May 2020

WHAT YOU NEED TO KNOW ABOUT

Municipal Bond Market

PRO POINTS

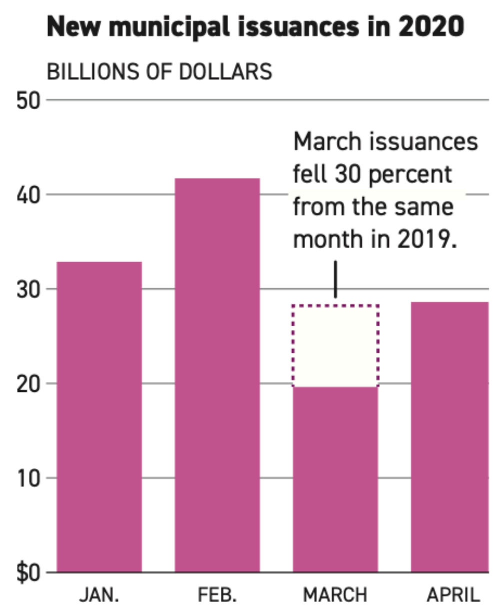
- **The federal government is facing a colossal challenge** in trying to help the economy weather the fallout from the coronavirus pandemic, but in many ways the $4 trillion municipal bond market that funds state and local needs nationwide is in a much more precarious spot.

- **That's because unlike the federal government, most** states, counties and cities can't deficit spend or rely on the Federal Reserve to print money if revenue dries up in a recession as it is now.

- **While investors have long considered municipal bonds —** which are used to fund parks, bridges, roads and other projects — stable products, a massive drop-off of billions in revenue triggered by the shutdown injected new, unknown risk into local finances throughout the U.S. As a result, municipal bonds suffered a $373 billion sell- off in the first quarter.

HOW WE GOT HERE

A spike in interest rates resulting from the muni bond sell-off when the shutdown began quickly put serious strain on state and local jurisdictions nationwide.



Cities and counties began to struggle to meet cash flow demands in an environment where they already had little room for error. Steep declines in employment and personal spending have triggered a drop in sales taxes, income taxes and user fees like bus or subway fares, leaving local governments strapped for money.

In response, the Federal Reserve stepped in to rescue the market for short-term debt in early April — the first time the central bank directly intervened to buy muni bonds. The Fed has long resisted involvement in local government finance to avoid getting entangled in political decisions about which issuances to support.

But officials say the Fed's commitment to purchase up to $500 billion in debt maturing in three years isn't nearly enough as much of the country remains on lockdown and thousands of debt service payments are coming due. The overwhelming majority of what's owed – more than 98 percent across state and local governments nationwide — are payments on long-term debt.

So much long-term debt at stake helps explain the magnitude of the sell-off in the first quarter of 2020, which accelerated when lockdowns began in March. Investors offloaded $128 billion more

in bonds compared to the same time period a year before, an increase of more than 50 percent, according to comprehensive data on customer sales tracked by the Municipal Securities Rulemaking Board, the municipal market's self-regulator.

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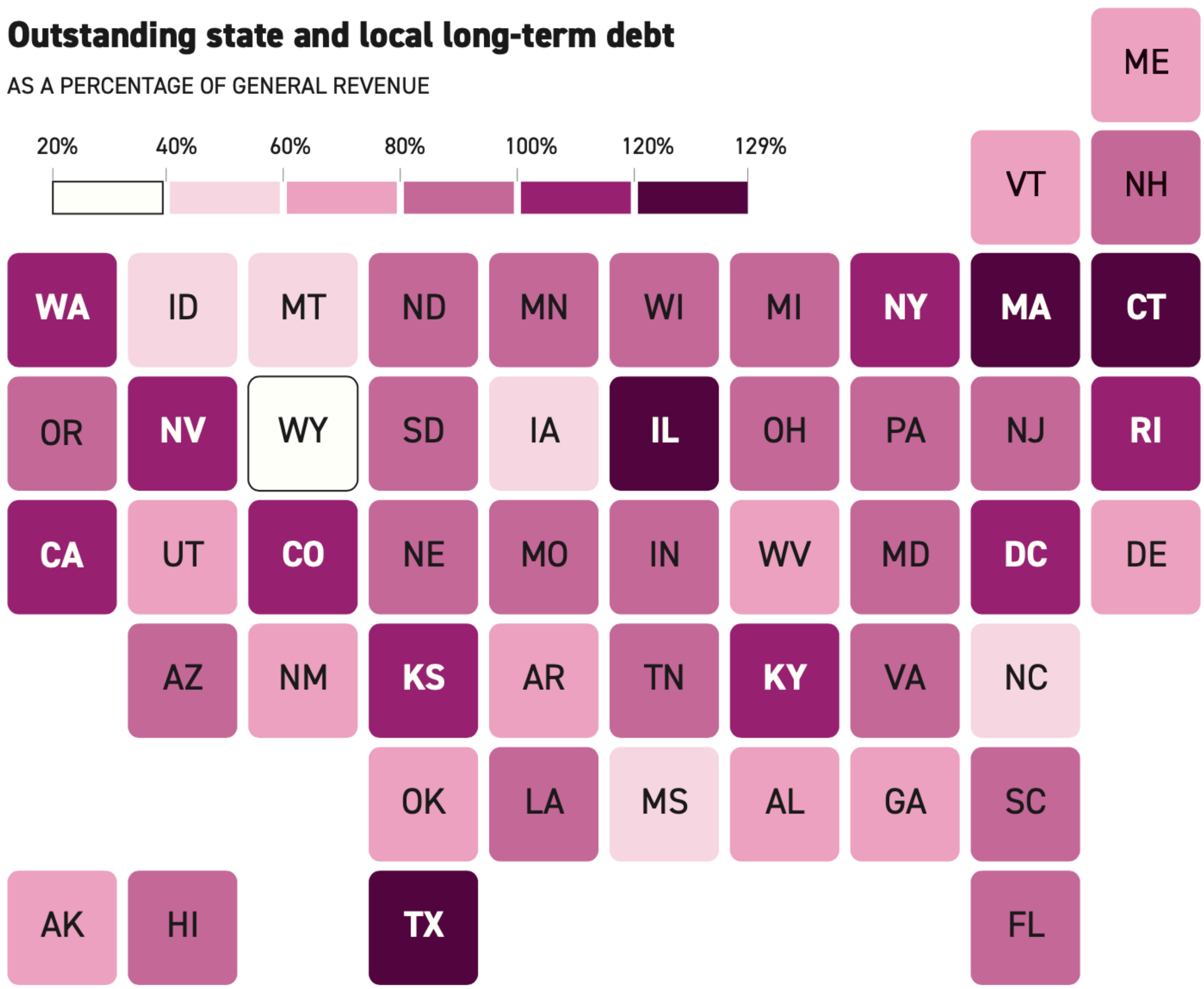
As a result, credit rating firms have an increasingly negative outlook. But missing debt payments would be the last, worst option for governments because the resulting credit downgrades would make any future borrowing more difficult and potentially kneecap recovery efforts.

WHAT'S NEXT

State and local governments are now calling for significantly more than the Fed's so-called Municipal Liquidity Facility, which is still being set up.

Some are hopeful for more action from the central bank, but advocates have largely turned their focus to pushing for more from Congress. Local leaders want at least $500 billion in grants to pay for coronavirus expenses and fill gaping revenue holes.



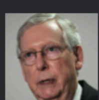
Without additional federal support, some state and local leaders are preparing massive budget cut proposals to meet their balanced budget mandates. In some parts of the country, governments have already had to furlough workers to make ends meet.

But any future aid package means House Speaker Nancy Pelosi and Senate Majority Leader Mitch McConnell will have to agree on how governments should be treated, and the two differ greatly in their views of Congress' responsibility.

While Pelosi has repeatedly pushed hard to aid local governments, McConnell sparked an uproar among governors like Andrew Cuomo of New York by suggesting that states should seek bankruptcy as a potential remedy for their financial crunch. He later walked that position back, suggesting liability protection for businesses as a possible trade-off for more local support.

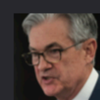
President Donald Trump has made support for states a political issue to hammer Democratic governors, who he blames for spending beyond their means. At the same time, he has also vowed strong support for state and local governments on Twitter.

POWER PLAYERS

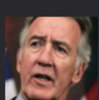


Speaker Nancy Pelosi and **Senate Majority Leader Mitch McConnell**
The House and Senate leaders have to set aside vast ideological differences if they're going to strike a deal to prop up states that are going broke.

Treasury Secretary Steven Mnuchin
The former Goldman Sachs executive has expressed deep commitment to helping businesses during the pandemic. But he has said less about state and local governments in an administration that has sometimes told localities they're on their own.



Federal Reserve Chair Jerome Powell
Powell previously indicated he doesn't see a broad role for the Fed in local government finance. But his decision to open up short-term lending signals he might be planning to do more.



House Ways and Means Chairman Richard Neal (D-Mass.)
The former Mayor of Springfield, Mass., carries particular weight as the House Ways and Means chairman and will push for robust state and local government support in any recovery bills.

Public Finance Advocacy Groups
Groups of state treasurers, mayors, government finance officials and national associations of counties as well as governors continue to advocate loudly for greater federal support as local budgets are under strain.