ASSET PRESERVATION ADVISORS

APA Q2 2022: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

Second quarter highlights

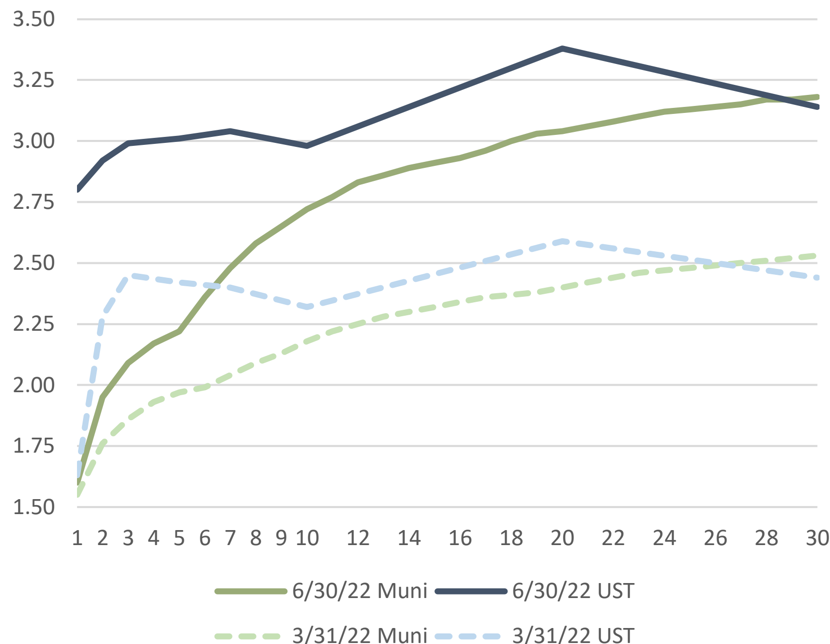
- The quarter began with yields moving sharply higher in April as the market priced-in a hawkish Fed in response to inflation concerns. For the month, the 10-year UST yield adjusted upward by 57bps.
- Municipals bounced back with a late-month rally in May, as the asset class saw its first month of positive returns in 2022.
- Following the Fed's May meeting, the Federal Open Market Committee (FOMC) raised rates 50bps as expected while also announcing plans to reduce its $8.9 trillion balance sheet, with the latter occurring in a two-step run-off beginning June 1st.
- The Consumer Price Index (CPI) report released in June showed a 1% increase for the month, handily beating the 0.7% consensus estimate for a year-over-year increase of 8.6%. This upside surprise caused the market to price in more aggressive Fed tightening to combat hotter than expected inflation.
- For the quarter, 1, 5, 10, and 30-year AAA muni yields increased by 5, 25, 54, and 65bps, respectively.
- Second quarter new issue supply totaled $106.5 billion, bringing 1H 2022 issuance to $208 billion. Year-to-date supply is down 11.5% over the same period in 2021, which is attributable to the sharp decline in taxable muni issuance.
- Per weekly reporting Lipper data, municipal mutual funds experienced outflows in 12 of 13 weeks for the quarter, for net flows of -$31.9 billion for the period.

Market update

The quarter began with yields moving sharply higher in April as the 10-year UST yield adjusted upward by 57bps for the month. Inflation concerns remained at the forefront as the market continued to price in aggressive Fed tightening while also weighing the impacts of the war in Ukraine and China's covid lockdowns on inflation, growth, and supply chain risks. Municipals followed the guidance of Treasuries, as for the month, 1, 5, 10, and 30-year AAA muni yields nudged higher by 39, 48, 54, and 52bps, respectively, to close the month at 1.94%, 2.45%, 2.72%, and 3.05%, respectively. Municipal mutual fund outflows persisted for the period, as the month saw net outflows of $13.5 billion, or an average of over $3 billion per week.

FIGURE 1

Muni & Treasury Yield Curves



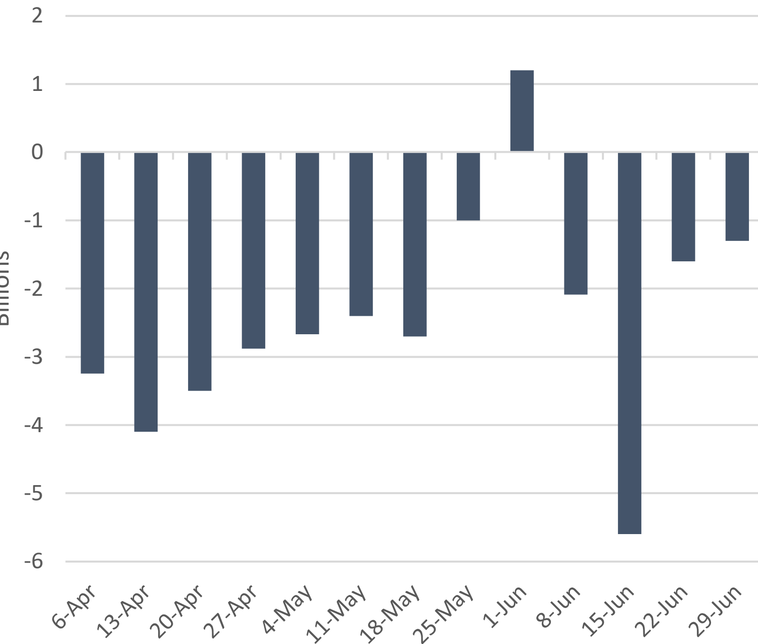
Source: Municipal Market Data, US Treasury

May started with yields continuing to drift higher as the CPI report released at the beginning of the month surprised to the upside. However, municipals quickly bounced back by the end of the month and staged their biggest rally in two years. May ended being the first month with positive returns for the asset class in 2022. The late-month

Past performance is not indicative of future results. Please see attached disclosures.

FIGURE 2

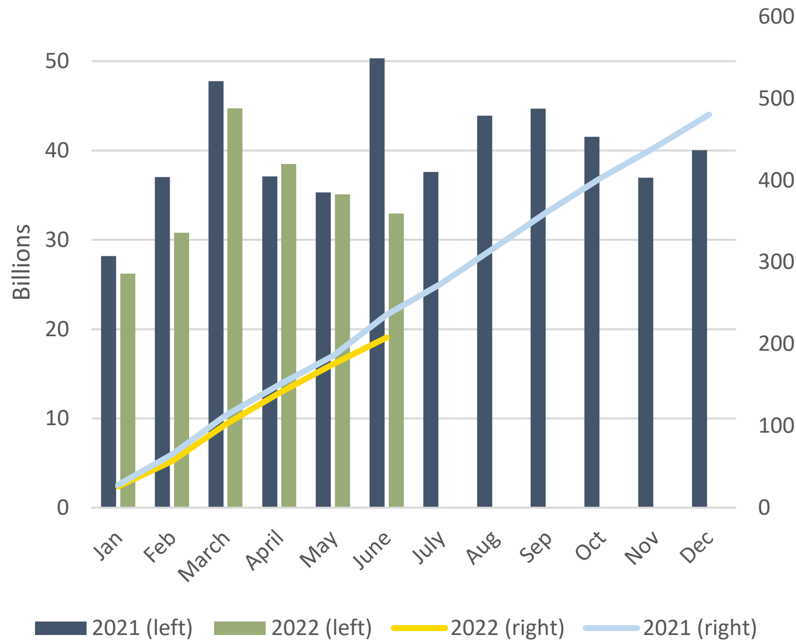
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

rally occurred after muni/Treasury relative value ratios widened to levels that historically have attracted "crossover" or non-traditional buyers to the space as the 10-year AAA muni/UST ratio closed at 105% on May 23rd. From there, the 10-year AAA spot rallied by 42bps to close the month at a 2.47%, outperforming the corresponding Treasury rally. The 10-year muni/Treasury relative value ratio ended May at 87% – more in line with historical averages.

Following the Federal Reserve's May meeting, the FOMC raised rates 50bps as expected while also announcing plans to reduce its $8.9 trillion balance sheet, the latter occurring in a two-step run-off beginning June 1st.

The CPI release in June showed a 1% increase for the month, handily beating the 0.7% consensus estimate for a year-over-year increase of 8.6%. This upside surprise caused the market to price in more aggressive Fed tightening to combat hotter than expected inflation. Over the first two trading weeks of the month, the 2-year UST yield increased by nearly 100bps, from a 2.53% on June 1st to a 3.45% at close on June 14th. During the same period, the 10-year UST yield moved higher by over 60bps, to close at a 3.49% on June 14th.

In its mid-June meeting, the FOMC ultimately raised rates by 75bps, the most significant increase since 1994, and indicated another 50 or 75bp hike was likely at the next meeting. Following the FOMC announcement, yields reversed course and moved lower over the second half of the month as the market pivoted from fears of elevated inflation to concerns of a global slowdown. Despite a late-month rally, municipals posted negative returns for the period as yields moved higher and the curve steepened. For the month, the 10-year AAA muni spot increased by 25bps to close at a 2.72%. For the quarter, 1, 5, 10, and 30-year AAA muni yields increased by 5, 25, 54, and 65bps, respectively.

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Supply

New issue supply for the quarter totaled $106.5 billion, bringing 1H 2022 issuance to $208 billion. Year-to-date supply is down 11.5% over the same period in 2021, which is attributable to the sharp decline in taxable muni issuance. Q2 taxable muni issuance totaled just $13.8 billion, a 47% decline year over year. Pure tax-exempt issuance totaled $83.6 billion for the quarter, a 3% decline year over year.

Fund flows

Fund flows were negative for the quarter, as muni mutual funds experienced outflows for 12 of 13 weeks in the period. Per weekly reporting Lipper data, outflows totaled $31.9 billion for the period, bringing year-to-date flows to -$46 billion. The week ending June 15th saw muni mutual funds report outflows of $5.6 billion – the largest weekly reported outflow of the year and the third largest on record (behind two weeks in March 2020).

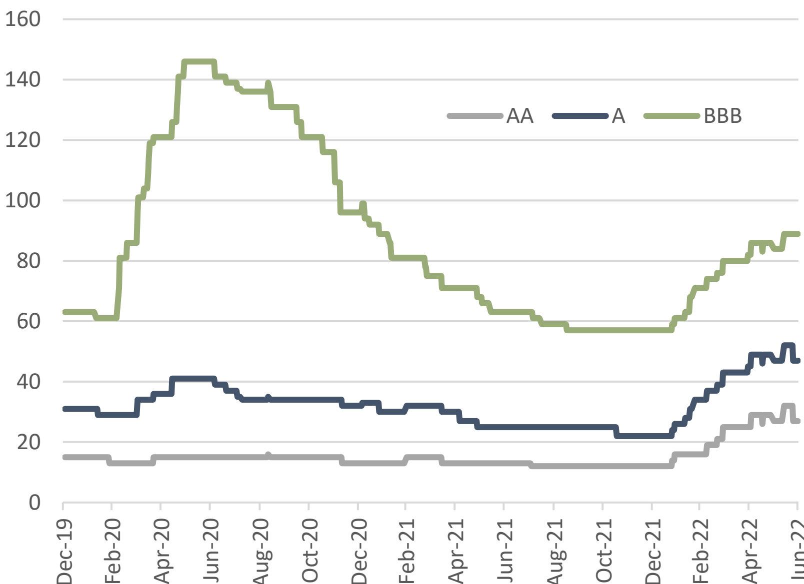
Positioning

Following the first quarter's historical one-way move higher in yields, rates continued to drift higher over Q2, though at a slower pace and with periods of relative stabilization. While the inverse relationship of prices and yields has been painful for performance, the adjustment higher in yields has provided opportunities for investment at levels we have not seen in some time. Additionally, the market move has provided the opportunity to execute beneficial tax-loss swaps – selling positions to harvest tax losses that can be carried forward and invest in bonds at higher current market levels with the proceeds. We have been actively executing such trades across accounts and will continue to do so as we find beneficial opportunities.

For much of the year's first half, we maintained a defensive posture, allowing duration to drift to the short end of our historical targets in anticipation of higher rates. However, beginning around mid-June and moving into the second

FIGURE 4

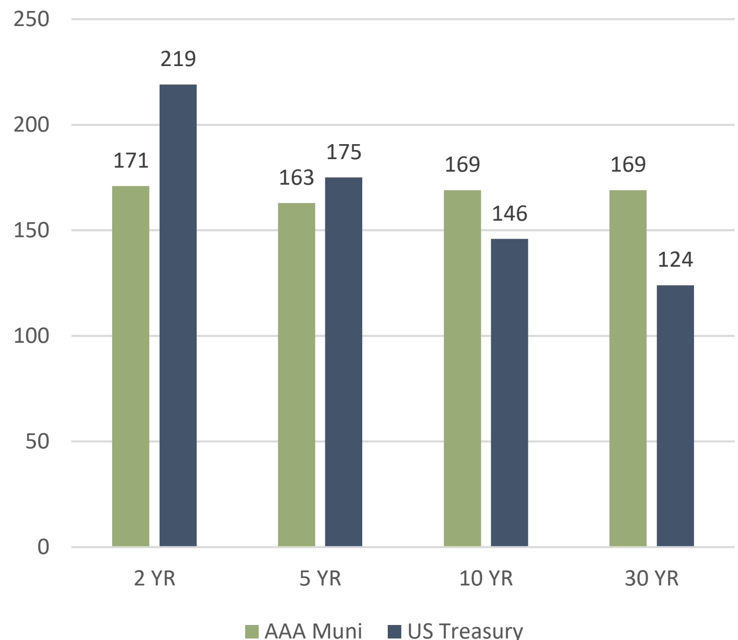
Credit Spreads



Source: Municipal Market Data

FIGURE 5

2022 YTD Yield Change



Source: Municipal Market Data, US Treasury

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half of the year, we are looking to take advantage of higher current market levels to nudge duration in line with long-term targets with reinvestment from maturity roll-off and through the execution of swaps. The muni curve takes on a very different shape than the Treasury curve, with the muni curve offering relative steepness. While the Treasury 2-10 year spread averaged 21bps for the quarter and closed the period at a spread of just 6bps, the muni 2-10 year spread averaged 62bps for the period and closed the quarter at 77bps. As a result, we have been focused on extending duration slightly by adding exposure to the 5-10 year part of the curve, where we believe relative value ratios are more compelling.

While we take the Fed at its word of remaining aggressive to tamp down inflation, much of the expected hikes are priced into the market, and we believe the worst of the adjustment higher in yields could be behind us. With the increasing possibility of a slowdown or recession, the likelihood increases that the Fed could have to cut rates more quickly than expected. Thus, we would like to have yields locked in and bonds rolling down the curve should that scenario play out.

We remain conscious of the possible recessionary risk ahead and expect further rate volatility into the second half of the year with an aggressive Fed. However, we believe the municipal credit landscape remains on sound footing and we feel confident in the municipal market's ability to weather an economic storm relative to that of its corporate counterparts. As a result, we will look to selectively take advantage of potential opportunities to increase portfolio yields should further widening of investment-grade credit spreads occur.

High Quality Intermediate

In response to market volatility to start 2022, we have allowed duration to drift to the lower end of our range for the strategy. However, with the moves that have taken place, we are now looking to take advantage of higher current market levels and relative curve steepness to nudge duration in line with long-term targets. As a result, we are actively looking to extend portfolio duration slightly, emphasizing the 5-10 year part of the curve.

This strategy's focus remains on high-quality bonds rated AA and up. However, with municipal credit continuing to trend positively, we will look to selectively add A-rated positions as we find opportunities to enhance portfolio yield.

Enhanced Intermediate

We came into this year targeting a higher quality tilt within Enhanced Intermediate, as credit spreads had reached record tight levels. Additionally, we allowed duration to drift to the short end of our target while continuing to focus on premium coupon bonds to defend against extension risk. We are now looking to take advantage of opportunities to extend duration in line with our long-term target. Additionally, with the municipal credit picture continuing to look strong, we will look to uncover pockets of value and add A and BBB-rated bonds that have strong underlying metrics and that we believe are well positioned to weather any potential economic slowdown.

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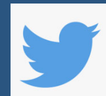

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