APA Q1 2019: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

Macroeconomic update

The first quarter played out to be a period of positive and even outsized returns for most major asset classes. Municipal bonds posted their fourth straight month of positive returns, while for the quarter oil was up 30%, the S&P 500 was up 13%, the broad Treasury index was up over 2% (of which 90% was gained during the last weeks of March), and gold and the dollar were each up roughly 1%. Market participants were left to ponder how numerous interrelated and often negatively correlated asset classes all finished the quarter in the green.

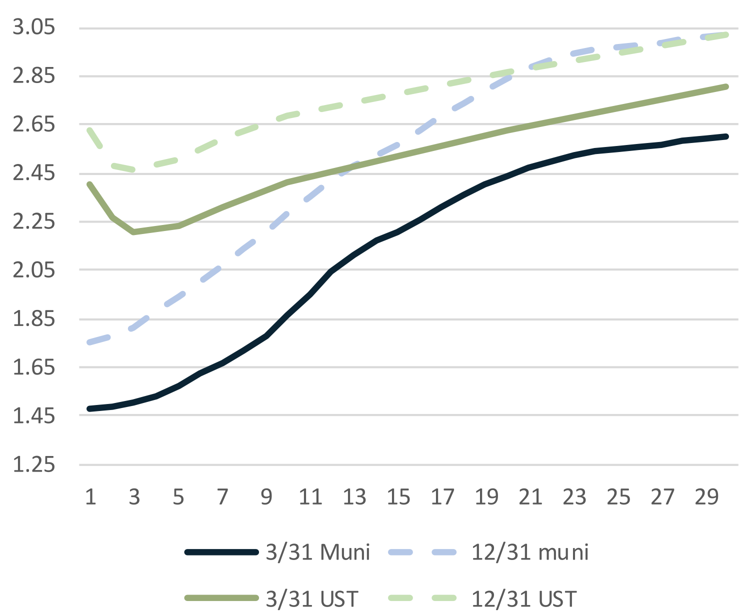
January saw most global central banks take a dovish turn. The now broadly questioned December Fed hike, as well as the two further hikes that had been priced into the market, were quickly reversed by traders. By the time the quarter closed, the short-end of the Treasury curve was pricing in 2 cuts by mid-2020, and the 3mo/10yr slope barely crept out of the inversion that lasted for several days over the latter part of March.

The shift by monetary policymakers coupled with constant trade headlines, weaker forward expectations by corporations from a fading tax-cut "sugar high," and a neverending Brexit process, and there was certainly a grab for yield, duration and carry that lasted through the quarter. The demand for fixed income products was buoyed by March's Fed meeting which resulted in an abandonment of further rate hikes in 2019, and the announcement that it would halt the decline of its balance sheet beginning in September. After the 10yr Treasury traded in a range of just 11.6bps in February, the tightest range for a month in two decades, March more than made up for the sleepiness with a 42.7bp trading range.

Continued weak economic data prints from European Union countries coupled with a clear, but maybe not fully disclosed, China slowdown, had GDP forecasts from the International Monetary Fund, many sell-side shops, and the closely followed Atlanta and New York GDPNow trackers, all calling for a global deceleration. Furthermore, traders at home were forced to contend with paused, delayed and even skewed data points as a result of the US Government shutdown. When data was released, excitement was stoked by several seemingly contradicting reports. Traders were perplexed as retail sales figures missed expectations while average hourly earnings were a beat, and as commodities prices ripped higher while inflation data softened.

FIGURE 1

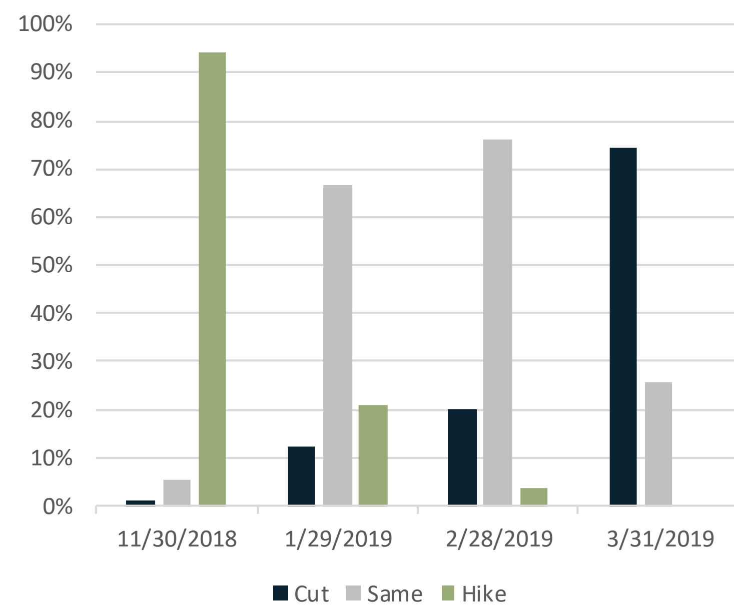
Yield Curves



Source: Bloomberg, Municipal Market Data

FIGURE 2

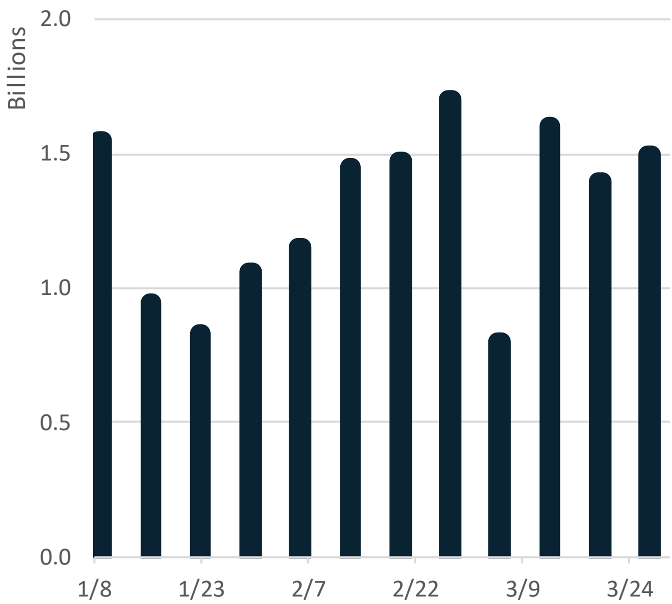
Probability of a Rate Change



Source: Bloomberg

FIGURE 3

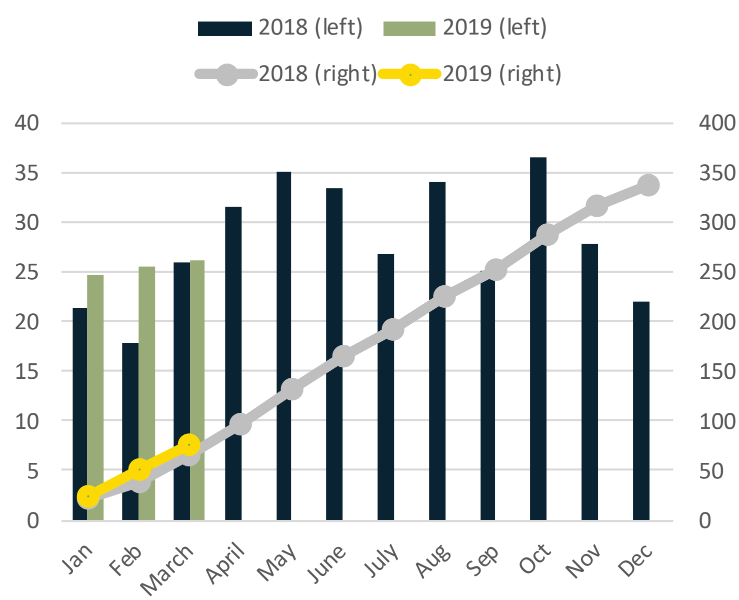
Weekly Fund Flows



Source: Bloomberg, Lipper Data

FIGURE 4

Monthly and Aggregate Supply ($bns)



Source: Bloomberg, SIFMA

Strong demand as taxpayers feel the effect of tax reform

These macroeconomic moves alone would've provided a tailwind for municipal bond returns. The large outperformance versus Treasuries, however, may have caught the average investor off-guard. As many high net-worth individuals are painfully finding out, the tax-cuts corporations received throughout 2018 may not have added cash to their pockets in the same way. We have spoken many times of the impacts of the Tax Cuts and Jobs Act and its effects on the municipal marketplace, but first quarter 2019 is when accountants and their clients placed a magnifying glass to the true consequences.

The well-publicized $10,000 cap on state and local tax (SALT) deductions buoyed demand for munis as investors searched for shelter from future tax bills. The quarter ended with 12 straight weeks of muni mutual fund inflows totaling $15 billion for the period or an average of $1.14 billion per week; good for the most robust start to a year since fund flow data collection began. On top of this new money from inflows, market participants have been actively putting cash to work from maturities and interest payments.

On the flip side, muni supply has been relatively muted, with gross issuance for the quarter coming in at $76 billion, or a decrease of -11.6% quarter over quarter. Furthermore, Q1 gross issuance was -11.1% below the trailing five-year Q1 average of $86 billion. Subdued supply coupled with the roll-off of maturing bonds has created periods of net-negative supply in the market. Or simply demand has outpaced supply, creating a strong technical environment for munis to outperform. Ratios to Treasuries are now near historically tight levels, with the 10yr AAA MMD/UST ratio closing the quarter at 78% vs. the historical average of around 85%.

Residents in high-tax states have felt the greatest impact on the cap of the SALT tax deduction, leading to an insatiable demand for tax-exempt products. Thus, yields on some credits in CA, NY and other states have been trading below those of the stated AAA MMD scale. Adding a 13% state income tax on top of CA residents may still allow munis make sense at current ratios; however, it is the extremely tight spreads and historically expensive ratios on general market names that are seeing the market wanting to take a breather heading into the new quarter.

A reversal in bond market sentiment

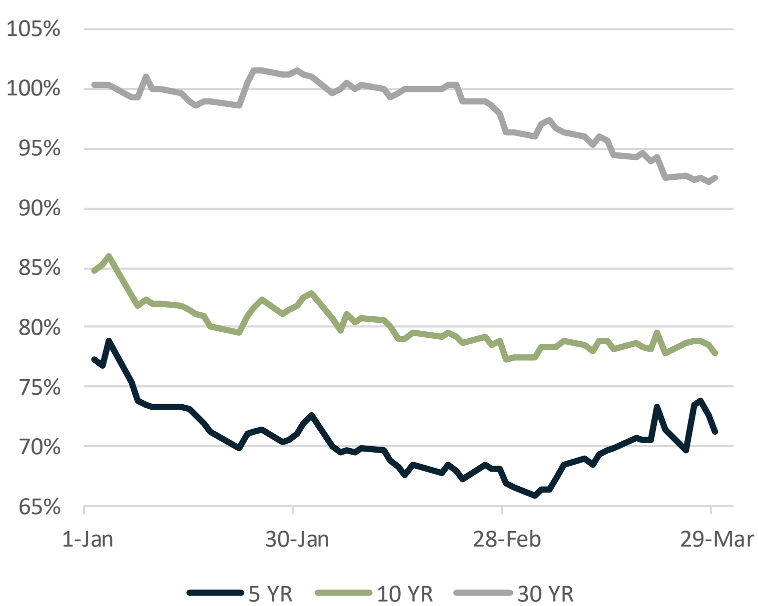
Municipal market strength was led by the long end as an abrupt flattening move took hold over the second half of the quarter. The MMD 2s-30s spread tightened from 140bps on February 15th to 111bps at the close of March. For the quarter, the 10yr and 30yr AAA MMD spots each declined by 42bps.

While the AAA muni curve has not followed the Treasury curve into a stated inversion, there are now daily trade prints that suggest otherwise – a very unusual occurrence in the municipal marketplace. Keep in mind, however, that the muni market is very ratio driven versus its taxable counterparts, so a 3-4 year tax-free may be deemed as "cheaper" on a ratio basis against a two year at a higher yield. While a Fed on pause certainly lends to a reach for extended duration products, the longer end of the muni curve can certainly be seen as a bit frothy at these levels.

APA is constantly analyzing the yield curve in an effort to target and identify the most value in each market. With the long end of the muni curve moving lower, and a market that has priced in interest rate cuts, we will begin to target opportunities in the belly of the curve, using maturing positions to build out a modified ladder structure. In doing so, we will look to take advantage of the Fed sensitive 5yr range and defend against a quick re-steepening, should we see any of the large inflows begin to reverse from the market.

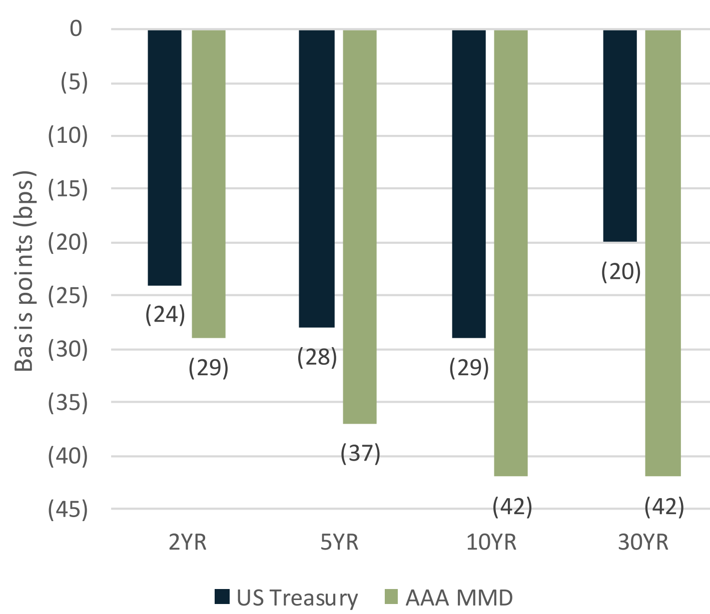
Tax time is historically a challenging period for tax-free performance as supply often picks up, fund flows turn negative as cash is distributed to meet tax payments, and clients' turn their attention to riskier asset classes. But, as we have seen, this may be no typical period.

FIGURE 5
MMD/UST Ratio Performance



Source: Bloomberg, Municipal Market Data

FIGURE 6
Quarterly Yield Changes



Source: Bloomberg, Municipal Market Data

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