Municipal markets feeling liquidity and credit pressures, but opportunities abound

As global financial markets continue to experience dramatic volatility, investors continue to rapidly sell off high quality liquid assets, including municipal bonds. Nuveen’s municipal investment team is seeing signs of liquidity stress and downward pressure on credit health, but also believes that the market remains fundamentally sound and offers opportunities.

Insights from

*Nuveen’s Municipal Investment Team*

**HOW HAVE MUNICIPAL BONDS BEEN PERFORMING?**
Heavy selling of liquid assets has rippled across financial markets. This has caused municipal yields to spike and widen significantly over Treasuries. The Federal Reserve (Fed), Congress and the Treasury are acting quickly, but the effects of the significant programs being enacted operate with a lag. As a result, the municipal market continues to have a negative tone, particularly in shorter maturity areas. New issuance has ground to a halt and SIFMA rates (short-term municipal rates) are unusually high, causing particular stress in that area. We think this temporary dislocation will subside over time.

For their part, high yield munipcials are also experiencing near-term pressure and have sold off. It is important to remember, though, that high yield municipal bonds are typically issued by stable and essential service providers that include transportation hubs and hospitals – yields are higher because the issuers are generally newer facilities that over time will issue lower yielding bonds. The long-term importance of these facilities will continue long after the coronavirus subsides, and we believe that most issuers remain fundamentally sound.

**WHAT IS THE STATE OF MUNICIPAL MARKET LIQUIDITY AND HOW HAVE MARKETS RESPONDED TO THE LATEST FED ACTIONS?**

Bonds are trading in volume and liquidity exists. Heavy outflows have pressured high quality municipal bond values, which are approximately 100 bps higher on average for AAA-bonds than at the start of the month. We are seeing volume in the secondary market, and dealer inventories are elevated with short-term debt, but most fixed-rate longer term bonds are selling in the market.
To inject liquidity, the Fed has turned to some of the same programs it enacted during the financial crisis. The Primary Dealer Credit Facility – a dealer borrowing mechanism – was announced this week and will allow short-term municipal bonds to be pledged as collateral, which should help boost liquidity for that segment of the market.

Looking ahead, a future round of Fed quantitative easing could possibly include purchases of municipal bonds. The Fed and other policymakers have made it clear they will do what it takes to promote broad market liquidity, and we think these policies will eventually help to stabilize the markets and restore liquidity. By supporting municipals, we also support the nation’s infrastructure.

**IS MUNICIPAL CREDIT QUALITY HEALTHY?**

Before the coronavirus crisis hit, municipal credit health was in some ways at its strongest since the financial crisis. Municipalities still have ample cash, have been experiencing credit upgrades and enjoy solid revenue growth. The good news is that municipal credit is starting from a strong position.

Diminished economic activity is putting downward pressure on entities such as smaller cities, convention centers and transit-related issues. We fully expect a sharp second quarter decline in GDP, but any stabilization and positive news will help investor confidence and credit health.

This health crisis is an exogenous shock, similar to a natural disaster. Munipals have been resilient through other such shocks due to their importance in the day-to-day functioning of our society. In our view, overall credit health remains solid for municipal issuers, but careful credit research is more critical than ever.

**WHAT IS YOUR NEAR- AND LONG-TERM OUTLOOK FOR THE MUNICIPAL MARKET?**

Municipals were looking expensive in late February. Now they are cheap, but have near-term liquidity stress. This is a technical issue, and we think the recovery could be strong and quick when it comes.

Once we see signs of plateauing in coronavirus cases, more clarity on the health care response and additional targeted fiscal stimulus, we expect buyers to return to take advantage of price dislocations and attractive tax-exempt yields.

It will take time for quantitative easing and stimulus programs to work through the system. But when we begin to see stabilization and clarity, investors should begin to again focus on fundamentals. This should be a tailwind for municipal bonds.

**WHERE ARE YOU SEEING OPPORTUNITIES?**

The short-term municipal market is unsettled, with unusually high yields. This could offer a near-term opportunity, but upside potential here is somewhat modest, as those yields should decline soon. For long-term investors, we continue to favor the long end of the yield curve. We think both higher quality and high yield areas of the market look attractive, as we believe wider credit spreads are adequately compensating investors.

Credit selection remains critically important and opportunities remain highly idiosyncratic. Our municipal credit team is working diligently to identify market stress points and look for areas of the market that may have become undervalued. The bottom line is that we believe this is a good environment for active management.

Municipal bonds are an inefficient asset class even at the best of times, and we see sharp value dispersions and areas that look relatively attractive. For those with long-term investment horizons and the capacity to take on near-term risk as markets recover, we see opportunities to invest in higher yielding securities with solid fundamentals.
For more information, please contact visit us at nuveen.com.

Endnotes

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