APA Q2 2020: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

Quarter highlights

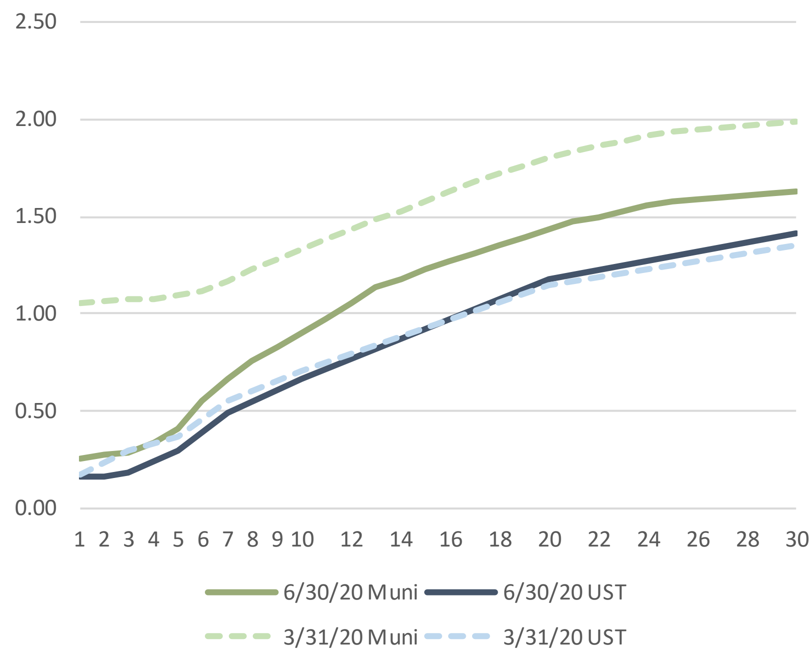
- The quarter began with markets digesting the first pieces of data measuring the economic impact of the COVID-19 pandemic
- Asset classes rallied off of late March lows on optimism around states reopening, as well as continued signs of financial support from Congress and the Federal Reserve
- In the muni sector, the Fed announced the creation of the Municipal Liquidity Facility (MLF) to help stabilize state and local governments
- After pausing amid the pandemic-related shutdown, primary market supply was robust in the second quarter, coming in at $108 billion
- The quarter concluded with seven consecutive weeks of inflows into municipal-funds, averaging $1.5 billion a week
- With a surge in issuance, APA believes taxable municipal bonds are worthy of investors' attention

Market update

The quarter began with the markets digesting the first pieces of data measuring the economic impacts of the COVID-19 pandemic. The March unemployment report released in early April showed payrolls fell by 701,000, while the unemployment rate ticked up to 4.4%. This was the first decline in payroll growth since 2010. Furthermore, the first-quarter GDP came in at -4.8%, the most significant drop since 2008, while personal consumption and home sale data missed to the downside.

FIGURE 1

Muni & Treasury Yield Curves



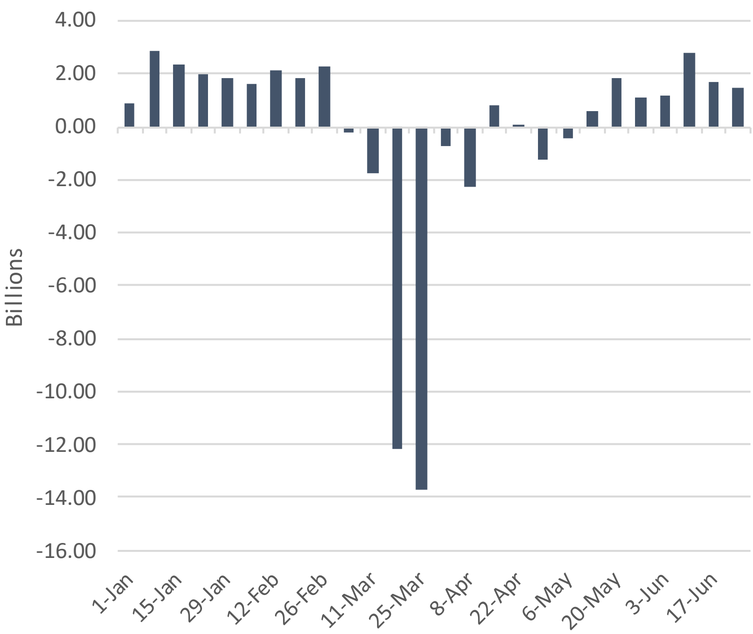
Source: Municipal Market Data, US Treasury

However, risk assets rallied from late-March lows thanks to massive stimulus efforts, including the Main Street Lending Program and the Paycheck Projection Program, which injected needed liquidity into the economy. Specific to municipals, the Fed also announced the creation of the Municipal Liquidity Facility (MLF) to support pressured state and local governments. In the launch of the MLF program, the Fed committed to lending up to $500 billion to a special purpose vehicle to purchase short term securities directly from issuers.

While Treasuries remained relatively flat in April, the muni curve steepened over that month, leading to a decline in

FIGURE 2

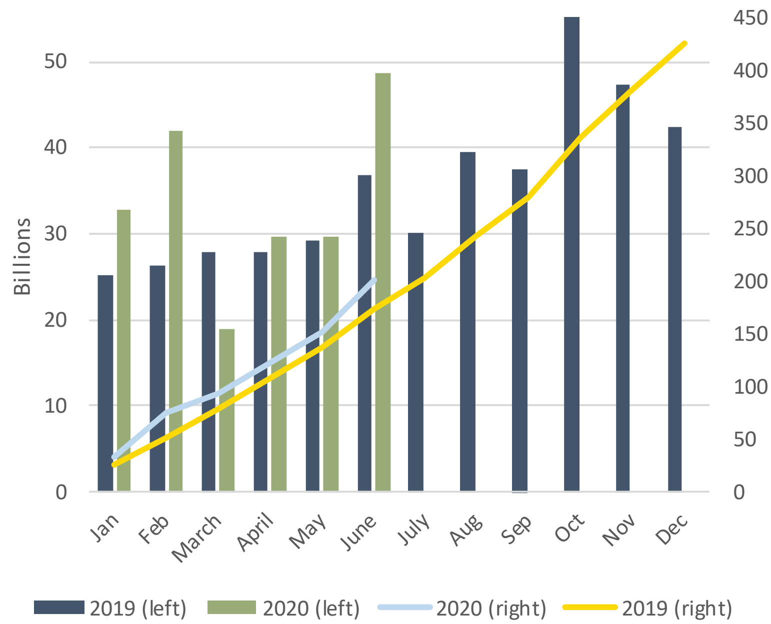
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

muni/Treasury ratios on the short end of the curve but nudging slightly higher in the intermediate to long spots. The one-year ratio ended April at 482% (March close 691%), the 5 year 319% (March close 297%), 10 year 236% (March close 197%), and the 30 year 180% (March close 150%). For the month, the 1 year AAA MMD spot moved lower by 24 bps, while the 2-10 year spread widened by 28 bps for the period.

May brought a significant rally across asset classes on optimism around the news of states re-opening as well as continued signs of legislative and Federal Reserve support. Additional muni market support came from favorable supply-demand technicals, driving tax-exempt yields lower across the curve by 62-75 bps. The front end led performance, as the one and two-year spots moved lower by 70 and 75 bps, respectively, on the back of the Fed's commitment to keeping short rates anchored down for the foreseeable future. With Treasuries continuing to remain rangebound, municipal/Treasury ratios plummeted on the short end, as the one-year ratio closed the month at 64% (April close of 482%).

Additionally, May brought the formal launch of the Fed's MLF, including the release of the pricing table and the establishment of the application materials. The pricing table, more severe than expected, suggested, at least in the muni space, that the Fed wants to be the lender of last resort.

After two months of steep declines, the unemployment report released in early June brought a positive surprise, with nonfarm payrolls coming in at +2.5 million, while estimates were calling for a decrease of 7.5 million. Auto- and retail-sales figures also beat expectations, which indicated rebounding consumer confidence despite the global slowdown.

Market update (continued)

After a slight selloff on the heels of the unemployment report, municipal yields joined Treasuries in a rangebound trade in June, with the muni curve flattening mildly as intermediate to long spots outperformed.

In June, the Federal Reserve announced an additional expansion of the Municipal Liquidity Facility, stripping the previously in place population requirements for access. Additionally, the expanded program gave governors the authority to "designate two issuers in their jurisdictions whose revenues are generally derived from operating government activities (such as public transit, airports, toll facilities, and utilities) to be eligible to directly use the facility." The State of Illinois became the first issuer to use the Fed MLF, borrowing $1.2 billion in early June through the issuance of one-year notes.

Supply

After pausing in March, primary market supply resumed in the second quarter, as issuers capitalized on lower rates to save on interest costs and to obtain financing to support operations. Issuance for the quarter totaled $108 billion, a 15% increase quarter over quarter, and 16% higher than the same period in 2019.

Taxable municipal issuance continues to lead the way, accounting for $28 billion of the quarter's total. This was good for 26% of all supply, far outpacing the previous five-year average of 8.8%. June, too, was a robust month for supply, which came in at $48.6 billion, with taxable municipals accounting for $17.5 billion of issuance or 36%.

Fund flows

After sharp outflows out of municipal mutual funds to end Q1, the pace of outflows slowed at the beginning of April and turned decidedly positive by mid-May. The second quarter ended with seven consecutive weeks of fund inflows, averaging $1.5 billion a week. Fund flows for the quarter totaled +$7.5 billion, though year-to-date flows are still in the red, at -$3.4 billion.

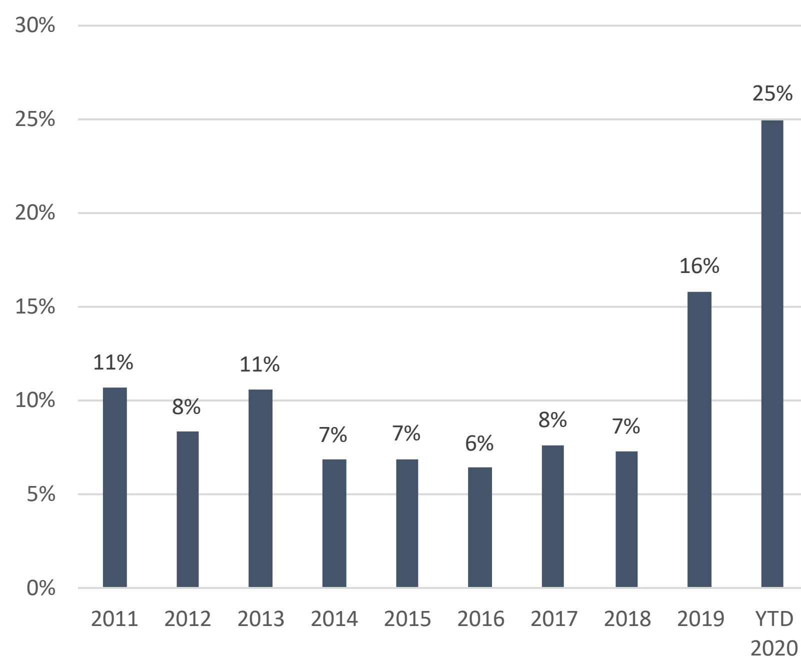
Taxable municipal bonds

As mentioned in the supply section, the trend of increased taxable-municipal issuance, which began in 2019 but stalled in March, resumed with force in the second quarter. Overall, new supply of federally taxable municipal bonds rose to $50.6 billion for the first half of this year, an amount greater than total annual issuances for four of the previous five years. Total taxable muni issuance in 2019 was $67 billion, or more than two times the average ($27.8 billion) from 2014 through 2018.

Although issuers have enjoyed the greater flexibility that comes with utilizing taxable municipal bonds since their

FIGURE 4

Taxable Muni Issuance as % of total Issuance



Source: SIFMA

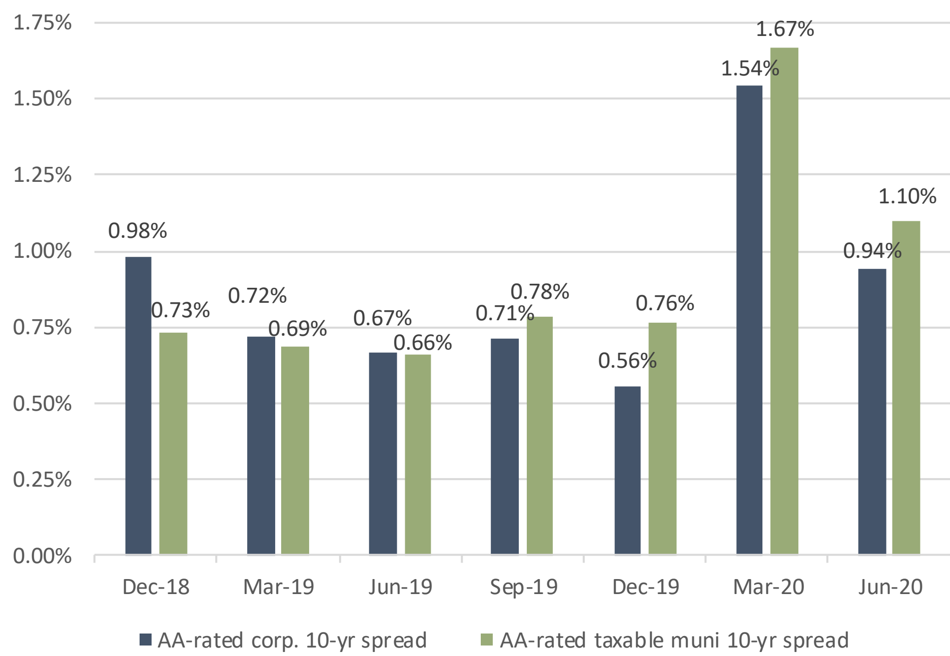
creation, this has remained a relatively quiet section of the market, save the explosion of issuance in 2009-2010 that occurred as part of the Build America Bond (BAB) program. The more recent uptick in supply is attributable to the passing of the 2017 Tax Cuts and Jobs Act, which included a provision eliminating tax-exempt advanced refunding for municipals. As a result, municipalities looking to refinance outstanding debt now must issue taxable municipals to do so. Issuers have frequently been able to save on interest costs through such issuance in recent years, with interest rates at or hovering near historic lows.

Many investors, it seems, have historically overlooked the taxable muni sector in favor of their corporate counterparts. However, after corporate bond yields spiked in the early stages of the COVID-19 pandemic, spreads quickly reversed on news of direct Fed support. As the Fed continues to be a significant participant in the corporate market through purchases of bonds and ETFs, corporate yields have stabilized and spreads have become more compressed. Conversely, in the taxable muni market, no direct Fed involvement coupled with increased supply has placed upward pressure on yields.

As a result, APA believes taxable municipals offer value. As detailed in the chart below, the spread of taxable municipal bonds has widened versus comparable-rate corporate bonds, a trend that APA believes will remain over the near term. Considering the additional benefits of taxable municipals, including enhanced diversification, generally higher credit quality, typically lower default rates, and in-state tax exemption, APA believes this is an asset class worthy of more investor attention.

FIGURE 5

Spread to 10 YR US Treasury



Source: Bloomberg

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APA-20-219

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