

# Market Volatility: The New, New Normal



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**C**OVID-19 has touched every part of public finance. It's been especially important in the municipal bond market.

In the throes of the COVID-19 crisis, investors bought and sold record numbers of muni bonds. The Federal Reserve took unprecedented steps into the muni market. Congress poured in billions of dollars to prop up faltering governments. COVID-19 created a brave new world for municipal market issuers and investors.

While they find their way through that new world, the watchword is volatility, or the tendency for large and unexpected changes in bond prices. Volatility is a double-edged sword for states and local governments looking to borrow money. Hit the market when the time is right, and you can borrow at record low rates. Hit it at the wrong time, and taxpayers take a hit. In a volatile market, the difference between the right time and the wrong time might be as little as a day or two.

The key to navigating this market is flexible debt management policies. Many of our pre-COVID-19 policies are appropriately prescriptive. They lay out how to navigate the markets in a transparent and accountable way under typical market conditions. But the post-COVID-19 world is not typical. It demands policies that are a bit less prescriptive, a bit more flexible, and more tuned into some potential trade-offs.

## Volatility, Now and in the Future

To put the COVID-19-induced volatility in perspective, consider the following. During the week of March 9 to 12, 2020, the price of the iShares National Municipal Bond exchange-traded fund—one of the largest bond funds that tracks the overall market—fell by more than seven percent. This drop was five times greater than any intraweek decline in the fund's history. By March 19, it had declined an additional seven percent. But by March 26, it had recovered almost to its March 9 level. Since then, this

fund's daily average price movements have more than tripled compared to the previous five years.

What's to blame for this wild ride? As COVID-19 took hold, the problem was liquidity. Many investors wanted the safety of U.S. Treasury bonds. To free up the cash to buy Treasuries, they had to sell other assets, including munis. That led to a large number of investors leaving the muni market at once. In this market, sellers struggled to find buyers, so they lowered their asking prices even more. The net effect was record price drops and record amounts of money leaving the market. These liquidity issues have subsided but remain a point of concern.

Going forward, the much bigger source of volatility will be credit deterioration. Bonds will default, especially in riskier sectors like hotels, convention centers, and speculative economic development projects. States and localities will struggle with massive budget shortfalls. Pension assets will decline precipitously. The municipal sector might look like an inhospitable place.

Investors will respond to this in a variety of ways. Cynics will decide the muni market is unsafe and sell at low prices. Opportunists will buy at low prices, thinking they're getting a value on otherwise good credits. Profit-takers will sell bonds whose prices increase a bit, thinking those prices have peaked. This churn across the market will lead to ongoing volatility.

## How to Respond—Flexible Debt Management Policies

How can states and localities stay ahead of volatility? Stock market investors pay close attention to the Chicago Board Options Exchange's Volatility Index (VIX)—euphemistically called the "fear index." The VIX is a projection of market volatility over the next 30 days. Unfortunately, there's nothing like it for munis. You don't know if the muni market is volatile until you're in the thick of it.



That said, state and local borrowers can make sure they have the tools and strategies to protect themselves from volatility, and maybe even take advantage of it. Each of these tools requires careful attention to policy trade-offs. Consider the following.

#### **Reconsider negotiated sales.**

One immediate area of interest is how to sell new bonds into a volatile market. Many bonds are sold through competitive underwriting, where banks bid publicly for the chance to take the bonds to market. The alternative is a negotiated sale, where the government selects a bank in advance. Competitive underwriting is more transparent and generally results in lower borrowing costs. This is why it is GFOA's recommended practice for most typical bond transactions.

But in a post-COVID-19 world, negotiated sales might make sense for a much wider range of bonds. Rather than picking a date and hoping banks show up to bid, many issuers might benefit from the flexibility of going to market when the time is right. This basic trade-off between transparency on the one hand, and added reliability and lower borrowing costs on the other, is a key policy consideration.

**Beef up financial disclosure.** Many muni investors are regular folks trying to save for retirement. They don't know the balance sheets of the particular governments whose bonds they own. But they do react to headlines. A few

high-profile defaults by a few high-risk issuers could send many of them out of the muni market altogether. This type of indiscriminate selling can harm otherwise good credits—and most munis are good credits.

How do you make sure the market doesn't undervalue your jurisdiction? One way is more frequent and more timely financial disclosures. Better visibility into revenue projections, new spending needs, pension fund returns, and other key data points will help investors make smarter buy and sell decisions about your bonds, even if the news is not good. The trade-off, of course, is that these disclosures are often based on uncertain information and don't have the benefit of financial audits and other formal reviews.

**Look at bond sizing strategies.** In volatile markets, income becomes especially important. If investors aren't sure whether bond prices will increase, they will seek out bonds that produce reliable cash flow. This is an opportunity for issuers to offer up slightly higher bond coupons to attract new buyers. The same applies to bond maturities. Bond investors tend to "shorten up" the duration of their portfolios in volatile markets. Governments that issue bonds with shorter maturities and lower overall duration might benefit.

Of course, these strategies require a delicate balancing act. Higher coupons can mean much higher debt service payments late in a bond's lifetime.


Shorter maturities might be difficult to manage in an uncertain near-term revenue environment. But for the right jurisdiction at the right time, new bond sizing strategies could add value.

#### **Flexible capital improvement programming.**

The Great Recession showed us the value of capital improvement planning. Projects that were "shovel ready" were much more likely to receive federal support. Since then, many governments have invested considerable resources in planning to have many different types of capital projects queued up. Market volatility and a big post-COVID-19 federal infrastructure plan will have the same effect.

#### **Conclusion**

Rearranging the capital improvement plan can be a great way to take advantage of these market conditions. But of course, it can also disrupt the capital budget and bring forward projects that are less well-prepared. This is also its own delicate balancing act.

Careful attention to these debt management policies and practices is a good first step toward navigating the post-COVID-19 municipal bond market. 

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