THIRD QUARTER HIGHLIGHTS

July saw the municipal market *outperform Treasuries for the third consecutive month*, which was attributable to the supply/ demand dynamics of the tax-exempt market.

PRESERVATION ADVISORS

After a pause in the prior meeting, the FOMC resumed its tightening cycle with a 25bps hike in July to a *target range of 5.25-5.50%*, a 22-year high.

Fixed income *curves steepened in August* as economic data releases, coupled with Fed commentary, suggested the Fed may be at or near its terminal policy rate.

September was challenging for fixed-income performance as *yields moved higher* in both taxable and tax-exempt markets.

The 10-year Treasury yield increased by 50bps for the month, *reaching a level not seen since* **2007**. Muni yields rose between 48 and 58 bps across the curve, with the most significant move coming in the 7-10 year range.

Sustained outflows from mutual funds provided added pressure as the quarter closed with *ten consecutive weeks of fund outflows* for the asset class.

Supply continues to lag behind last year's pace, as new issuance for the *third quarter came in at \$95.3 billion*, bringing year-to-date issuance to \$276.5 billion, a 12.4% decline over the same period last year.

QUARTERLY MARKET UPDATE

July saw the municipal market outperform Treasuries for the third consecutive month. Municipal yields were relatively quiet despite the weak Treasury backdrop, which was attributable to the supply/demand dynamics of the tax-exempt market. Per ICI data, the month saw net inflows into mutual funds, while supply totaled just \$27 billion, a month-over-month decline of 35.9%, and 4% lower than July of last year.

After a pause in the prior meeting, the FOMC resumed its tightening cycle with a 25bps hike in July to a target range of 5.25-5.50%, a 22-year high. On the economic front, the Q2 GDP report released in July came in above expectations at 2.4%, which pressured yields higher at the end of the month. Additionally, June's CPI report released in July showed growth of 3% year over year, the lowest level since March 2021.

August began with surprise news of Fitch downgrading US Treasuries to AA+ from AAA, citing "the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to AA and AAA rated peers over the last two decades that has manifested in repeated debt-limit standoffs and last-minute resolutions."

The Treasury curve steepened for the period as economic data released in August, coupled with Fed commentary, suggested the Fed would leave its policy rate unchanged at the next meeting and may be at or near its terminal policy rate. The market grappled with the idea of larger deficits as the Treasury announced a larger-than-expected auction of securities to meet funding needs, which pressured yields higher.

The municipal curve steepened over the month while underperforming the move in Treasuries, as tax-exempt bonds beyond five years increased by 30-40bps. Municipal mutual funds experienced outflows of \$1.7 billion for the period, while supply increased 16% month over month to total \$38.7 billion for August. Additionally, municipals experienced the seasonal headwind of the shift in net supply as the calendar moved out of the robust summer redemption months and into fall.

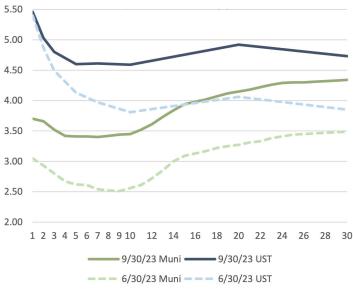
ΑΡΑ

September was challenging for fixed-income performance as yields moved higher in both taxable and tax-exempt markets. The 10-year Treasury yield increased by 50bps for the month, reaching a level not seen since 2007.

Muni yields rose between 48 and 58 bps across the curve, with the most significant move coming in the 7-10 year range. The stated 10-year AAA muni yield reached the highest level of the year and even eclipsed the highs seen during the 2022 selloff.

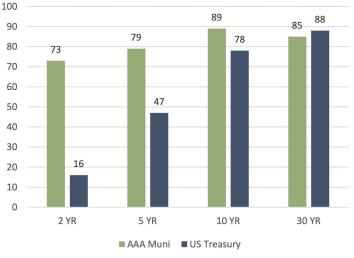
Rates drifted higher over the first couple of weeks of the month before picking up steam following the Fed's FOMC meeting. As expected, the FOMC left overnight rates unchanged at 5.25-5.50%. However, the surprise came in the FOMC's Summary of Economic Projections (SEP), which forecast a lower unemployment rate, stable GDP growth, and a slower path of rate cuts in 2024 and 2025. This optimistic forecast caused the market to reprice the implications of the Fed keeping rates higher for longer.

MUNI & TREASURY YIELD CURVES



While the selloff in Treasuries provided direction, municipals also felt the impact of a more challenging technical environment of lower redemptions, thus less natural reinvestment demand. Sustained outflows from mutual funds provided added pressure as the quarter closed with ten consecutive weeks of fund outflows for the asset class. Per ICI data, municipal mutual funds experienced net redemptions of \$5.7 billion in September, the largest monthly outflow for the asset class this year. This caused muni/Treasury relative values to reset higher after being stretched at historically tight levels for much of the year, a positive for new investors on a relative value basis.

Q3 2023 YIELD MOVES (bps)



Source: Municipal Market Data, US Treasury

FUND FLOWS

Municipal mutual fund outflows continued over the third quarter. The Investment Company Institute (ICI) reported ten consecutive weeks of outflows to close the period. For the quarter, aggregate fund outflows totaled \$6.9 billion. The changing supply/demand dynamic heading out of summer caused tax-exempt relative values to reset higher after being stretched at historically tight levels, a positive for new investors on a relative value basis.

MONTHLY FUND FLOWS



source: ICI, Barclays

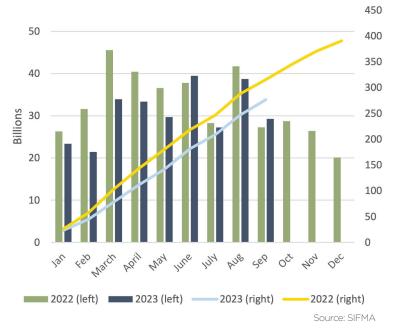
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SUPPLY

Supply continues to lag behind last year's pace, as new issuance for the third quarter came in at \$95.3 billion, bringing year-to-date issuance to \$276.5 billion, a 12.4% decline over the same period last year. Tax-exempt issuance is down just 0.6% year-over-year, while year-to-date taxable municipal issuance has totaled just \$24 billion, or a 42.1% decline.

MUNICIPAL MARKET SUPPLY



OUTLOOK

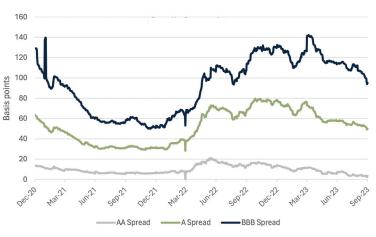
Municipal yields moved higher over the third quarter, following the guidance of the Treasury market. The selloff in rates picked up steam following the September FOMC meeting. While the overnight policy rate remained unchanged at 5.25-5.50%, the surprise came in the Summary of Economic Projections, which forecast a lower unemployment rate, stable GDP growth, and a slower path of rate cuts in 2024 and 2025. Thus, the market adjusted over the final two weeks of the quarter to account for the idea that rates could remain higher for longer. Municipal yields increased by 65-93 basis points for the quarter as the curve steepened (became less inverted). The most significant move came from the 8–11-year range, where yields increased by an average of 91 basis points.

While over the near term, rates could remain volatile, 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 the past 18 months 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 we believe to be attractive nominal tax-exempt yields on a historical basis.

Furthermore, we believe the municipal credit profile remains stable. Local government rainy day funds are at historical highs, and market upgrades continue to outpace downgrades. Per Moody's, upgrades have outpaced downgrades by a 4:1 ratio in 2023, signaling the broad 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 move out of what is typically a strong seasonal summer technical environment of robust maturity and coupon reinvestment demand, we will look to take advantage of better relative value ratios, a positive for new investors on a relative value basis. 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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ABOUT APA

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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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