Intra-Quarterly: Selling Begets Selling (3/20/2020)

Uncertainty and fear are prevailing as the duration and fallout of the Coronavirus pandemic are still unknown. With fear morphing into panic, investors have been busily reducing exposure to virtually all asset classes and reinvesting their proceeds into U.S. Treasury Bills and Notes.

Yesterday was yet another miserable day for municipal bond investors. Tax-free yields rose a whopping 50 basis points, up and down the yield curve. Perhaps, even more dramatic was the widening of the bid-to-ask spread. This gap represents the price a buyer is willing to pay compared to the price that a seller is willing to accept. On Thursday, at times, this differential expanded to an unprecedented 10 points (10%), depending on lot size, issuer, maturity, etc.

Similar to nearly all asset classes, municipal bonds have also been caught in a liquidity trap. For example, until recently, for 60 straight weeks an average of approximately $2 billion flowed into municipal bond mutual funds. Last week, however, the tide turned decidedly negative as individuals yanked nearly $13 billion from tax-free mutual funds in just 5 days.

With funds selling bonds to meet shareholder redemptions, the broker/dealer community, already in a financially weakened position, was reluctant to take on additional risk. Individuals joined the crowd of forced sellers as some experienced margin calls. As prices fell, hedge funds, who had previously borrowed money to purchase municipal bonds, also leaned on the dealer community in search of a bid. As is typically the case, selling begets selling. When individuals see the Net Asset Values of their mutual funds decline, they begin to panic. Their behavior is based on the assumption that the sole culprit of the price deterioration is that the municipal issuers will not have the financial wherewithal to continue to pay principal and interest.

While we believe that the fiscal health of many municipalities will be tested, we anticipate that high quality investment grade municipal credits will continue to make debt service payments without disruption over the short and long term. However, various issuers could be subject to negative credit watch outlooks and downgrades by the rating agencies depending on the length and breadth of the economic disruption.

With that being said, sometimes the price volatility is just what it seems. Too many forced sellers trying to fit through a tiny door at the same time to sell an abundance of bonds that dwarfs the capital base of the broker/dealer municipal bond trading desks. Second only to the Great Financial Crisis, this is creating a buyer versus seller imbalance the likes of which we have never seen. Similar to the housing market, the price set by an extremely motivated seller becomes the new benchmark ("comparable") for the next transaction.

Perhaps by observing the price dislocations of the "pre-refunded" municipal bond market, illiquidity can best be explained. Pre-refunded bonds (pre-re's) are short term tax-exempt securities secured by U.S. Treasury Obligations. As you can imagine since the bonds are essentially "tax-exempt Treasury" securities, their yields are almost always notably below those offered on U.S. Treasury debt. Yesterday, however, these highest quality two-year maturity pre-re's briefly traded as high 3% while federally taxable U.S. Treasury Notes were offered for sale at 0.42%.

No one has a crystal ball that can ascertain when the liquidity light switch gets turned back on. The Coronavirus certainly complicates anyone's calculus. All we can do is what you would expect us to do in managing these types of liquidity episodes (1987, 1994, 2008). Our game plan is in place and we stand ready to benefit from the “wreckage” as we closely monitor our credit and interest rate exposure.

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