and credit card sectors, as well as structural protections, should aid in the resiliency of those sectors.[7]

THE FED RESPONDED WITH SEVERAL CRISIS-ERA POLICIES[8]

The Fed is trying to address the liquidity crunch faced by the fixed income markets. While Fed policy is important, it cannot fix or counteract the supply shock from the mandatory shutdown of the global economy. To combat the liquidity issues facing the market the Fed is currently using an arsenal of tools at its disposal, reinstating and expanding upon a number of Global Financial Crisis-era programs, including:

1. ZLB (Zero Lower Bound to the Fed Funds rate)
2. Quantitative Easing (QE): increase in Treasury holdings to support rates and liquidity, and an increase in agency MBS holdings to lower mortgage borrowing costs
3. Swap Lines: Coordinated action to provide standing USD liquidity/funding to other major central banks
4. Primary Dealer Credit Facility to address the triparty repo market
5. Commercial Paper Funding Facility to address short-term corporate funding
6. Money Market Mutual Fund Liquidity Facility to back-stop money market funds
7. Primary Market Corporate Credit Facility (PMCCF): Support new bond and loan issuance for U.S. investment-grade companies
8. Secondary Market Corporate Credit Facility (SMCCF): Purchase investment-grade corporate bonds issued by U.S. companies in the secondary market to support market liquidity

While liquidity strategies may help smooth market operations in the near term, the markets await fiscal policies that will help the market overcome the near-total stop placed on the global economy with the explosion of COVID-19 infections. In our view, the emergence of effective fiscal policies to address market imbalances and economic recovery will ultimately help investors better assess the potential magnitude and timeline of an economic contraction that most market observers contend is underway already.

FOOTNOTES:

1. Fund flow data per Lipper and ICI sources.
2. Market trading conditions per Bloomberg and Breckinridge Capital Advisors.
3. Municipal Market yield curve data and associated ratios per MSRB and Breckinridge Capital Advisors.
4. Observations per Breckinridge Capital Advisors.
5. Barclays.
6. IG data and market observations per Barclays, Bloomberg and Breckinridge Capital Advisors.
7. Securitized market data and market observations per Bloomberg and Breckinridge Capital Advisors.
8. News reports and Breckinridge Capital Advisors.