Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

NOVEMBER 30, 2020

Municipal Bonds

Sunsetting the Municipal Liquidity Facility may be negative for muni market

Bill Delahunty, CFA
Director of Municipal Research
Eaton Vance Management

Boston - The US Treasury has communicated that the Municipal Liquidity Facility (MLF) will not be extended beyond December 31, 2020. Let's look at the impact of this announcement on the municipal bond market.

"While the MLF may not be needed in today's strong market, its absence could accelerate a future sell-off stemming from a mutual fund outflow cycle or a headline-grabbing municipal default."

Volatile market calmed despite limited use

Created as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed in late March 2020, the MLF was intended to provide $500 billion in lending capacity to certain cities, states, counties and revenue bond issuers. We believe the presence of the MLF helped to calm the volatile muni market during the COVID-driven downturn in early 2020.

To date, we have observed little impact on the municipal market from the announced termination of the MLF at the end of this year. One reason is that the MLF has barely been used thus far, and we expect it was unlikely to be used significantly in 2021. In fact, since its inception, only two municipal issuers have tapped the MLF:

1. State of Illinois drew down $1.2 billion from the MLF in June 2020 (and is expected to draw down an additional $2 billion before the MLF expires at year-end)
2. Metropolitan Transportation Agency of New York (MTA) drew down $450 million in August 2020 (and is expected to draw down an additional $2.9 billion before the MLF expires at year-end)

The $1.65 billion that has been borrowed through the MLF equates to just over 3% of the MLF's $500 billion capacity.

Muni market functioning well

Another reason for the limited impact is that the municipal market is currently functioning very well, as technicals remain positive. Fund flows into the muni market have totaled $31 billion year to date in 2020, which has helped to offset the robust bond issuance of $414 billion through October — a23% increase from 2019.

To cite one recent example of the market's health, consider the successful pricing of $3.7 billion in bonds by the State of New Jersey. Just one month ago, this state was exploring tapping the MLF for deficit financing, but instead was able to issue bonds at a true interest cost below 1.95%, as the bond deal was significantly oversubscribed and traded up substantially in the secondary market.

Muni credit proving resilient but MLF still useful

Finally, municipal credit has proved to be resilient in 2020. In the spring of 2020, many forecasts estimated that state revenues could decline by 15% to 20% through fiscal year 2022. However, on a year-to-date basis through September, state revenues have declined just 1% compared to 2019. State revenues are highly correlated with GDP, and therefore could fall as the economy continues to grapple with COVID-related stresses.

The strength in tax receipts year to date in 2020 has been positive for state credit and the municipal market overall. Nevertheless, we believe that sunsetting the MLF may be negative for muni bonds, as it had provided a backstop for stressed issuer, and helped heal the market from bouts of illiquidity this past spring.

Bottom line: While the MLF may not be needed in today's strong market, its absence could accelerate a future sell-off stemming from a mutual fund outflow cycle or a headline-grabbing municipal default. The Biden administration could just re-instate the programs, but funding would need to be approved by a divided Congress, which has proven to be no easy task.

An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. Low rated or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.