ASSET PRESERVATION ADVISORS

APA Q3 2020: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

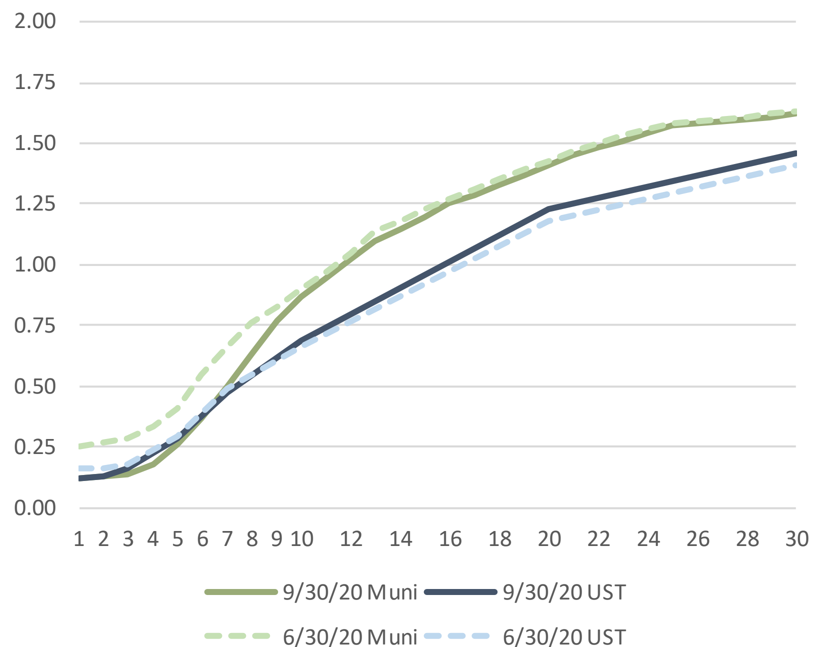
Third quarter highlights

- The quarter began with encouraging economic data points as local economies continued to reopen
- After seeing a net loss of 13 million jobs for the first half of the year, the employment rebound continued, as 3.8 million jobs were added in the third quarter
- Despite continued talk of an additional aid package and testimony from former Fed chairs Yellen and Bernanke about the need for further support from Congress, including for state and local governments, no tangible legislative progress was made
- The Fed announced an update to their written policy statement, calling for an inflation target of 2%, suggesting short yields are likely to remain anchored down over the near term
- The New York Metropolitan Transportation Authority (MTA) became the second issuer to utilize Federal Reserve's Municipal Liquidity Fund program, borrowing $450 million in notes from the facility
- Municipal yields moved slightly lower for the period, led by the short end in a modest steepening move. For the quarter, 2 YR, 5 YR, 10 YR, and 30 YR AAA muni yields moved lower by 14, 15, 3, and 1 bps, respectively
- Robust municipal issuance continued, as $140.6 billion in supply came to market for the period. New issuance was again led by taxable municipals, which accounted for $53.6 billion, or 38% of the total supply for the quarter

Market update

FIGURE 1

Muni & Treasury Yield Curves



Source: Municipal Market Data

The quarter began with parts of the country experiencing a surge in cases of COVID-19. While some states had to pause or roll back reopening plans, as a whole, local economies continued to reopen, and economic indicators showed signs of recovery. June's nonfarm payroll report released in early July surprised to the upside as 4.8 million jobs were added for the month. Additionally, the retail sales report released in July showed a sharp rise of 7.5%, nearly reaching pre-pandemic levels. July brought the Q2 GDP report, which, as expected, showed the largest decline on record, falling at an annualized rate of 32.9% quarter over quarter. However, this report was largely overlooked by the market, as bonds rallied alongside risk assets for the period. Municipal demand remained strong across the curve, supported by the characteristic summer period of elevated reinvestment income coupled with sustained fund inflows. Tax-exempts returns were sharply positive for the month, as the 10 year AAA spot moved lower by 25bps to close out July at a historic low of 0.65%. Municipals outperformed Treasuries, as ratios tightened across the curve. Despite continued talk of an

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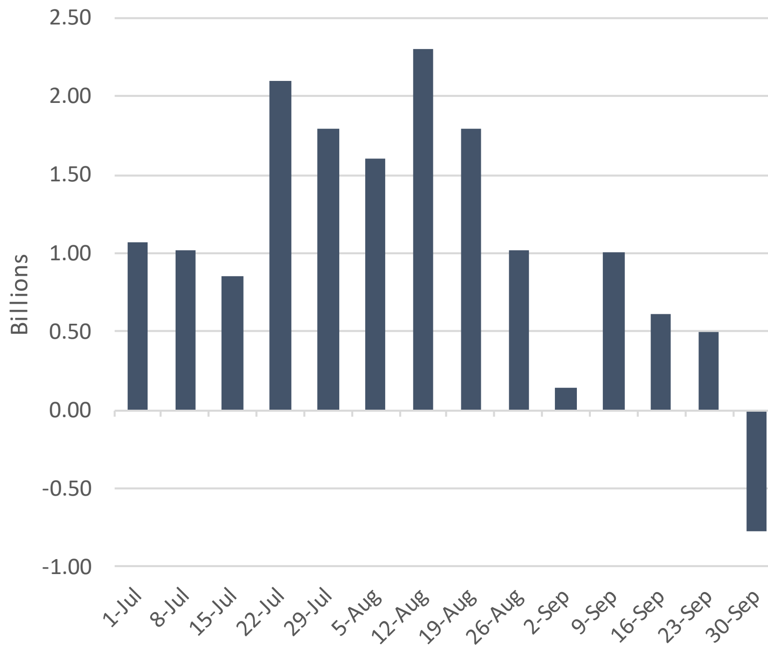
FIGURE 2

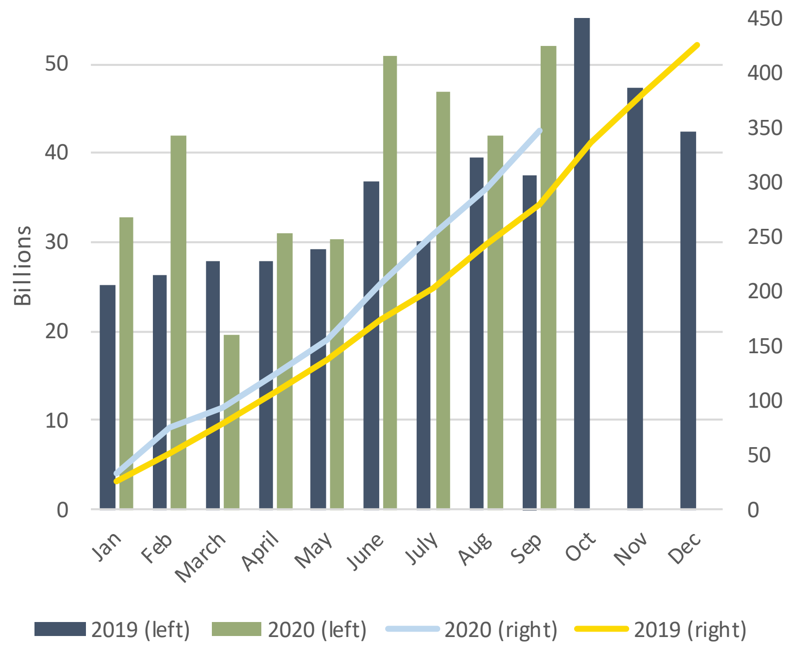
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

additional aid package and testimony from former Fed chairs Yellen and Bernanke about the need for further support from Congress, including for state and local governments, no tangible legislative progress was made.

July's unemployment report, released in early August, saw another upside surprise, as 1.76 million jobs were added in the period. The first half of the month saw municipal yields move steadily lower, as market participants' reinvested the robust coupon and maturity income from August 1st, coupled with continued demand in the form of fund inflows. However, after seeing the 10 year AAA muni spot touch a record low on August 12th, rates climbed higher for the remainder of the month. By the end of the period, municipal yields moved higher for the first time in three months, led by the long end in a slight steepening move. For the month, the 2, 10, and 30-year AAA yields moved higher by 3, 16, and 19bps, respectively. At Federal Reserve's annual economic symposium, the FOMC announced an update to its written policy statement. The surprise change called for an average inflation target of 2%, suggesting the Fed would keep short rates anchored down and allow for periods of inflation above the 2% level. In August, the Fed announced revised pricing for issuers accessing its Municipal Liquidity Facility, as borrowing costs were reduced by 50bps for each rating category. Despite market sentiment that the updated rates are still too penalizing, the New York Metropolitan Transportation Authority (MTA) became the second issuer to utilize the MLF program. MTA borrowed $450 million in notes from the facility after rejecting the bids received from banks on a competitive bond anticipation note sale.

Municipals traded in a narrow range for most of September, with the most significant price action coming on the last day of the quarter. Heavy municipal supply, a slowdown in maturing bond roll-off, and uncertainty around additional fiscal stimulus all weighed on the market. Ultimately, the municipal yield curve steepened marginally towards the

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Market update (continued)

end of the month, as the 2-year spot moved lower by 2 bps, the 5-year remained unchanged for the period, and the 10 and 30-year spots each moved higher by 6 bps. The month's new issue supply came in at $52 billion, well above the average of $31 billion for the month over the previous 5 years, and the largest total for any September on record. Net supply was a robust +$29 billion for the month, as the heavy summer redemption period cooled as the calendar turned to fall. The ratio of 10 year AAA municipals as a percentage of US Treasuries closed the quarter at 126%, well above the historical average of 85-90%, signaling municipals look attractive relative to their taxable U.S. Government counterparts.

Supply

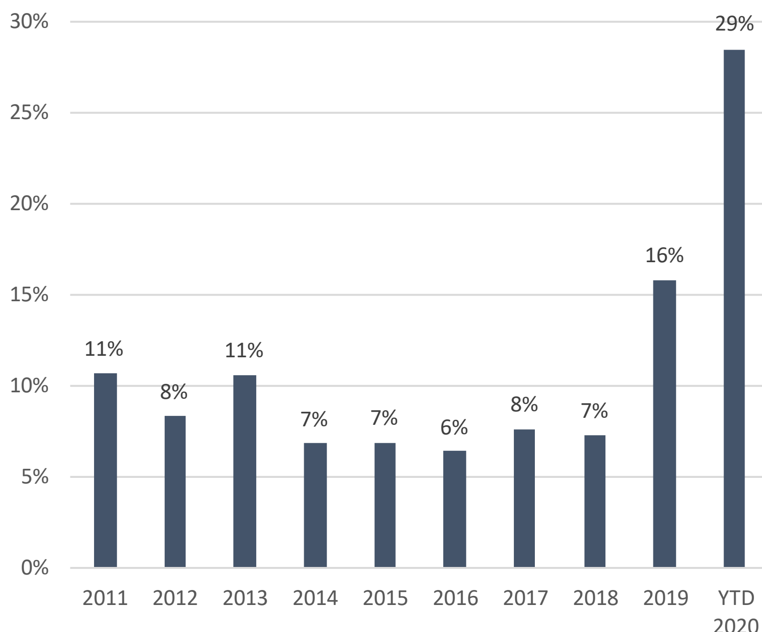
Robust supply continued, as Q3 saw new issuance of 140.6 billion, far exceeding the previous three-year, third-quarter average of 95 billion. Issuance surged as municipalities rushed to get ahead of any election induced volatility. However, the headline supply figure remains inflated as issuance was again led by taxable municipals, which accounted for $48.4 billion, or 34% of the total supply for the period. For comparison, from 2010 to 2019, taxable muni issuance averaged 11.5% of the total supply. The surge in taxable issuance is attributable to municipalities looking to capitalize on lower rates to refinance outstanding debt. Looking at pure tax-exempt figures, the 2020 YTD total of $224 billion is in line with $221 billion for the same period from 2019.

Fund flows

Demand for municipals remains strong, as flows into municipal bond funds were positive in all but the final week of Q3. Inflows totaled +$15 billion for the quarter or an average of $1.07 billion per week. The Lipper reported outflow of $775 million on the final week of the period broke a streak of 20 consecutive weeks of muni fund inflows.

FIGURE 4

Taxable Muni Issuance as % of total Issuance



Source: SIFMA

FIGURE 5

10 YR Muni vs. UST Ratio vs. 3 YR Avg

Source: MMD, US Treasury

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Contact Us:

3344 Peachtree Rd.
Suite 2050
Atlanta, GA 30326
(404) 261-1333

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assetpreservationadvisors.com

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