ASSET PRESERVATION ADVISORS

APA Q3 2022: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

Third quarter highlights

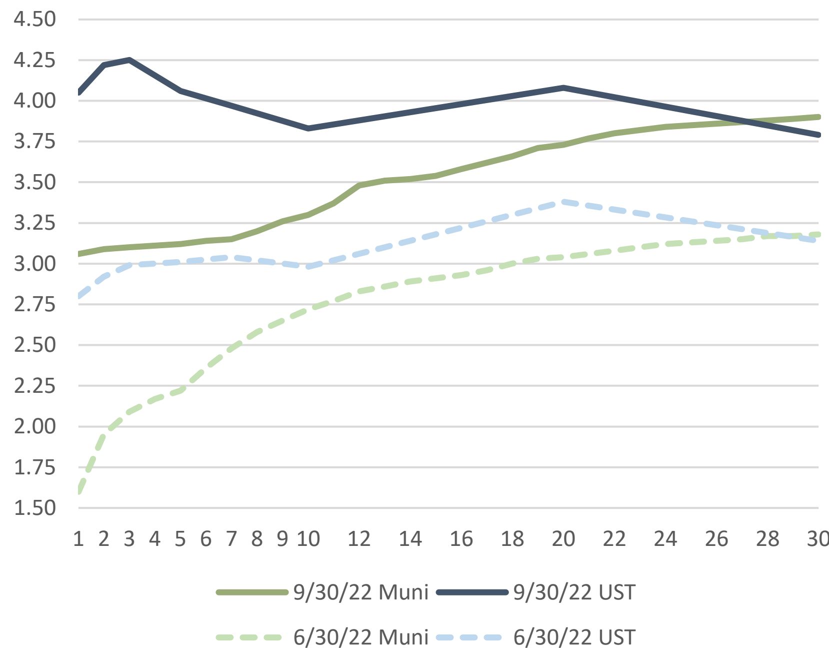
- The quarter began with yields moving lower, as July saw municipals post the best month of performance for the year.
- Sentiment turned in August, as municipal yields followed Treasury yields higher for the month, though munis out-performed as the strong technical environment for the asset class continued.
- Municipals underperformed in September as reinvestment demand from large-scale maturity and coupon flows waned while facing the added pressure of mutual fund outflows and elevated secondary market supply.
- For the quarter, 1, 5, 10, and 30-year AAA MMD yields increased by 146, 90, 58, and 72bps, respectively.
- As expected, the FOMC executed its third straight 75 bps hike at its September meeting. This moved the target range for the fed funds rate to 3.00 to 3.25%.
- The third quarter closed with eight straight weeks of mutual fund outflows to the space, bringing YTD outflows to a record $91.5 billion through the end of Q3.
- Third quarter issuance totaled $93.9 billion, or a 25% decline from the same period last year.

Market update

The quarter began with municipal yields moving lower, as July saw the asset class post the best month of performance for the year. The strong summer technical environment of low issuance and high coupon and maturity reinvestment provided a tailwind for tax-exempts as municipals outperformed Treasuries, and muni/Treasury ratios moved lower across the curve. After seeing outflows for much of the first half of the year, municipal mutual funds experienced inflows in two of the final three weeks of the period. The shift in demand slowed down the robust secondary market supply from selling pressures, which has been a significant theme for the year. As expected, the FOMC announced a 75 bps increase following its July meeting and indicated that the committee would not slow down hikes until inflation is more under control.

FIGURE 1

Muni & Treasury Yield Curves



Source: Municipal Market Data, US Treasury

Sentiment turned in August, as municipal yields followed Treasury yields higher for the month, though munis outperformed as the strong technical environment for the asset class continued. The period saw a bear flattening of the curve, as 1, 5, 10, and 30-year AAA Municipal Market Data (MMD) tenors closed August at 83, 52, 38, and 40 bps higher, respectively. In an unusual move, the municipal curve followed the Treasury curve into an inversion for four

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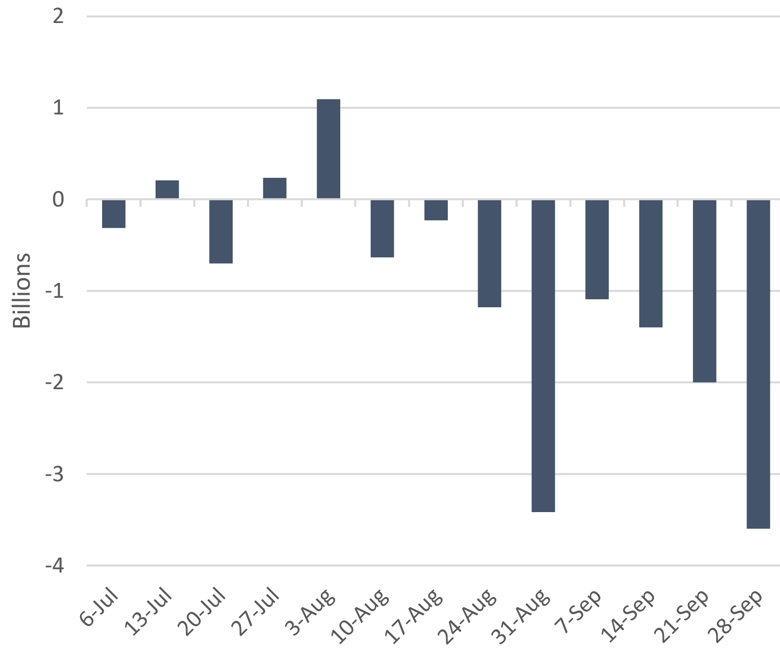
FIGURE 2

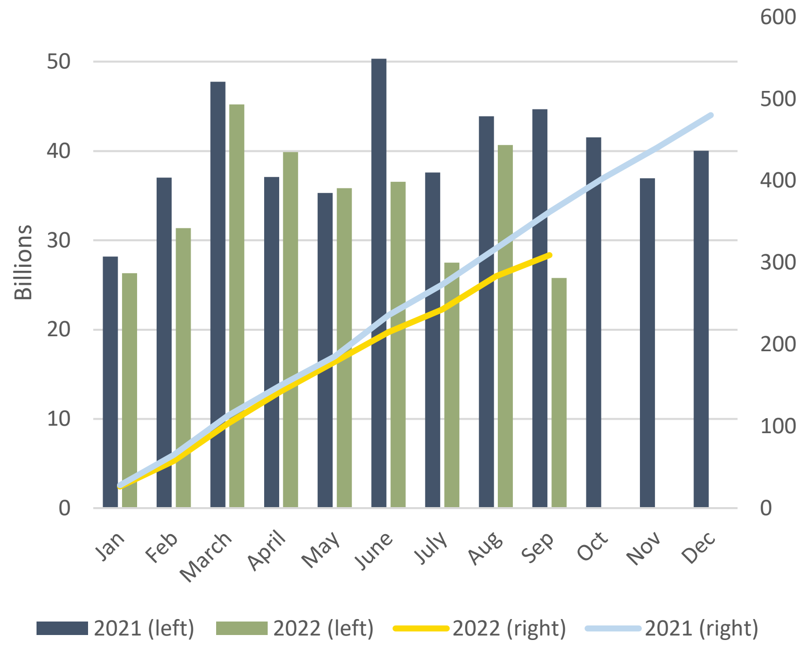
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

trading days in the month as the muni 1-5 year spread reached a low of -7 bps around mid-month before adjusting back to a positive sloping curve.

August inflation data released in September surprised to the upside, which led to a sharp sell-off in the equity and fixed-income markets, with municipals unable to evade the moves. As expected, the FOMC executed its third straight 75 bps hike during its September meeting. However, the rise in dot plots caught the market a bit by surprise as the fed signaled a willingness to tolerate a significant slowdown to get inflation under control. As a result, short-end taxable rates increased as the market adjusted in response to the Fed's hawkish guidance. The 2-year UST yield increased by 77 bps for the month to close at 4.22%.

Municipals underperformed in September as the calendar shifted out of the strong summer technical environment of reinvestment demand from large-scale maturity and coupon flows. Municipals faced added pressure of mutual fund outflows and elevated secondary market supply. For the month, AAA muni yields moved higher by 59-85 bps across the curve, with maturities inside of 5 years seeing the greatest adjustment. This brought quarterly adjustments to the 1, 5, 10, and 30-year AAA MMD tenors of 146, 90, 58, and 72 bps, respectively.

Supply

September issuance dropped significantly, coming in at just $25.8 billion, or a decline of 42% year-over-year. Third-quarter issuance totaled $93.9 billion, or a 25% decline from the same period last year. The sharp reduction in supply is attributable to higher market yields, making it less attractive for municipalities to come to market for new projects or refinance outstanding debt.

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Fund flows

One of the year's biggest stories in the tax-exempt space has been the record outflows from municipal mutual funds. The third quarter closed with eight straight weeks of outflows, as fund flows totaled -$13 billion for the period. Per JP Morgan data, this brought YTD outflows to a record $91.5 billion through the end of Q3.

Positioning

After seeing municipal yields stabilize and rally to start the quarter, 2022's historic move higher in rates resumed over August and September. While the inverse relationship of prices and yields has weighed on portfolio market values, 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 look to continue doing so over the year's final quarter.

We opened the third quarter with average composite durations on the lower end of our strategy targets as we allowed duration to drift down in anticipation of higher rates. However, with the sharp moves higher in yield the market experienced over the final two months of Q3, we are now 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. While Treasury yields could continue to drift higher on inflation concerns and quantitative tightening from balance sheet run-off (ramping up from $47.5 billion to $95 billion in September), with munis facing additional pressure from mutual fund outflows/secondary selling, there are reasons to believe that as the impacts of tighter monetary policy begin to trickle through to the economy, the Fed could have to have to pivot and slow down the pace of rate hikes in the not-too-distant future.

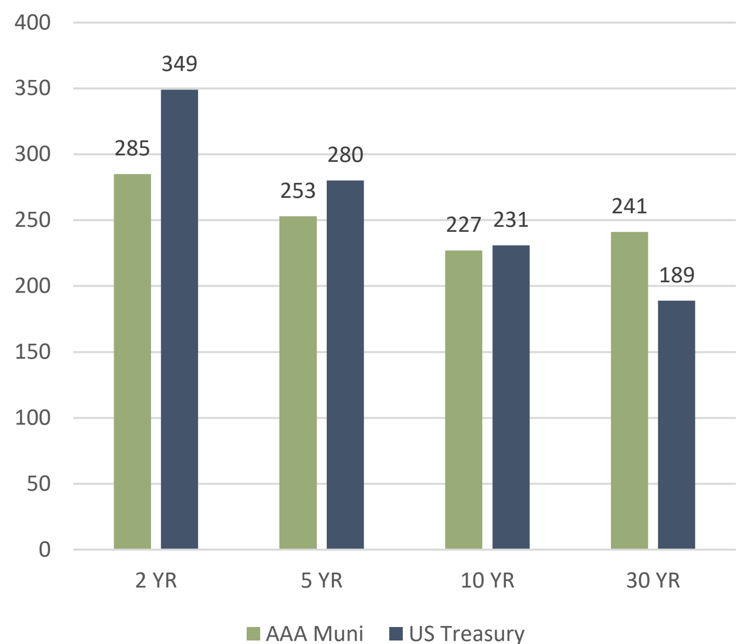
FIGURE 4

Muni / Treasury Ratios

Source: Municipal Market Data, US Treasury

FIGURE 5

2022 YTD Yield Change (basis points)



Source: Municipal Market Data, US Treasury

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Additionally, with the market pricing in a terminal Fed Funds rate of nearly 4.50%, on the assumption that at least a majority of the move higher in rates has taken place, we believe it could make sense to lock in yields that we have not seen in some time. As a result, after allowing duration to drift down for much of 2022, we are tactically taking advantage of opportunities to extend duration slightly within respective strategy mandates, more in line with our long-term targets (4 years for HQ Intermediate and 5.5-6 years for Enhanced Intermediate).

We remain conscious of the possible recessionary risk ahead and expect further rate volatility over the final quarter of the year with an aggressive Fed. However, the municipal credit landscape remains on sound footing and has a proven ability to weather an economic storm compared to its corporate counterparts. As a result, we will look to selectively take advantage of opportunities of spread widening within the investment-grade space.

High Quality Intermediate

In response to market volatility over much of 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 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. With this, we might look to add bonds whose prices have fallen to pricing discounts, adding 5% coupon structures at discounts, as available. Finally, 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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APA-2210-30

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