APA

ASSET PRESERVATION ADVISORS

# MARKET COMMENTARY

Q3 2024

CARING FOR CLIENT PORTFOLIOS, BOND BY BOND.

## MARKET COMMENTARY Q3 2024

### THIRD QUARTER HIGHLIGHTS

- As the calendar turned to the second half of the year, markets remained laser-focused on the timing and magnitude of the impending Fed easing cycle.
- Inflation and employment figures released in Q3 supported the idea that the Fed would begin to cut rates soon. CPI dipped below 3% on a year-over-year basis for the first time in three years, with the final reading of the quarter showing inflation cooling to 2.5% year-over-year, moving closer to the Fed's stated long-term target.
- With inflation continuing on a declining path, market sentiment shifted focus to the employment side of the Fed’s dual mandate. The employment reports released in Q3 showed signs of cracks, as headline figures came in below expectations while prior months saw revisions downward. By the end of the quarter, the unemployment rate ticked up to 4.3%, the highest level since October 2021.
- Yields declined sharply over the quarter, led by the short end, on the idea that restrictive policy was impacting the labor market and that the Fed would need to take action soon.
- For the quarter, 2-year, 5-year, 10-year, and 30-year AAA muni yields declined by 81, 58, 24, and 20bps, respectively.
- Municipal new issuance volume continues to outpace last year’s levels significantly. For the third quarter, the muni market saw new issue supply of $136.6 billion vs. $98.3 billion over the same period last year. This brought YTD issuance to $381 billion, or a 35% increase year over year.
- Per ICI data, municipal mutual funds experienced strong inflows for the quarter. For the period, municipal mutual funds brought in $11 billion for the quarter, with each month of the quarter seeing net positive flows.

As the calendar turned to the second half of the year, markets remained laser-focused on the timing and magnitude of the impending Fed easing cycle. July began with two “bond-friendly” readings on the inflation and employment fronts. Inflationary pressures continued to subside, as the Consumer Price Index (CPI) release showed that inflation cooled more than expected. CPI fell by 0.1% in June, continuing the downward trend seen throughout 2024.

The jobs report released in early July showed a labor market with signs of weakness. While the headline number aligned with expectations, the report saw significant revisions to prior months, and the unemployment rate ticked to 4.1%. With inflation continuing on a cooling path, market sentiment shifted focus to the employment side of the Fed's dual mandate, as yields dropped sharply following the payroll report on the idea that restrictive policy was impacting the labor market and that the Fed would need to take action soon.

Despite growing market anticipation for rate cuts, the FOMC opted not to act during its July meeting, electing instead to wait for more economic data. However, with expectations firmly set on the beginning of cuts later in the year, Treasury yields continued their downward trend over the month, led by the more policy-sensitive short end as the yield curve bull steepened. For the month, 2-year, 5-year, 10-year, and 30-year Treasury yields declined by 42, 36, 27, and 16bps, respectively. By the end of the month, the market was pricing in more than 75bps of Fed easing by year-end.

Municipal bonds underperformed their Treasury counterparts in July, which was largely attributable to elevated new issue supply. The muni market saw $41.1 billion of issuance during the month vs. $28 billion for the same period last year. Muni yields declined by 26, 14, 2, and 4 basis points for the 2-year, 5-year, 10-year, and 30-year spots, respectively.

August kicked off with a weaker-than-expected headline payroll figure, while prior months were revised down as well. As a result, the unemployment rate ticked up to 4.3%, the highest level since October 2021. Inflation data remained encouraging, with the CPI report showing year-over-year inflation dipping below 3% for the first time in over three years. This sustained improvement in inflation, coupled with the weakening labor market, led Fed Chair Jay Powell to signal at the Fed's annual Jackson Hole Symposium that "the time has come for policy to adjust," indicating that the long-anticipated rate-cutting cycle was imminent.

The market responded decisively to these developments, with yields falling across the curve over August, particularly on the short end. For the month, 2-year, 5-year, 10-year, and 30-year Treasury yields declined by 38, 26, 18, and 15bps, respectively, while market futures closed the month pricing in 100bps of cuts by year-end. Municipal bond yields followed suit, with the AAA muni scale seeing 2-year, 5-year, 10-year, and 30-year yields decline by 40, 33, 11, and 8bps, respectively.

Primary issuance in the municipal market remained robust in August, with new supply totaling $50.5 billion for the month—marking the largest monthly issuance of 2024 and the first time in three years that supply exceeded $50 billion in a single month. The heavy issuance was met with solid demand, driven by reinvestment flows from redemptions and new money inflows. Redemptions were estimated at $42 billion, while mutual funds saw $4.2 billion in positive flows, per ICI data.

Ahead of the Fed's widely anticipated September meeting, the market was fully pricing in a reduction in policy rates. Consensus eventually moved from expectations of a 25bps cut at the beginning of the month to pricing for a 50bps cut by the time of the September 18th meeting. The Fed ultimately met the market's expectations and kicked off its easing cycle with a 50bps reduction in rates.

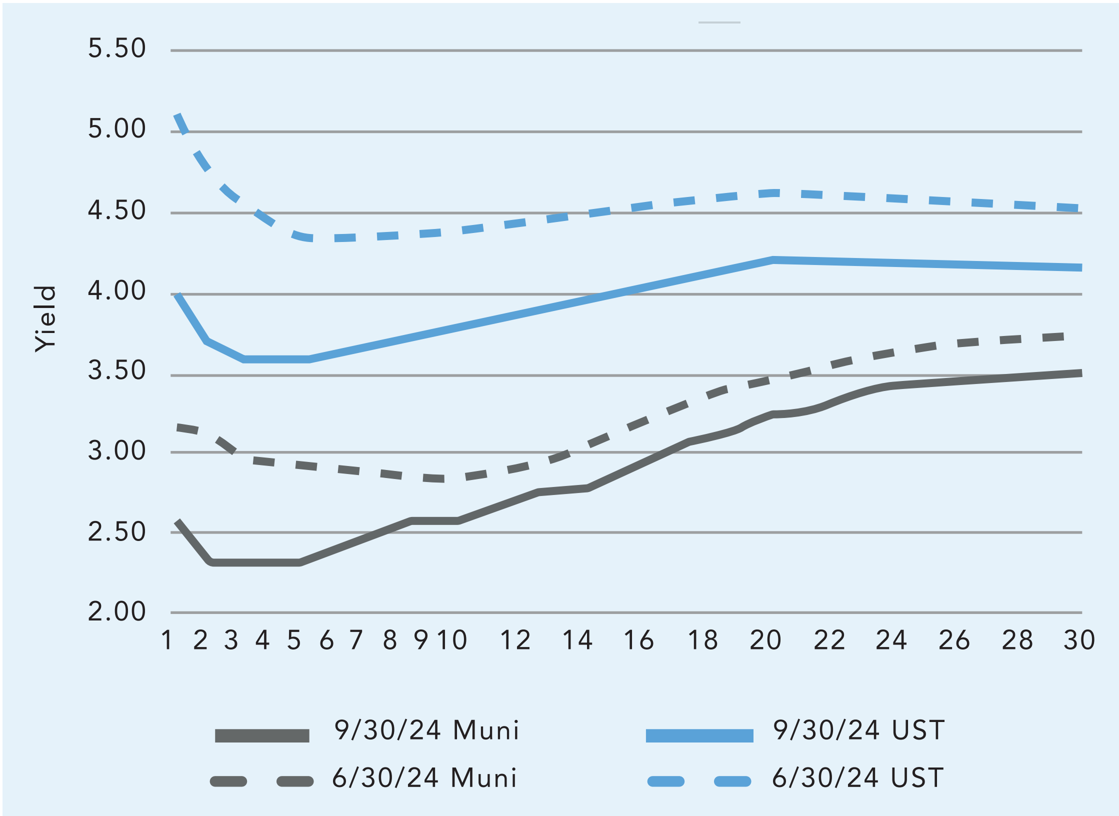
Key data releases over the first half of the month likely influenced the Fed's decision to make a more aggressive cut. The CPI report released in early September showed inflation cooling to 2.5% year-over-year, moving closer to the Fed's stated long-term target. Additionally, the payroll report came in below expectations and saw significant downward revisions to the prior two months, reinforcing concerns about the labor market's softening.

Most of the action in yields occurred ahead of the Fed's meeting as rates declined leading up to the meeting, then traded mostly sideways to slightly higher following the meeting to close out the month.

For September 2-year, 5-year, 10-year, and 30-year Treasury yields declined by 25, 13, 10, and 6bps, respectively. Municipal yields followed suit, with the AAA muni scale showing declines of 15bps on the 2-year, 11bps on the 5-year and 10-year, and 8bps on the 30-year.

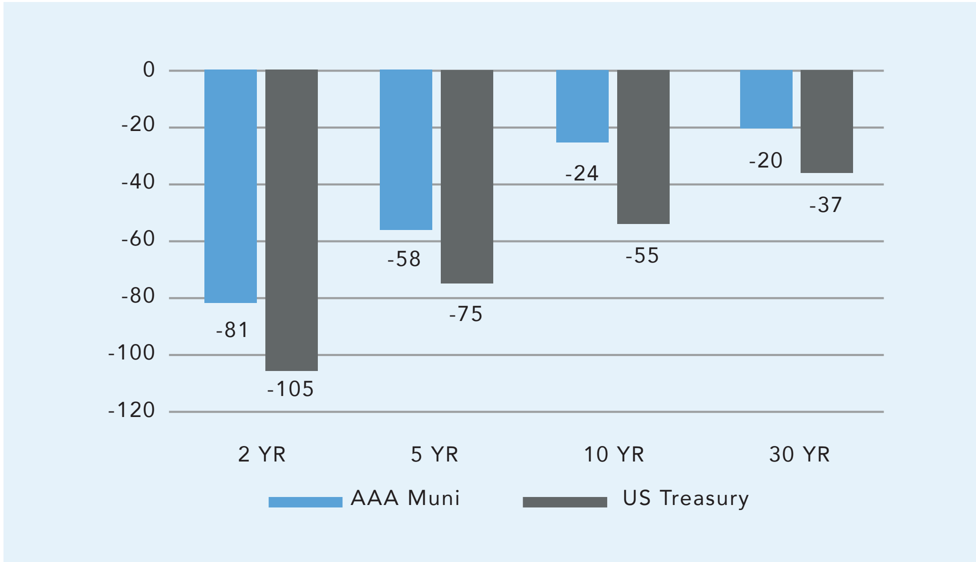
New issue supply continued its torrid pace, as September saw issuance of $45 billion, a 45% increase over the same period last year.

MUNI & TREASURY YIELD CURVES




Source: Municipal Market Data, US Treasury

Q3 2024 YIELD MOVES (bps)

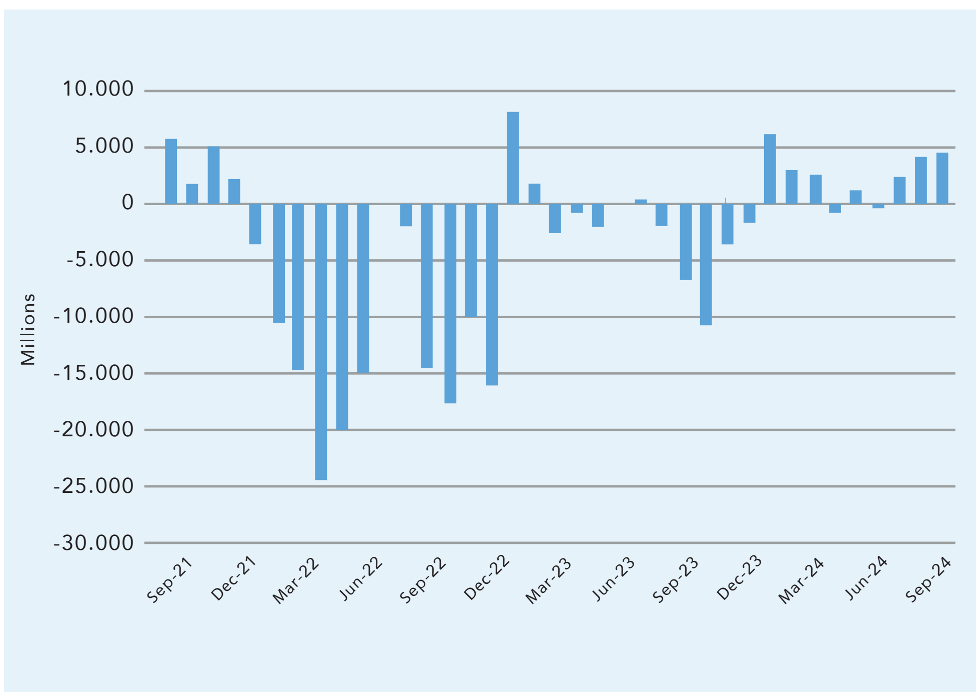



Source: Municipal Market Data, US Treasury

## FUND FLOWS

Per ICI data, municipal mutual funds experienced strong inflows for the quarter. For the period, municipal mutual funds brought in $11 billion for the quarter, with each month of the quarter seeing net positive flows. After seeing net outflows for calendar year 2023, tax-exempt mutual fund inflows have totaled $22.6 billion year to date.

MONTHLY FUND FLOWS

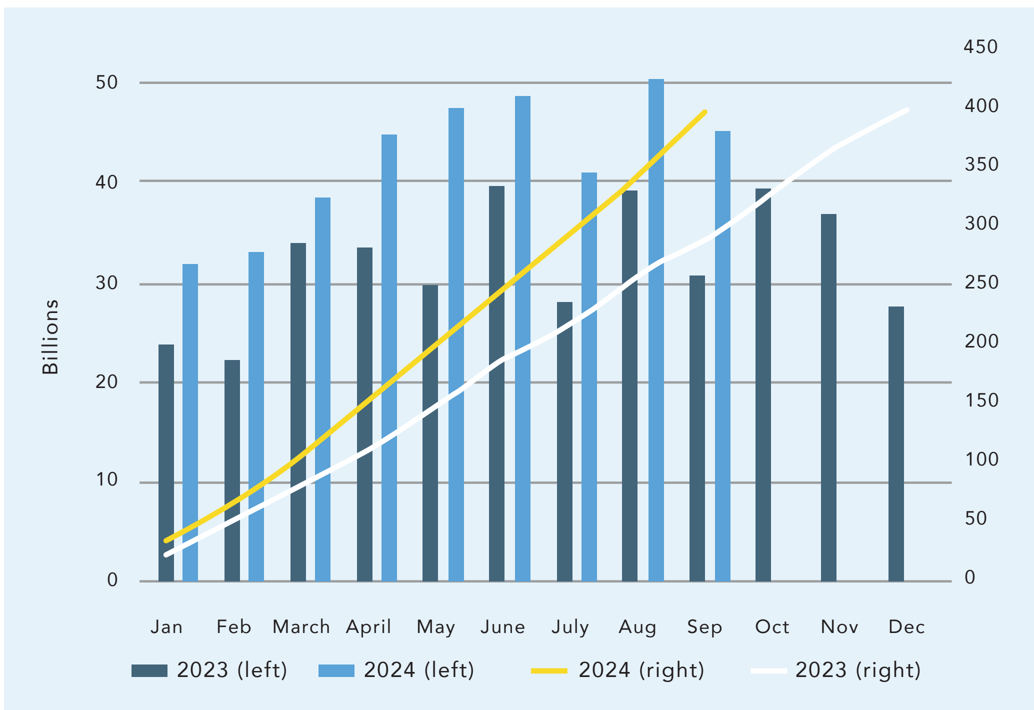



Source: Investment Company Institute (ICI)

## SUPPLY

New issuance volume continues to outpace last year's levels significantly. For the third quarter, the muni market saw new issue supply of $136.6 billion vs. $98.3 billion over the same period last year. This brought YTD issuance to $381 billion, or a 35% increase year over year. The surge in issuance can be attributed to municipalities addressing ongoing financing needs as pandemic-related stimulus measures burn off while also looking to get ahead of any potential election-related market volatility. The sustained elevated supply helped pressure muni/Treasury relative value ratios to the highest levels of the year during the third quarter.

MUNICIPAL MARKET SUPPLY




Source: SIFMA

## OUTLOOK

As we move into the final quarter of the year, APA remains positioned in a modified ladder structure to defend against a potential continued steepening of the yield curve. In Q3, the curve slope adjusted significantly, with the 2-10-year Treasury spread widening by 50bps, from a 35 basis point inversion to a +15 basis point positive slope by quarter-end. This trend was mirrored in the municipal market, where short-term yields saw the most pronounced declines as the curve bull steepened.

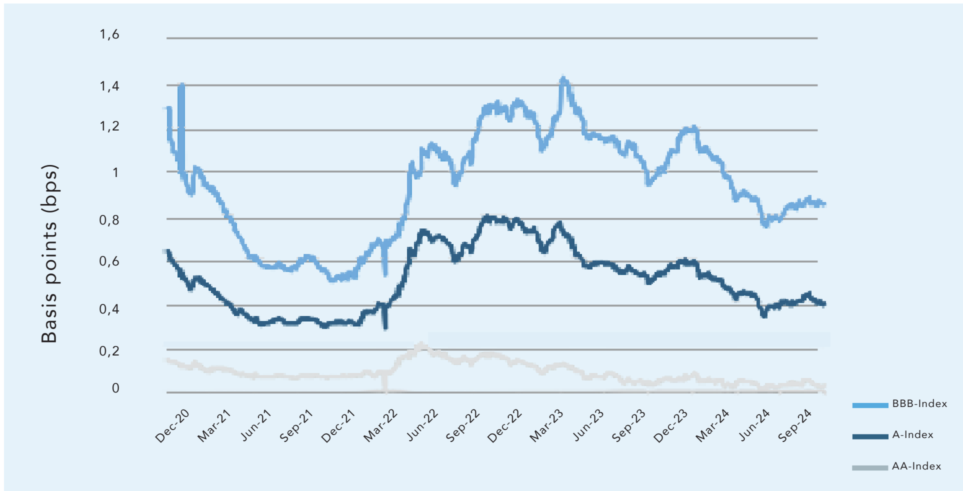
Despite tight municipal-to-treasury ratios for much of the year, APA continues to seek relative value opportunities, as elevated supply levels helped push muni/treasury ratios to their highest point of the year during Q3. Municipal supply is expected to remain elevated through year-end, coinciding with the historically weaker fall period when reinvestment demand tends to slow. Given this backdrop, APA will continue to identify what could be attractive long-term entry points throughout the remainder of the year.

The upcoming election presents potential implications for the municipal market, with our greatest focus being on the impact to tax rates. Regardless of the outcome, APA expects individual tax rates to remain relatively stable, given the current deficit environment. However, should corporate tax rates face upward pressure with the expiration of the Tax Cuts and Jobs Act (TCJA) next year, banks and insurance companies could return to the market, impacting demand on the longer end of the curve.

In the medium to long term, Treasury yields could face upward pressure due to the need for increased issuance, as both major political parties are proposing continued deficit spending. Additionally, the expiration of the SALT cap in 2025 could reduce demand from buyers in high-tax states, potentially softening what has been insatiable demand from residents in these states.

One final focus as we approach year-end will be positioning ahead of the robust January reinvestment period. Over the past two years, Q4 has provided opportunities for tax-loss swaps. However, with the recent market rally, many bonds purchased in the past two years are now held at gains. While APA will continue to actively pursue beneficial tax-loss swap trades, such opportunities may be more limited to close the year.

CREDIT SPREADS VS. AAA-RATED INDEX



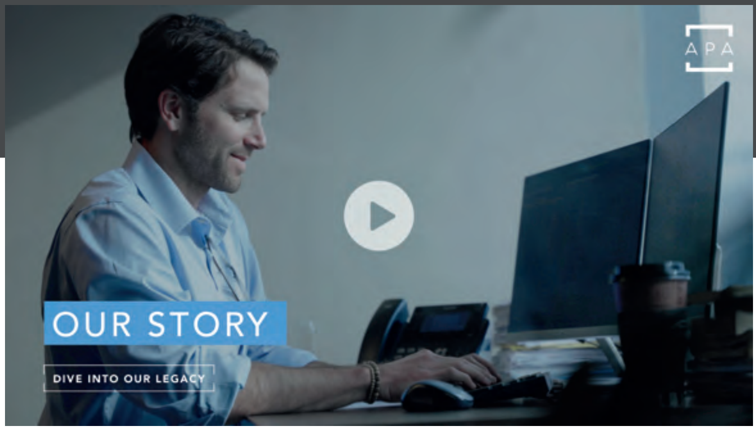

Source: Bloomberg, ICE Data, Bank of America (YTW of AAA, AA, A, BBB-Rated ICE BofA Indices).

## ABOUT APA

***Asset Preservation Advisors (APA) is a registered investment advisor founded in 1989. APA specializes in managing high quality tax-exempt and taxable municipal bond portfolios for other registered investment advisors, family wealth offices and institutional clients.***

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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