APA Q3 2019: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

Executive summary

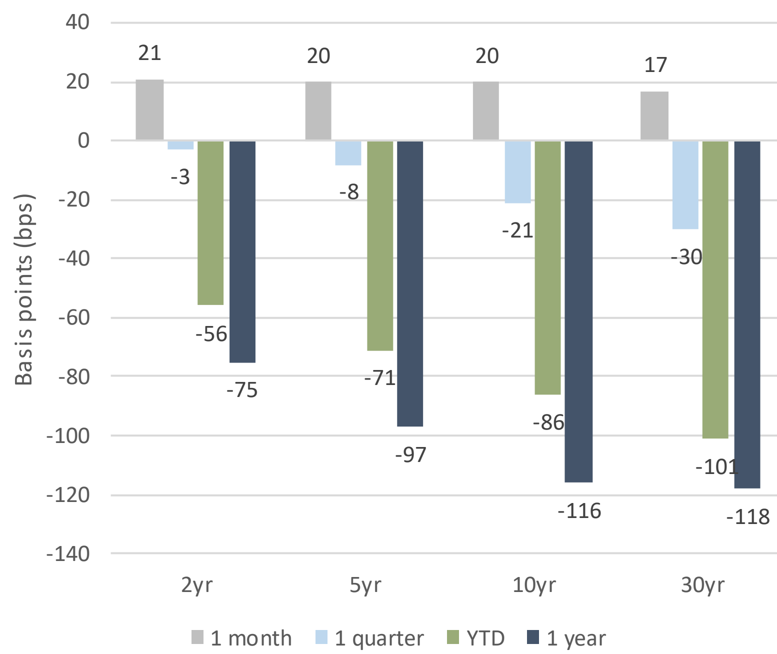
- The Fed cut the target range for the federal funds rate at the July and September FOMC meetings, in line with market expectations
- Inflows into municipal funds remained strong, reaching 38 straight weeks
- New issue supply picked up during the quarter, with August and September coming in as the most significant two month stretch of supply for the year
- With redemptions still outpacing new supply for the year, the trend of a shrinking municipal market continues. The total amount of municipal debt outstanding has decreased by $75 billion since the end of 2017
- The end of September brought flow of funds data, and recent trends continued with bank and insurance company holdings of municipals continuing to shrink as a result of changes in the tax rate
- US personal and corporate income tax receipts grew year over year, topping expectations, a positive for municipal credit

Market update

The quarter began with news of better than expected US economic data, including stronger than expected payrolls and retail sales reports released in July. Economic data beats coupled with a dovish Fed caused a pause in the downward trend of Treasury yields for the first month of the quarter. The Fed met market expectations, and for the first time in a decade, cut the target range for the federal funds rate by 25bps at the July meeting. While Treasury yields moved higher for the month, munis outperformed in the face of a strong technical environment of low supply and high redemptions.

FIGURE 1

Muni Yield Movements



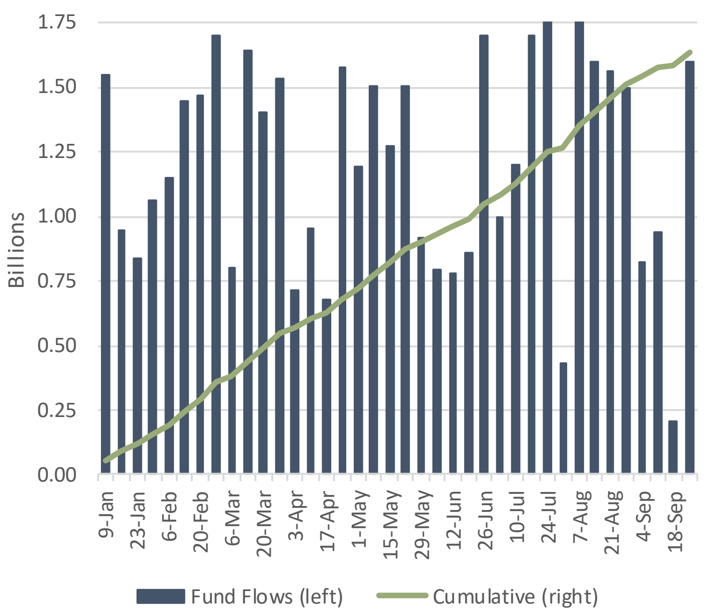
Source: Municipal Market Data

August brought a reescalation of US-China trade tensions and underwhelming global economic data, including news of a contraction of German GPD for Q2 2019. In a flight to safety trade, Treasury yields moved lower by 45-55bps for the month, to near all-time lows. The long end led the move lower in yields, and headlines focused on the inversion of the 2-10s Treasury curve, which lasted for a couple of trading days at the end of the period.

After reaching multi-year lows in August, September saw a rapid move higher in rates for the first couple of weeks of the month on positive trade headlines, a higher than expected CPI print, and a strong retail sales report. However, geopolitical tensions flared in the second half of the month, leading to a grab for yield, causing rates to sink during the final couple of weeks of the period. After touching a high of 1.90% on September 13th, the yield on the 10-year Treasury closed the quarter at a 1.65%. The Fed again cut rates at the September FOMC meeting, in a move that had been well priced in by the market.

FIGURE 2

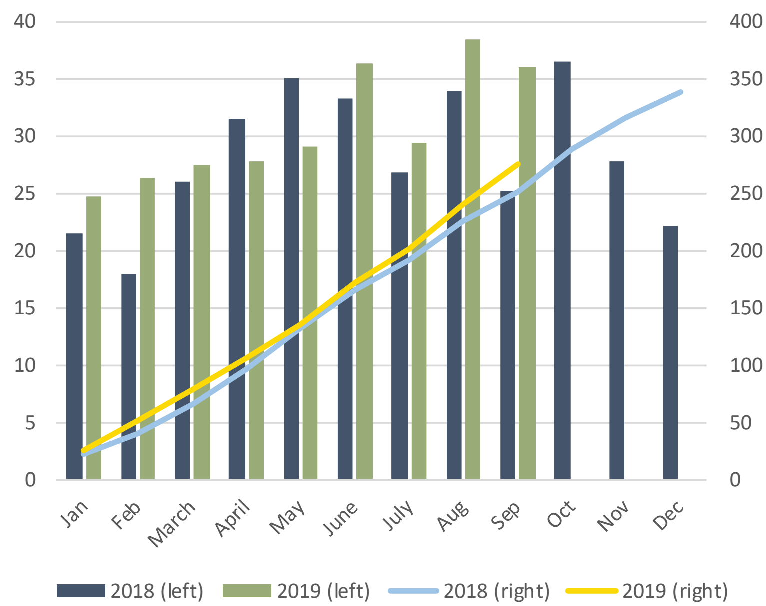
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Fund flows

Demand for tax-exempts remained strong, as flows into muni funds continued. The market has now experienced 38 straight weeks of fund inflows for a total of over $46 billion. However, flows did waiver somewhat towards the end of the quarter, a sign that investors are more hesitant to put cash to work at lower rates. September inflows averaged roughly $1 billion per week, down from nearly $2 billion per week in August and $1.5 billion per week in July.

Supply

September was defined by a large amount of issuance across the fixed income spectrum. Monthly Treasury auctions were joined by $196 billion of corporate bond sales (one of the highest monthly totals on record), and $36 billion of new muni issuance. Furthermore, August and September combined for the largest two month period of muni supply for the year. Issuance was 11% higher quarter over quarter as issuers rushed to the market to capitalize on record low interest costs.

Taxable municipal bond issuance has been one of the drivers of the increase in supply, as taxable issuance is up 50% year over year for a total of $30 billion year to date. Estimates call for taxable supply to reach $65 billion for 2019, compared to the trailing five year average of $30 billion. The uptick in issuance is attributable to issuers opting to advance refund outstanding deals by issuing taxable municipals, as tax-exempt advanced refundings were terminated as part of the Tax Cuts and Jobs Act (TCJA), effective January 1, 2018.

With issuers taking advantage of lower financing costs, forward supply calendars have swelled, and many firms are revising their 2019 issuance estimates upward. We believe supply will continue at a healthy pace, but not to a level that would overwhelm the market and pressure spreads. The recent boost in issuance has been welcomed by corporate and foreign investors in an era where an estimated $15 trillion of bonds globally have negative yields.

Redemptions & shrinking market

Redemptions slowed down in the final month of the quarter, totaling $20 billion for the month vs. an average of $37.3 billion a month for June-August. As a result, net supply came in at +$18 billion for the month, bringing year-to-date gross and net issuance to $277 billion and -$12 billion, respectively. With redemptions still outpacing new supply for the year, the trend of a shrinking municipal market has continued. The total amount of municipal debt outstanding has decreased by $75 billion since the end of 2017. The shrinking market has been supportive to performance and could place downward pressure on spreads going forward.

Muni flow of funds data

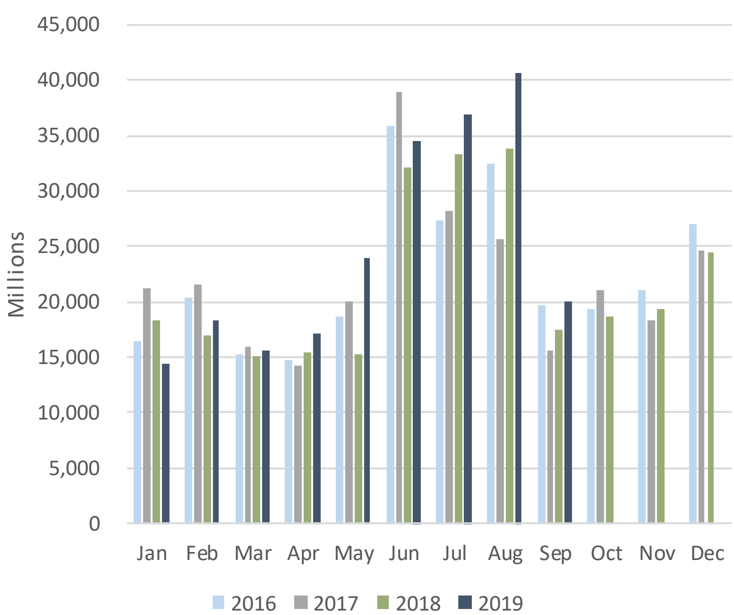
The end of September brought the Q2 flow of funds data and revealed that banks continued the trend of shedding their muni holdings. Bank holdings declined by -$13 billion as a result of changes in the corporate tax rate. However, muni mutual funds, ETFs, and SMA accounts have more than picked up the slack, increasing their holdings by $46 billion over the quarter.

State tax revenues

Also released in late September was Q2 2019 local tax revenue figures. The data show personal and corporate income tax revenues exceeded expectations, signs that the effects of the Tax Cuts and Jobs Act continue to be a positive for states' fiscal well being. Furthermore, the positive effects of the TCJA on state tax revenues, combined with strong economic growth and low unemployment, has helped to boost underlying credit fundamentals for many states. This is captured in an overall positive credit rating trend, which is the strongest since Q1 2017.

FIGURE 4

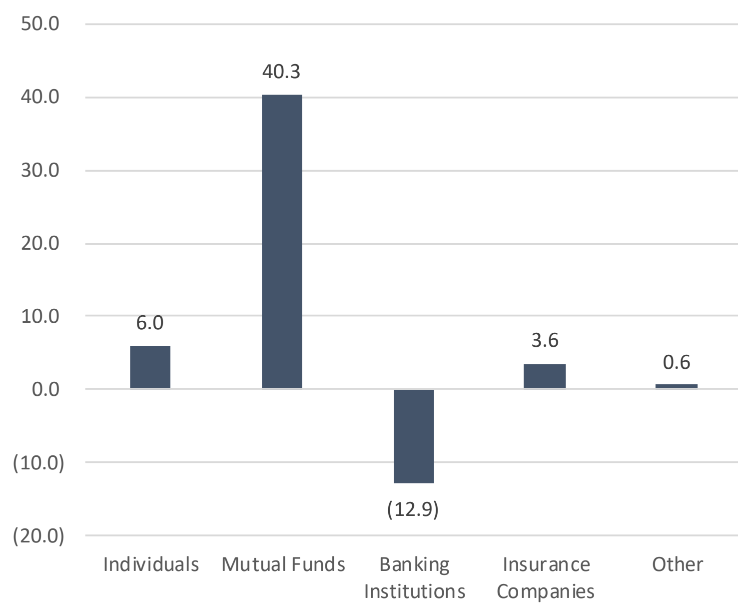
Total Monthly Redemptions



Source: Bloomberg, Loop Capital

FIGURE 5

Changes in Muni Holdings (Q2 2019)



Source: SIFMA

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