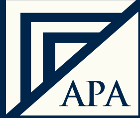


ASSET PRESERVATION ADVISORS

Market Commentary | Q2 23

SECOND QUARTER HIGHLIGHTS

Municipals diverged from Treasuries in April, ***as Treasury yields moved modestly lower,*** while AAA muni yields moved higher by between 7-51 bps for the month.

Tax-exempts experienced relative outperformance in May as ***rates moved higher for the period*** on debt ceiling anxieties and stronger-than-expected economic data releases.

After hiking the federal funds rate over ten consecutive meetings, the FOMC paused its tightening cycle in June. Despite the pause, ***Treasury yields moved higher as the market adjusted expectations*** to additional hikes this year and pushed rate cuts from late 2023 into next year.

Supply for the quarter came in at $100 billion, ***bringing first-half issuance to $178.5 billion,*** an 18% decline over the same period last year.

After seeing fund flows stabilize to start the year, ***the market experienced outflows over the second quarter*** during what is typically a more challenging technical environment around tax time.

QUARTERLY MARKET UPDATE

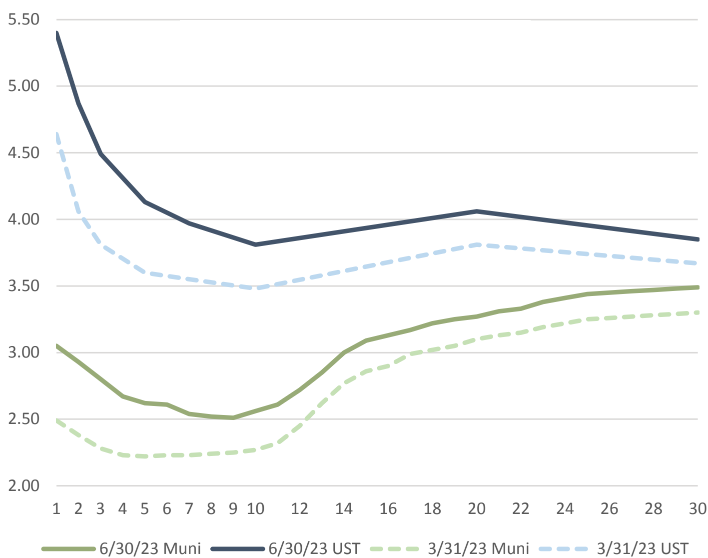
Municipals diverged from Treasuries in April, as Treasury yields moved modestly lower, while AAA muni yields moved higher by between 7-51 bps for the month. The most significant move for tax-exempts came on the short end of the curve, where stated 1 and 2-yr AAA yields (MMD) increased by 51 and 31 bps, respectively. This helped reset muni/Treasury relative value ratios to more typical historical levels by the end of the month. The muni 2–10-year inversion widened for the period by 23 bps. On the credit front, upgrades continue to outpace downgrades significantly, and New Jersey was the latest major issuer to receive a "bump." In April, Moody's, S&P, and Fitch each raised the State's general obligation bonds one notch, citing solid economic recovery and job gains." This marked six upgrades for the state across the major agencies since March 2022 and brought the State's rating to the highest level in nearly a decade. New issue supply remained subdued, as higher borrowing costs and municipalities still flush with cash issuers on the sidelines. Supply for the month came in at $32.9 billion, an 18.6% decrease over the same period last year.

Tax-exempts experienced relative outperformance in May as rates moved higher for the period on debt ceiling anxieties and stronger-than-expected economic data releases. The employment report released at the beginning of the month signaled continued labor market strength, while the industrial production and retail sales reports signaled a resilient economy in the face of a Fed tightening cycle and led to markets repricing FOMC rate hike expectations. Banking concerns subsided while bank portfolio liquidations proved orderly thus far and caused little market disruption. Yields peaked in late May before recovering over the final trading days of the month as the white house and congressional leaders announced an agreement on debt ceiling talks. As expected, the FOMC hiked 25bps in their early May meeting, bringing the target range to above 5% for the first time in 16 years.

Municipals outperformed in June, as tax-exempt yields moved lower across the curve, while Treasury yields adjusted higher.

After hiking the federal funds rate over ten consecutive meetings, the FOMC paused its tightening cycle in June. In explaining the decision, Chair Powell indicated that the FOMC has "covered a lot of ground, and the full effects of our tightening have yet to be felt." Despite the pause, markets interpreted Fed sentiment as hawkish in its resolve to tame moderating but still higher than target inflation. Following the June FOMC meeting, Treasury yields moved higher as the market adjusted expectations to additional hikes this year and pushed rate cuts from late 2023 into next year. The Treasury 2-10 year inversion surpassed 100bps for the first time since March as the 2-yr Treasury yield adjusted higher by 47bps in June and 81 bps for the quarter. The municipal market's reaction was more orderly, as AAA 2, 5, 10, and 30-yr yields moved -15, -14, -9, and -6bps for the month, respectively. June's new issue supply came in at $38bn, an increase of 29% month over month but below the $42bn average for the month during the past five years.

MUNI & TREASURY YIELD CURVES

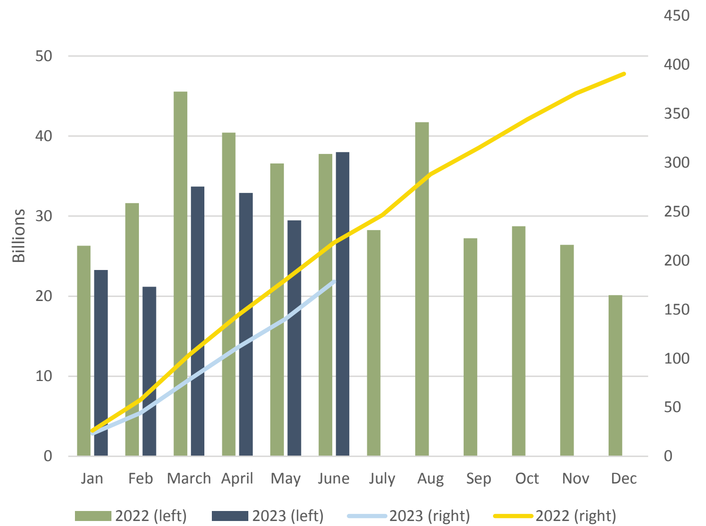


Source: Municipal Market Data, US Treasury

SUPPLY

A consistent theme in 2023 has been the lack of new issue supply, which reflects issuers' cautiousness amid interest rate volatility. Additionally, the abundance of cash on hand from pandemic-related stimulus packages has decreased municipalities' reliance on debt issuance for financing their obligations and capital projects. Supply for the quarter came in at $100 billion, bringing first-half issuance to $178.5 billion, an 18% decline over the same period last year. Tax-exempt issuance is down just 7.5% year over year, while year-to-date taxable muni issuance totaled just $17.7 billion, or a 40.7% decline over the same period in 2022.

MUNICIPAL MARKET SUPPLY

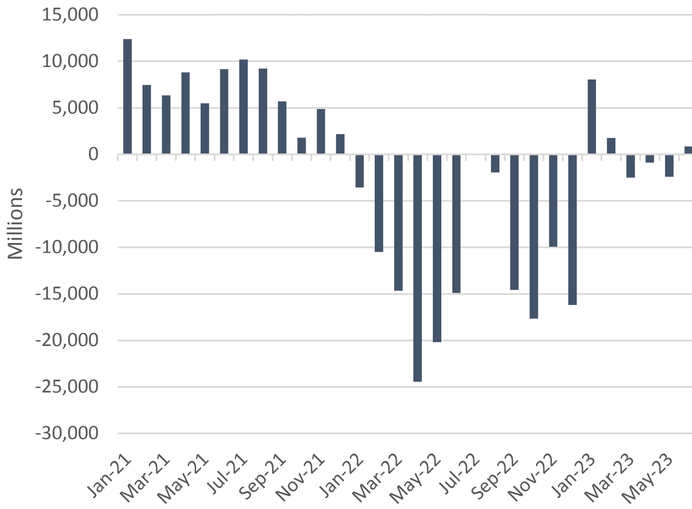


Source: SIFMA

FUND FLOWS

After seeing fund flows stabilize to start the year, the market experienced outflows over the second quarter during what is typically a more challenging technical environment around tax time. Per ICI data, municipal mutual funds experienced aggregate outflows of $2.5 billion for the quarter.

MONTHLY FUND FLOWS



Source: ICI, Barclays

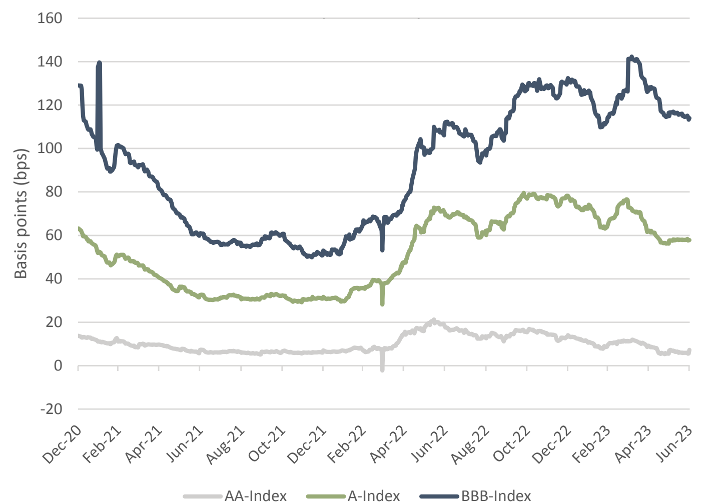
OUTLOOK

Municipal yields moved higher over the second quarter as stronger-than-expected economic data and a resilient economy caused markets to reset Federal Reserve rate hike expectations. In the municipal space, the most significant move was on the short end, where 1-yr and 2-yr AAA maturities moved higher for the quarter by 56 and 55 bps, respectively. While over the near term, rates could continue to drift higher as the Fed remains committed to bringing inflation down to its target level via rate increases, our more medium-term outlook is for a re-steepening of the curve (either short rates moving lower or long yields moving higher). As a result, we continue to advocate a laddered structure to position for various scenarios, adding spots along the yield curve and allowing bonds to roll down. Additionally, after allowing duration to drift lower for much of 2022 in the face of higher rates, we continue to actively execute trades to extend portfolio duration more in line with long-term targets with reinvestment from maturity roll-off and through the execution of beneficial tax-loss swaps to lock in what believe to be attractive nominal tax-exempt yields on a historical basis.

Furthermore, we believe the municipal credit profile remains stable. Municipal issuers have chosen to pay down debt, be more selective in new issuance, and build cash balances ahead of any potential slowdown. Revenue collections have remained stable, and local governments continue to reap the benefits of the boost provided by fiscal aid. There was just one Moody's-rated municipal default in 2022, following zero Moody's-rated defaults in 2021 and just one in 2020. New Jersey and Kentucky received rating upgrades in the second quarter, and per Fitch data, upgrades outpaced downgrades 3 to 1 in 2Q 2023, reflecting the broad underlying strength of the asset class. While APA remains conservative in its approach to credit, we will look to uncover pockets of value to selectively add lower-rated positions (within strategy mandates) with solid underlying metrics that we believe are well-positioned to weather any potential economic slowdown.

As we continue through what is typically a strong seasonal technical environment of robust maturity and coupon reinvestment demand, we will look to uncover relative value opportunities. Specifically, we have looked to add positions just beyond standard retail demand, where the curve begins to steepen and relative value ratios more closely align with historical norms. Additionally, we will look to take advantage of any uptick in supply and reset higher of relative value ratios to reposition portfolios towards long-term targets.

CREDIT SPREADS



Source: Bloomberg, ICE Data, Bank of America (YTW of AAA, AA, A, BBB-Rated ICE BofA Indices).

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Since its founding, Asset Preservation Advisors is committed to delivering a high level of service, quality and wealth preservation. APA believes our growth in assets under management can be attributed to a consistent investment process and corresponding trading discipline.

We value highly the trust our clients have shown in APA and remain committed to adhering to a high level of ethical, moral and business standards first envisioned at our founding in 1989. Asset Preservation Advisors (APA) is a registered investment advisor founded and specializes in managing high quality, tax-exempt and taxable municipal bond portfolios for other registered investment advisors, family wealth offices and institutional clients.

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