THE BOND BUYER

Munis follow USTs in flight to quality as Credit Suisse imperiled

By

Jessica Lerner

Published

March 15, 2023, 10:36am EST

As a result of the expanding crisis in the banking sector, with Credit Suisse now in trouble, bond yields fell Wednesday in choppy trading with municipals continuing to follow U.S. Treasuries in a flight to quality as market volatility persists.

UST yields initially fell, then recovered and fell again, but didn't reach the lows of Wednesday morning, with the two-year UST at 3.907% and the 10-year UST at 3.474% at 4 p.m.

Triple-A benchmarks were bumped two to 15 basis points, depending on the scale, as of 4 p.m.

Markets have been turbulent this week, with further stress after Credit Suisse announced it found "material weaknesses" in its financial reporting procedures for 2022 and 2021, on the heels of the Silicon Valley Bank and Signature Bank failures.

Credit Suisse's issues are a big reason why the market is seeing a flight to quality Wednesday.

"The way that Treasuries go is the way that munis will go to a degree, depending on supply and demand imbalances that are out there," said Cooper Howard, a fixed income strategist focused on munis at Charles Schwab.

"We're not seeing as sharp moves in the muni market as we are in the Treasury market, but there is definitely a flight to quality overall, in the markets Wednesday."

Munis are relatively isolated from everything going on in the banking crisis, he noted.

"So far, munis have sat on the sidelines, as all of this has really started to play out," he said.

Wednesday's retail sales data and producer price index "are strengthening expectations that the Federal Reserve will raise the fed funds rate by only 25 basis points or perhaps make no rate change when it meets next week," said José Torres, senior economist at Interactive Brokers.

Investors "are renewing their focus on the troubled banking sector after Saudi National Bank said it won't increase its investment in troubled Credit Suisse due to regulatory requirements," he said.

Credit Suisse "has been hit hard by a surge of customer withdrawals and financial losses, which led the bank to raise $4 billion through an equity offering last fall," Torres said.

Wednesday morning, "the Saudi National Bank news ignited fresh concerns about the Swiss bank and the impact of aggressive monetary tightening worldwide on the overall banking sector's financial stability," he said.

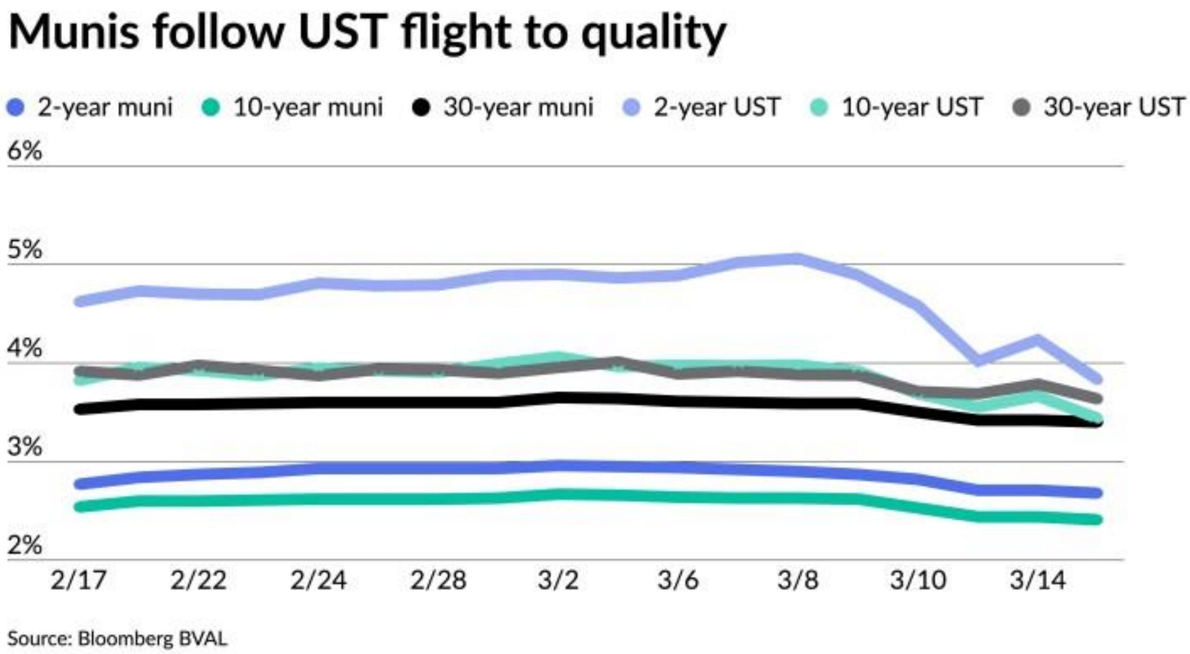
Dave Schabes, an assistant instruction professor at the University of Chicago's Harris School of Public Policy, said the sentiment in the bond market is positive. "It's the classic risk-off trade, right, where now everyone's going to Treasuries, and I think they'll go to other high-rated corporates and munis and try to put their money there and out of the stock market and the banking sector," he said.

In the short-term, he said, the banking crisis may be a positive for munis, as it has been for the U.S. Treasury market. Investors will try to buy "some of the better-rated munis," he said, "but it will be difficult to do so because people aren't going to give up what they have, if they're well-rated credits because this is going to become a credit issue."

Howard noted there are two avenues that the banking crisis could impact the sector. Munis could follow USTs' movements. "There's a lot to kind of shuffle through and a lot of volatility that I think could still be ahead, as maybe potentially the next shoe drops," he said. "That's what the Treasury market is looking at right now."

The other avenue is banks selling their muni bond portfolios to raise liquidity, though Howard doesn't see that happening.

"Banks are some of the largest holders of munis, even though their appetite for the asset class deteriorated after the tax reform of 2017, which dramatically decreased corporate taxes, making tax-exempts less appetizing (a lot of banks, especially regionals, got more involved in taxable munis)," said Barclays strategists Mikhail Foux, Clare Pickering and Mayur Patel.



Nevertheless, in the past several years, "bank municipal holdings have remained stable in the $600 billion range — this includes both bonds and direct loans to municipalities — making them the third largest group of muni holders after direct retail/separately managed accounts and mutual funds."

"Aside from market volatility and a flight to quality that caused a significant rally in U.S. Treasuries and actually helped muni total returns, the main question for investors recently has been: will we see bank selling of municipals that exerts pressure on the market, and what kind of market effects could occur," they said.

Barclays' strategists "expect pressure on banks to persist, but the fallout for the overall industry appears limited."

They said they "would not be surprised to see some muni bond selling pressure from mid-sized banking institutions looking to shore up their liquidity; meanwhile, [globally systemically importantly banks] are unlikely to sell and, if anything, might add exposure if muni levels are attractive enough."

Overall, they said, "banks were not aggressive buyers of the asset class in the past several quarters, and they might become net sellers, but to us, this would not be really a game changer."

The market volatility of the past several days had a pronounced effect on the market and on munis, with two-year Treasuries "rallying more than 100 bp over the course of just a few days and even long-dated UST yields dropping 30-50 bp prior to [Tuesday]'s sell-off sparked by a stronger [consumer produce index] print," they said.

Due to the financial market turbulence, Barclays' strategists "think that a 50 bp hike is off the table next week and that the decision will be between a 25 bp hike or a pause." They said, "Fed fund futures also adjusted rather dramatically — now only one hike is fully priced in, compared with four less than a week ago."

Both taxable and tax-exempt munis were "quite rich going into the current market turbulence and had lagged the rally in Treasuries, making them somewhat more attractive," they said. Except for the long end, "which is starting to look interesting with ratios in the mid-90s, we would not rush in and would prefer to wait for better entry point and add on weakness."

Nevertheless, Barclays strategists said, "supportive technicals have not really changed, high-quality tax-exempts might benefit from the flight to quality, and supply has remained rather anemic."

Muni taxables have come under pressure, but "compared with high-grade corporates (especially financials), municipals have done relatively well, as frequently happens in times of market stress — they outperformed the corporate index by about 16 bp in just a few days," they said.

The spread differential between the two indexes is "currently the largest in several years, indicating that taxable muni spreads might continue to adjust higher in the medium term," they said.

Barclays strategists "would not be surprised to see some selling by regional banks that have been aggressive buyers of taxable munis over the past several years."

The three-year muni-UST ratio was at 63%, the five-year at 65%, the 10-year at 68% and the 30-year at 92%, according to Refinitiv MMD's 3 p.m. ET read. ICE Data Services had the three at 61%, the five at 62%, the 10 at 67% and the 30 at 91% at 4 p.m.

Outflows continued, with the Investment Company Institute reporting investors pulled $731 million from mutual funds in the week ending March 18, after $344 million of outflows the previous week.

Exchange-traded funds saw inflows of $158 million after $130 million of outflows the week prior, per ICI data.

In the primary market Wednesday, BofA Securities priced for institutions $809.055 million of GOs for the state of Oregon (Aa1/AA+/AA+/) with bumps up to 15 basis points from Tuesday's retail pricing. The first tranche, $655.490 million, 2023 Series A, saw 5s of 5/2024 at 2.64% (-9), 5s of 2028 at 2.47% (-10), 5s of 2033 at 2.60% (-4), 5s of 2038 at 3.20% (-15), 5s of 2043 at 3.57% (unch) and 5s of 2048 at 3.72% (unch), callable 5/1/2033.

The second tranche, $153.565 million, 2023 Series D, saw 5s of 6/2024 at 2.64% (-9), 5s of 2028 at 2.47% (-10), 5s of 2033 at 2.60% (-4), 5s of 2038 at 3.20% (-15) and 5s of 2043 at 3.57% (unch), callable 6/1/2033.

BofA Securities also priced $184.130 million of taxable GOs for the state (Aa1/AA+/AA+/). The first tranche, $175.600 million of sustainability bonds, 2023 Series B, saw all bonds priced at par: 4.097s of 5/2026, 4.142s of 2028, 4.477s of 2033 and 4.677s of 2035, callable 5/1/2033.

The second tranche, $8.530 million, 2023 Series C, saw 4.097s of 5/2026 price at par, noncall.

Barclays Capital held a one-day retail order period for $620.575 million of senior sales tax bonds, 2023 Series A, for the Massachusetts Bay Transportation Authority (/AA/AAA/AAA/). The first tranche, $512.330 million, Subseries A-1, saw 5s of 7/2025 at 2.60%, 5s of 2028 at 2.45%, 5s of 2033 at 2.57%, 5s of 2038 at 3.22%, 5s of 2043 at 3.65%, 4s of 2048 at 4.19%, 5.25s of 2048 at 3.78%, 4s of 2053 at 4.26% and 5.25s of 2053 at 3.87%, callable 7/1/2033.

The second tranche, $108.245 million of sustainability bonds, Subseries A-2, 5s of 7/2025 at 2.60%, 5s of 2028 at 2.45%, 5s of 2033 at 2.57% and 5s of 2038 at 3.22%, callable 7/1/2033.

Ramirez & Co. held a one-day retail order period for $309 million of power system revenue bonds, 2023 Series A, for the Los Angeles Department of Water and Power (Aa2//AA-/AA/), with 5s of 7/2023 at 2.57%, 5s of 2028 at 2.38% and 5s of 2032 at 2.47%, noncall.

In the competitive, Maryland (Aaa/AAA/AAA/) sold $184.135 million of tax-exempt general obligation bonds State and Local Facilities Loan of 2023, First Series A, Bidding Group 2, to BofA Securities, with 5s of 3/2034 at 2.48% and 5s of 2038 at 3.05%, callable 3/15/2033.

The state also sold $165.865 million of tax-exempt general obligation bonds State and Local Facilities Loan of 2023, First Series A, Bidding Group 1, to BofA Securities, with 5s of 3/2028 at 2.35% and 5s of 2033 at 2.36%, noncall.

The Davis School District Board of Education (Aaa///) sold $100 million of GOs to RBC Capital Markets, with 5s of 6/2024 at 2.58%, 5s of 2028 at 2.40%, 5s of 2033 at 2.44%, 5s of 2038 at 3.125% and 4s of 2043 at 3.95%, callable 12/1/2032.

Secondary trading

Hawaii 5s of 2024 at 2.66%. California 5s of 2025 at 2.61%. Maryland 5s of 2025 at 2.61%.

NYC TFA 5s of 2027 at 2.62% versus 2.68% Tuesday. Maryland 5s of 2028 at 2.38%-2.36%. Dallas County, Texas, 5s of 2029 at 2.58%.

DC 5s of 2041 at 3.47%-3.46% versus 3.53% Tuesday and 3.67% original on Friday. Baltimore County, Maryland, 5s of 2041 at 3.26% versus 3.30%-3.31% Monday and 3.49% original on 3/8. Plano ISD, Texas, 5s of 2041 3.48% versus 3.66% on 3/9 and 3.69%-3.67% on 3/8.

San Jose Financing Authority 5s of 2052 at 3.52%-3.51% versus 3.57% Tuesday and 3.72% on 3/9. Massachusetts 5s of 2052 at 3.79%-3.80% versus 3.76% Tuesday and 3.83% Friday.

AAA scales

Refinitiv MMD's scale was bumped up to 10 basis points. The one-year was at 2.60% (-10) and 2.59% (-10) in two years. The five-year was at 2.37% (-10), the 10-year at 2.40% (-5) and the 30-year at 3.42% (unch) at 3 p.m.

The ICE AAA yield curve was bumped four to 12 basis points: 2.59% (-12) in 2024 and 2.59% (-12) in 2025. The five-year was at 2.39% (-9), the 10-year was at 2.44% (-4) and the 30-year yield was at 3.46% (-4) at 4 p.m.

The IHS Markit municipal curve was bumped up to 10 basis points: 2.63% (-10) in 2024 and 2.61% (-10) in 2025. The five-year was at 2.37% (-10), the 10-year was at 2.41% (-2) and the 30-year yield was at 3.40% (unch) at a 4 p.m. read.

Bloomberg BVAL was bumped two to 15 basis points: 2.64% (-15) in 2024 and 2.59% (-12) in 2025. The five-year at 2.37% (-8), the 10-year at 2.39% (-5) and the 30-year at 3.40% (-2).

Treasuries rallied.

The two-year UST was yielding 3.907% (-33), the three-year was at 3.801% (-28), the five-year at 3.560% (-26), the seven-year at 3.545% (-23), the 10-year at 3.474% (-19), the 20-year at 3.794% (-13) and the 30-year Treasury was yielding 3.665% (-12) at 4 p.m.

Primary to come:

A $485.7 million sale of gas project revenue bonds is planned by the Black Belt Energy Gas District. The revenue bonds are rated A1 by Moody's and will be senior managed by Goldman, Sachs & Co.

A $150 million sale of homeowner mortgage revenue bonds is planned for Thursday by the State of New York Mortgage Agency. The social bonds will consist of $115.8 million Series 250 non-AMT paper structured with term bonds in 2038, 2043, 2048, and 2053. Series 251 AMT paper will consist of $34.1 million maturing from 2023 to 2034 with a term bond in 2036.

The Idaho Housing & Finance Association will sell $115.2 million of single-family mortgage bonds in a two-pronged offering that is rated Aa1 by Moody's. The $65.1 million Series A fixed-rated, non-AMT bonds mature serially from 2024 to 2035 with terms in 2038, 2043, 2048, and 2053, while Series B-1 consists of $50 million of fixed-rate taxable paper maturing serially from 2024 to 2035 with term bonds in 2038, 2041, and 2053. Barclays is the lead book runner.