APA Q2 2019: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

Municipal market strength continued during the second quarter as demand for tax-exempts remained robust. A dovish shift in global central bank sentiment sent yields lower, as markets began to price in rate cuts at home and additional stimulus abroad. Inflows into municipal funds continued for the quarter, while supply remained manageable.

Market update

The quarter began with the market digesting better than expected economic data at home, including an upside headline Q1 GDP surprise of 3.2%. As a result, Treasury yields to sold off mildly in April, while munis outperformed. The outperformance was most significant in the long end as the muni curve flattened in the face of a strong technical environment of low supply and high redemptions. From the beginning of the quarter through May 16th, the spread between muni 2 year and 30 year bonds tightened by 24 bps, while the 2-10s spread reached a low of just 21 bps. Muni outperformance continued through mid-May, as the ratio of the 10 year muni vs. UST yield flirted with an all-time tight of just above 70%.

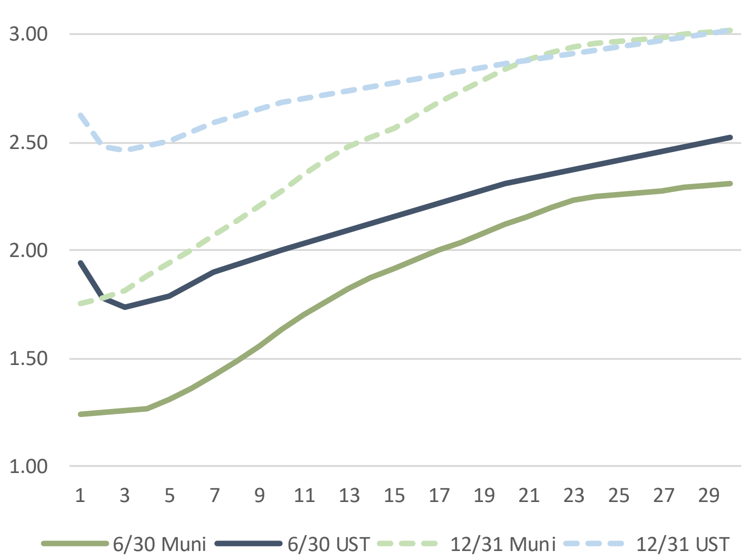
The market shifted the latter half of May through June, as dovish central bank rhetoric and weaker economic data at home and abroad grabbed headlines, coupled with US-China trade tensions. The June FOMC meeting left the market all but certain rate cuts were on the horizon, while the ECB signaled they were prepared to inject further stimulus into their markets to spur growth amidst weakening inflation expectations.

The dovish turn by central banks led to a grab for all assets, including yield, sending bond valuations higher and rates lower. While US yields have remained positive, the amount of global debt with yields below zero continues to balloon. Negative yielding global assets eclipsed a record $13 trillion during the second quarter, as the German 10 year government bond reached a low of negative 32 bps, the while the Austrian 10 year bond traded below zero for the first time.

Back home, the market began to price in easing by the Fed. As of the end of the quarter, the market priced in a 100% probability of a rate cut in July and is pricing in two additional cuts in September. As a result, the muni curve bull steepened during June, with the strongest performance coming for the 2 year and 5 year spots, where yields declined by 14 and 11 bps, respectively.

FIGURE 1

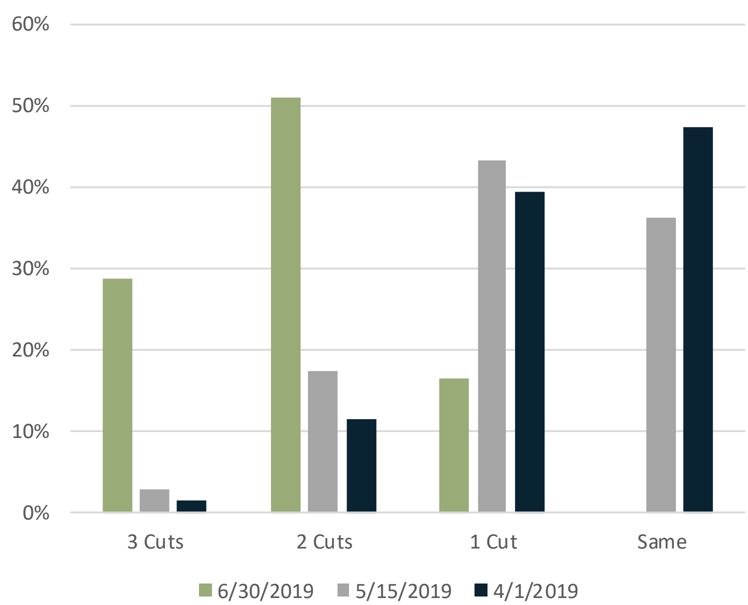
Yield Curves



Source: Bloomberg, Municipal Market Data

FIGURE 2

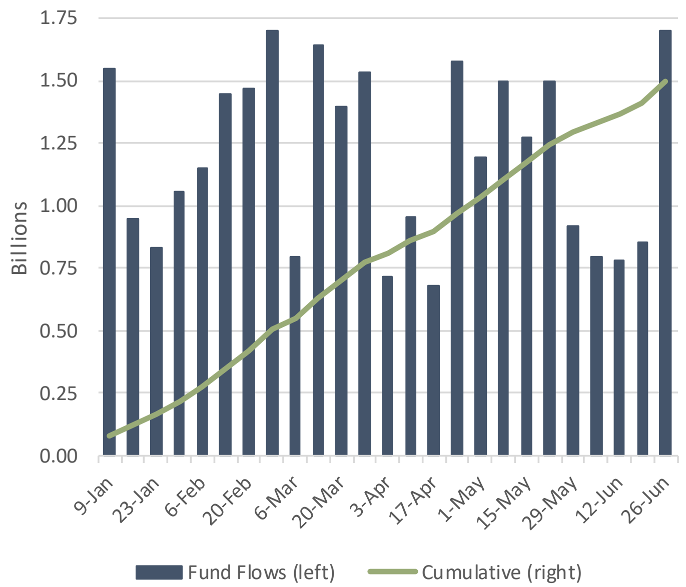
Probability of a Rate Change (by September 2019)



Source: Bloomberg

FIGURE 3

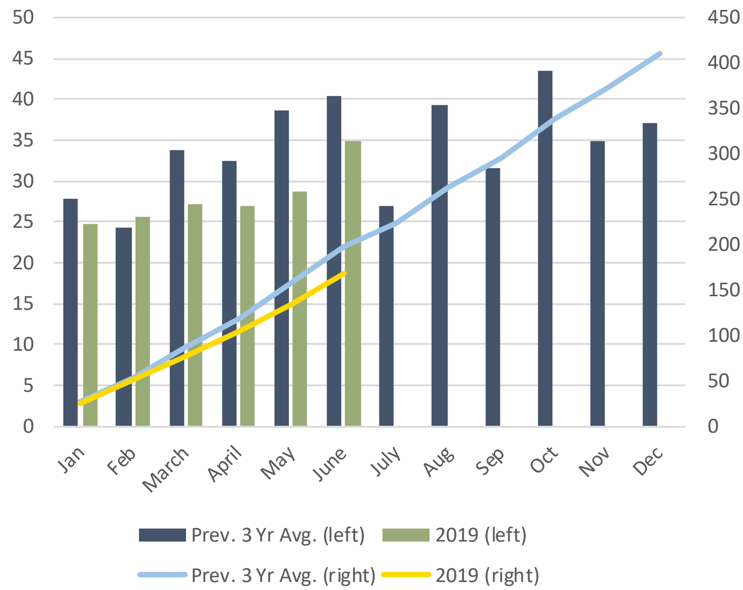
Weekly Fund Flows



Source: Bloomberg, Lipper Data

FIGURE 4

Monthly and Aggregate Supply ($bns)



Source: Bloomberg, SIFMA

Supply & redemptions

Muni issuance was sluggish to begin the year, but picked up by the end of the second quarter, with June gross supply coming in at $35 billion. Supply increased 17% quarter over quarter, for a total of $91 billion for the period. However, supply could not keep pace with redemptions, which totaled $96 billion during Q2, resulting in net supply of -$5 billion for the period. While the 10 year muni to UST ratio closed the quarter at approximately 80%, more in line with the historical average, ratios could face downward pressure ahead as we move away from what is typically the heaviest quarter for issuance (Q2) and enter the highly supportive technical summer environment of limited supply and high redemptions.

Fund flows

Positive fund flows persisted for the period, as fund inflows averaged a vigorous $1.1 billion per week. Furthermore, per Lipper Data, fund inflows have been positive for 25 straight weeks for aggregate inflows of just under $30 billion. Demand for tax-exempts has been driven by the Tax Cuts and Jobs Act's $10,000 cap on state and local tax (SALT) deductions.

APA positioning

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.

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