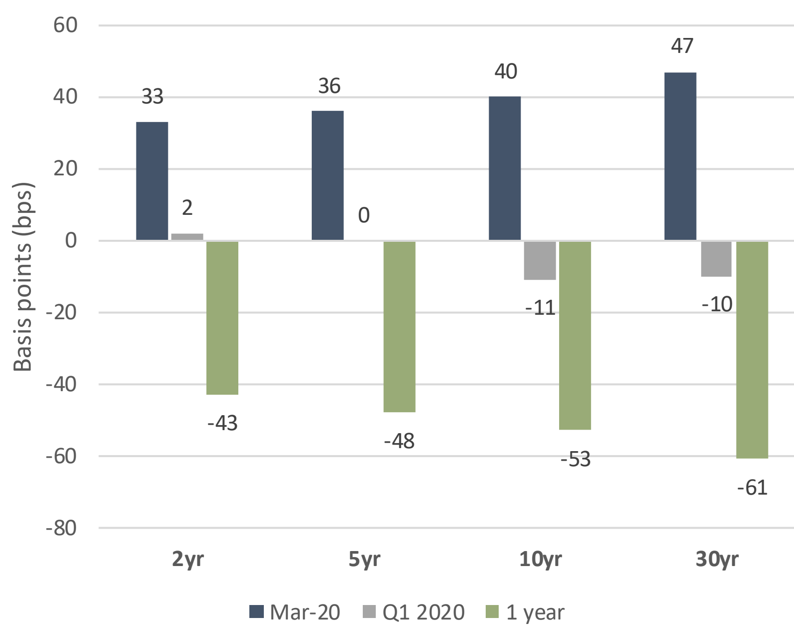
Quarter highlights

- Municipal performance was strong the first two months of the year, as demand remained robust and the "January effect" was in full swing
- COVID-19 news dominated headlines, causing unprecedented volatility as markets digested the impacts
- After 60 consecutive weeks of inflows, municipal bond mutual fund flows turned sharply negative in March
- Liquidity challenges caused municipal yields to rise most of March, before whipsawing back to close the month on the passage of the CARES Act, which includes support to the market and muni issuers
- After steady new issue supply in January and February, issuance ground to a halt in March
- APA is concentrating on sectors that we believe are more insulated from credit deterioration and event risk surrounding the fallout from the COVID-19 pandemic

Market update

FIGURE 1

Muni Yield Movements



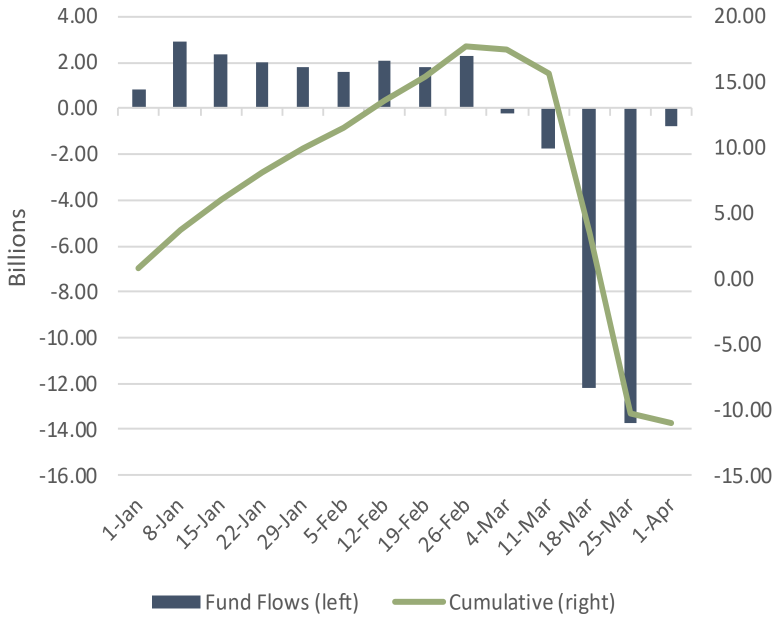
Source: Municipal Market Data

After a quiet start to the quarter, Treasury yields declined sharply towards the end of January in a flight to quality trade as risk assets sold off on news of the COVID-19 virus. The Treasury curve flattened for the period, as 10-year and 30 year Treasury yields moved lower by 41 and 40 basis points, respectively. Municipal yields followed suit, as the "January effect" was in full swing. During this period, cash coming due from maturities and coupon payments tends to outpace new issue supply, which is supportive for municipal performance. The 10 year AAA muni yield closed the month at an all-time low of 1.15%. Also of note for the month, on January 29th, the House released a $760 billion infrastructure plan. While the passage is unlikely in an election year, the bill notably proposes the utilization of the muni market for financing tools. Such tools include reinstating the Build America Bond (BAB) program, expanding the use of private activity bonds, and restoring the use of tax-exempt advance refundings. Finally, as expected, the Federal Open Market Committee (FOMC) left rates unchanged following their planned meeting on January 29-30th.

In February, news of COVID-19 dominated headlines as the virus began to spread globally, including the revelation of the first case reaching the United States. After reaching record highs mid-month, equities declined 11% to close out February, erasing all year to date gains. The flight to quality trade continued, as Treasury yields broke through all-time lows, with the 10 year yield closing the month at a then-record low of 1.15%. Muni yields declined for the period

FIGURE 2

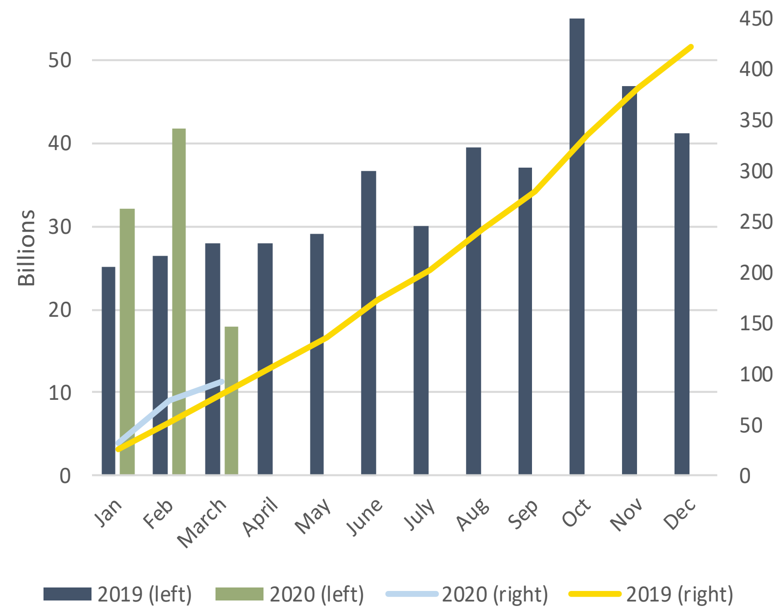
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

as well, but lagged behind Treasuries, as ratios increased slightly for the month. Flows into municipal mutual funds continued, reaching 60 consecutive weeks.

The global market selloff accelerated into March, as unprecedented volatility took hold. The World Health Organization upgraded COVID-19 to pandemic status, and countries around the globe went into lockdown to mitigate the spread of the virus. As a result, markets were forced to grapple with the increased likelihood of a severe recession. In an effort to prop up the economy, the FOMC cut rates twice in the period, down to a range of near-zero.

Treasury yields continued to dive lower, as the 10 year yield closed at 70 basis points, or 43 basis points lower for the month. Municipals shunned the usual guidance of Treasuries and were caught in the crossfire of the mass-selling that took place across asset classes. After 60 consecutive weeks of inflows, muni mutual fund companies closed the quarter with five straight weeks of net redemption requests as the market was flooded with bid lists from investors looking to raise cash. For the week ending March 18th, municipal mutual funds experienced cumulative outflows of $12.2 billion, topping the previous weekly outflow record of $4.5 billion. However, the title was short-held, as the week ending March 25th saw muni mutual fund outflows of $13.7 billion.

The liquidity crunch that played out in March was intensified as broker-dealer balance sheets, and appetite for risk-taking, are down in the wake of the financial crisis. By default, fund companies have become an increasingly important source of market liquidity. Thus, as fund investors headed for the exits at the same time, there were far more sellers than buyers in the market. This created a cycle where funds were forced to sell at prices below market value to meet redemption requests, leading to lower returns, spread widening, and more outflows.

Market update (continued)

However, the intense selloff quickly reversed course over the final week of March. Shortly after muni/Treasury ratios reached record highs, with tax-free municipal yields trading at many multiples of Treasuries, large institutional or ”crossover” buyers stepped in to provide support on select names and structures. Furthermore, market sentiment improved with the passage of the America CARES Act, which provides funds to municipal issuers and includes language for Federal Reserve to be able to purchase short-dated muni securities. After seeing the 10-year AAA muni yield move higher by 193 bps over the two week period ending March 23rd, the market whipsawed back to rally by 146 bps over the final week of the month, to close at a 1.33%; good for a seemingly innocuous 11 bps decrease for the quarter.

Supply

New issue supply started the year strong as issuers took advantage of favorable market conditions to come to market. January and February saw issuance of $78 billion, a 44% increase over the same two-month period from last year. Supply was again led by taxable advanced refundings, which totaled a robust $19 billion for January and February.

However, with the volatility that grabbed hold in March, issuance conditions deteriorated, and supply ground to a halt. Total issuance for the month was $19 billion, much lower than the trailing 5-year average of $35 billion. This brought Q1 gross issuance to $91.8 billion, good for a 15% increase of the same period last year.

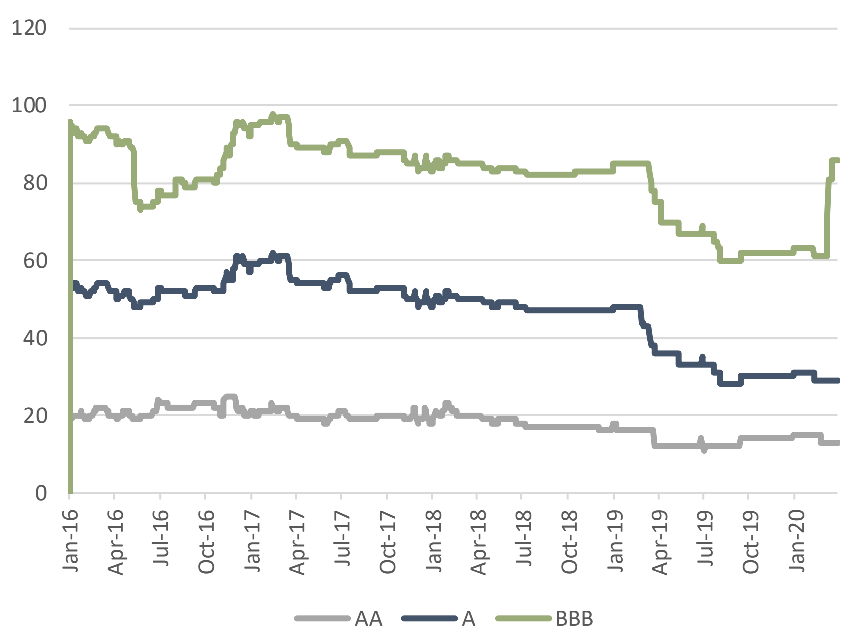
APA focus on quality

(from APA white paper published April 2020, “Sector Selectivity)

Over the past several years, and particularly the latter part of 2019, credit spreads reached all-time tight levels, to a point where credit risk was essentially not being priced into the market. During this period, APA took a high-quality bias across all our portfolios and took advantage of market conditions to work out of weaker credits more susceptible to such event risk. While this was a headwind to performance during periods of spread tightening, a high-quality tilt has served investors well during the recent volatility. At this point, we are comfortable with our positioning and our continued focus on high-quality issuers.

FIGURE 4

Spread to 10 YR AAA Muni Yield (bps)



Source: Municipal Market Data

APA is concentrating on sectors that we believe are more insulated from credit deterioration and the risks associated with underfunded-pension liabilities. Specifically, we continue to focus on water, sewer, and electric bonds because of those services' indispensability in Americans' everyday lives. Even in tough times, customers are likely always to pay those bills to avoid shutoff. Also, issuers of such bonds usually have more than sufficient liquidity and offer bondholder protections, including rate covenants, debt-service-coverage-level minimums, and a reserve fund. Additionally, certain school bonds are attractive because they rely on a dependable source of revenue — property taxes — and state enhancement programs. APA avoids issuers with exposure to risks associated with underfunded pension obligations, at both the state and local level. We maintain that underlying, pension-related financial metrics provide insight into the overall credit strength and discipline of the issuer. Additionally, many high-quality municipal securities have backstops for investors, notably state guarantees, the backing of permanent school funds, and a history of healthy cash reserves. Securities with characteristics like those, APA believes, are likely to retain their value, even during unpredictable periods.

Sector weightings

In the wake of the COVID-19 pandemic, APA's credit research group has updated their sector overweights:

Sector	Rationale
School Districts	Enhancement programs, prefer property tax based, high collection rates, lower expenses while not physically operating, single source of service (education)
Water Revenue Bonds	Essential service, increase in usage, typically have strong liquidity levels, additional bond holder protections such as rate covenants and reserve funds
Sewer Revenue Bonds	Essential service, increase in usage, typically have strong liquidity levels, additional bond holder protections such as rate covenants and reserve funds
Electric Revenue Bonds	Essential service, increase in usage, typically have strong liquidity levels, additional bond holder protections such as rate covenants and reserve funds

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