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CREDIT MARKETS

How the Muni Market Became the Epicenter of the Liquidity Crisis

A concentration of power and risk has resulted from a fundamental shift in how municipal bonds are bought and sold

Bonds for amusement park and mall American Dream, where its roller coaster ran last fall, plunged mid-March amid coronavirus concerns.

PHOTO: BRYAN ANSELM FOR THE WALL STREET JOURNAL

By Heather Gillers and Gunjan Banerji

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The coronavirus triggered a liquidity crisis in municipal bonds, but the volatility that resulted has been brewing for a decade.

Desperate sellers across most markets sold assets at deep discounts last month as the spreading new coronavirus left investors fearful and hungry for cash. Perhaps no investment flipped from coveted haven to spurned hot potato as quickly as municipal bonds.

Prices have started to recover as U.S. lawmakers authorized the Federal Reserve to prop up a wide swath of state and local government debt. But the marketwide breakdown exposed a new vulnerability in the nearly $4 trillion municipal market: a concentration of power and risk resulting from a fundamental shift in how muni bonds are bought and sold on Wall Street and on Main Street.

More money than ever is managed by a few financial behemoths that can swallow large chunks of debt at premium prices and don't shy away from risk. Meanwhile, the banks and brokers that trade munis have become less inclined to warehouse debt.

That shift left the market susceptible to extreme volatility when worried investors fled bond funds, triggering waves of forced selling with few other buyers willing to pay top dollar. Yields on 10-year bonds doubled in three days, a price drop never seen before, according to Refinitiv, and the S&P Municipal Bond Index gave up more than a year's worth of gains. State and local governments were locked out of the debt market for days and investors who cashed out likely suffered tens of millions of dollars in losses. Yields rise as bond prices fall.

Powerful participants in municipal funds such as Nuveen LLC, BlackRock Inc., BLK **3.78%** ▲ Goldman Sachs Group Inc. GS **0.95%** ▲ and Invesco IVZ **4.31%** ▲ helped the sector's record run last year. Now, outflows from those same funds helped fuel a record selloff in the historically safe corner of the market.

Municipal-bond funds hemorrhaged an unprecedented $28 billion last month through March 25, with more than half of that money flowing out of funds managed by those four asset managers, according to Refinitiv. Nuveen attempted to unload roughly $700 million in munis in a single day, shocking a market where the majority of trades are $50,000 or less, according to Municipal Securities Rulemaking Board data.

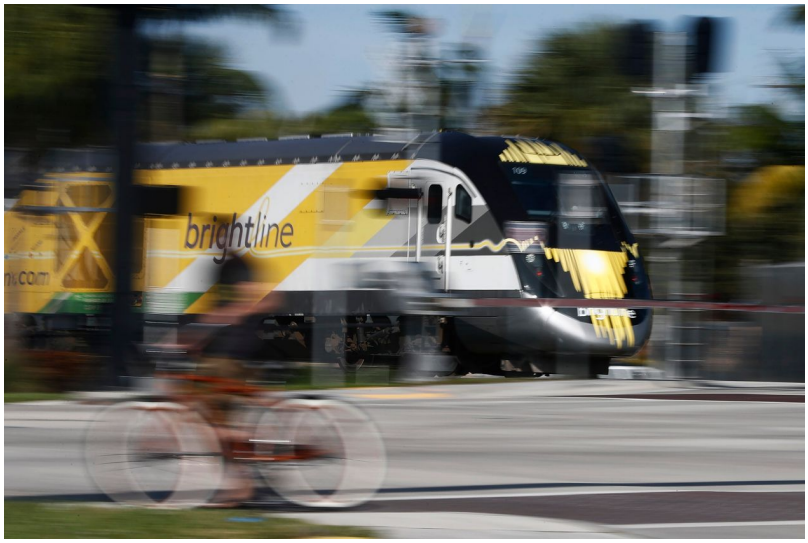
Those muni holdings had built up over the past decade as it got easier for investors to buy and sell munis. Money managers now control nearly $1.6 trillion in munis through mutual funds, separately managed accounts and exchange-traded funds, according to data from the Federal Reserve and Citigroup.

To help satisfy investors' hunger for yield, some funds piled into risky debt, financing projects such as charter schools and nursing homes. As of February, five money managers control more than half of the assets in high-yield funds, according to Morningstar data.

But no manager dominated the competition for junk bonds like Chicago-based Nuveen. As high-yield assets under management by muni mutual and exchange-traded funds more than doubled over the past decade to $136 billion, Nuveen's holdings grew sixfold, Morningstar data show, making it the biggest high-yield muni money manager.

Nuveen, a subsidiary of asset manager TIAA, controls about 1-in-4 dollars in high-yield muni mutual and exchange-traded funds as of February, Morningstar data show. In 2018, Nuveen named John Miller, who ran one of the firm's first high-yield muni portfolios 20 years ago, as its new head of municipals.

When backers of a planned New Jersey amusement park and mall, American Dream,wanted to raise money about three years ago, Nuveen purchased $105 million of the amusement-park bonds within days. Prices on the unrated bonds rose by about 10% over the next three months as Nuveen, flush with investors' cash, bought up more than half of the entire $500 million of bonds. A far cry from the highway and high-school construction bonds that make up the typical muni portfolio, the attraction includes one of the largest indoor ski hills in the Western Hemisphere. It opened last October, but its bonds plummeted mid-March amid coronavirus concerns. The pandemic has led to the indefinite closure of the amusement park and mall.



Nuveen reports holding at least a $1 billion stake in a train line in Florida.

PHOTO: BRYNN ANDERSON/ASSOCIATED PRESS

Nuveen also reports holding at least a $1 billion stake in an unrated train line connecting Orlando, Fla., to Miami—known as Virgin Trains USA, or Brightline—about a third the total deal. The firm has accumulated about $1.8 billion of city and school bonds issued by Chicago, which Moody's Investors Service rates as speculative grade.

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When investors rattled by the spread of the coronavirus began pulling their money from muni mutual and exchange-traded funds in mid-March, high-yield funds lost 8% of their holdings to redemptions in two weeks.

Nuveen had net outflows of $5.4 billion in March through the 25th, more than any other fund. The level of redemptions surprised even Nuveen's Mr. Miller. He acknowledged that the accumulation of money in mutual funds contributed to the selloff but said the shift in sentiment was the paramount reason for the selloff. He said he still has confidence in his high-yield investments.

"The way people viewed the securities switched...in the blink of an eye," he said.

These outflows hit a market that has already condensed in recent years, as the number of banks and brokerage firms that trade munis fell by 37% over the past decade, according to Municipal Securities Rulemaking Board data. Since the last financial crisis, major brokers have also significantly reduced the maximum amount of municipal debt they are willing to hold in inventory until new buyers materialize.

"There's nothing any dealer balance sheet can do when the mutual funds are getting $12 billion of redemptions a week," said Patrick Brett, head of municipal debt capital markets at Citigroup.

The plummeting prices had ripple effects in the thinly traded muni market, where managers revise the value of their portfolios based on trades of similar securities. Chris Brigati, head of municipal trading at Advisors Asset Management, said his firm marked down the value of its holdings for more than a week during the recent tumult.

Calmed by Congress, muni selling has slowed for now, according to MSRB data. But with a vast chunk of the market sitting in mutual and exchange-traded funds that investors can easily exit, another shock could provoke further outflows, causing prices to plummet again, analysts and money managers said.

"If they're gobbling up the bonds on the way up, it's a two-edged sword," said Little Rock, Ark., investment adviser Edward Mahaffy, who has been managing municipal-bond portfolios for 35 years. "When people want to exit, the reverse is going to happen."

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