Executive summary

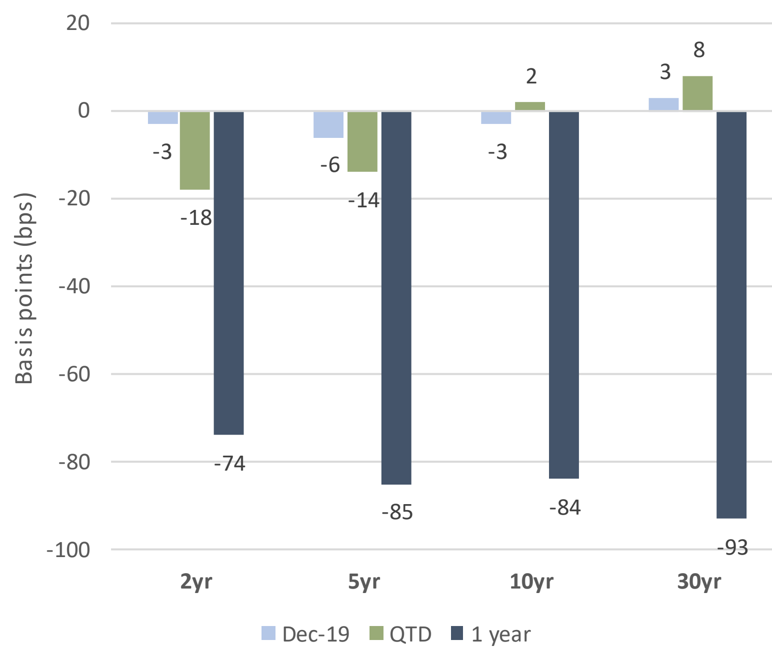
- US-China trade news dominated headlines, as the market seesawed back and forth on the prospects of a deal being reached
- The Fed cut rates for the third time in 2019, and signaled they would remain "on hold" over the near term, barring any shocks to the market
- New issue supply surged in Q4, led by an increase in taxable advanced refundings
- 2019 finished with 51 consecutive weeks of mutual fund inflows for a total of $65 billion, the greatest annual period since records began in 1992
- In a report released by the Urban Institute for October, preliminary data show improvements in state tax collections, a positive for municipal credit
- Throughout 2019, APA looked to opportunistically transition our High-Quality Intermediate strategy to more of a "modified ladder" structure
- APA's credit research and trading teams update their sector weightings heading into 2020

Market update

The quarter began with economic data sending mixed signals. Manufacturing data continued to disappoint, while the jobs report released in early October signaled strength in the labor market as the unemployment rate fell to 3.5%, the lowest level since December 1969. However, as was the case for much of the latter part of 2019, economic data took a back seat to US-China trade headlines, as the market seesawed back and forth on the prospects of a deal being reached. Positive signals from both parties on a "phase one" deal caused risk assets to rally and bond yields to move higher around the middle of the month. October closed with the Fed meeting market expectations and cutting rates for the third time in 2019. However, bond yields dropped on signals that the Fed would stay "on hold" over the near term, barring any unexpected shocks to the market.

FIGURE 1

Muni Yield Movements

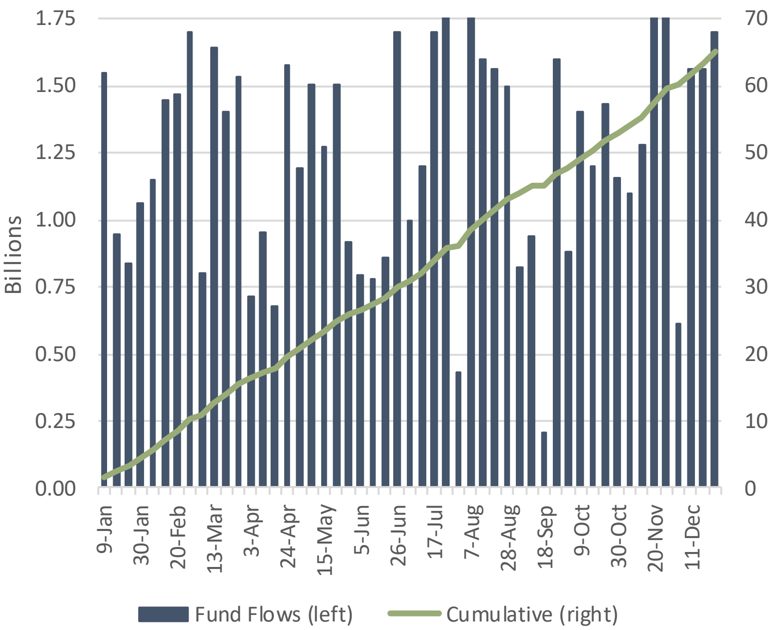


Source: Municipal Market Data

US-China trade negotiations continued to dominate markets in November. Optimism surrounding a deal placed upward pressure on yields, as the 10-year Treasury yield touched a four-month high of 1.95% on November 8th. Minutes released by the FOMC detailed a more cautious outlook for the US economy and shifted market bias toward further cuts, though not immediate. This news caused bonds to rally as the yield on the 10-year Treasury dropped the second part of the month to close November at a 1.78% (though still 9bps above the October month-end level).

FIGURE 2

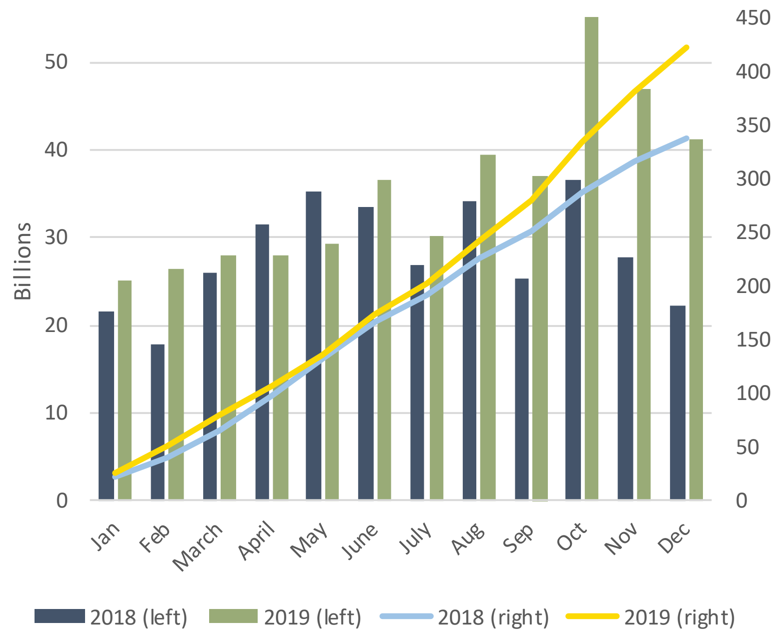
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

December brought news of robust job growth from November, as nonfarm payrolls surged by 266,000, beating the consensus estimate of 187,000. Additionally, an announcement of a "phase one" US-China trade deal pleased equity markets and caused bonds to sell off/yields to rise over the second part of the month. The 10-year Treasury yield closed 2019 at a 1.92%, 74 bps lower for the year.

Supply

One of the biggest stories of the quarter and the second half of 2019 was the large amount of new issuance that came to the market. Q4 2019 saw new supply of $144 billion, a 55% increase over the same period in 2018. Issuance was led by an increase in taxable advanced refundings as declining interest rates, and a flattening of the yield curve created an environment of interest cost savings for issuers. Taxable issuance totaled $37 billion for the quarter, bringing the 2019 total to $67 billion, a staggering 141% increase over the previous five year average of $28 billion. Total muni issuance for 2019 came in at $423 billion, of which $250 billion came over the second half of the year.

We expect new issue volume to remain strong into 2020, and for supply to continue to be easily absorbed by the market. Factors supporting a favorable issuer environment include an accommodative Fed, low inflation, and global sovereign yields near historic low levels.

Fund flows

Another theme for 2019 was the consistent demand for municipals in the form of mutual fund inflows. The year finished with 51 consecutive weeks of mutual fund inflows for a total of $65 billion, the greatest annual period since records began in 1992. Inflows for Q4 2019 averaged a robust $1.4 billion per week, which helped munis outperform Treasuries as ratios tightened across the curve.

We believe demand for municipals should continue to remain healthy. With the passing of the Tax Cuts and Jobs Act (TCJA) in 2017, municipals remain as one of the best sources for investors seeking to earn tax-exempt income and minimize their tax liability. Furthermore, we expect demand for taxable municipals to remain strong as negative sovereign yields globally should continue to attract non-traditional investors looking for yield with relatively high credit quality.

State tax revenues

In a report released by the Urban Institute for October, preliminary data show improvements in state tax collections. Year over year growth was seen in three tax sources: personal income tax, corporate income tax, and sales tax. The report signaled total state tax revenues increased by $66 billion, 6.9% higher than a year earlier.

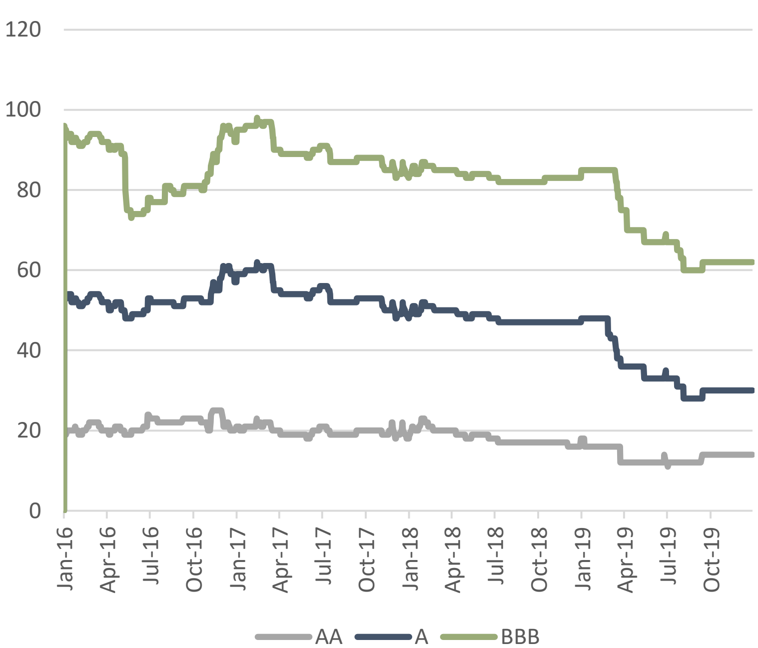
The increase in revenue growth has been a positive for general obligation municipal credit. Additionally, revenue bonds have benefited from continued economic expansion. Overall credit quality improved in 2019 as signaled by the market experiencing twice as many upgrades as downgrades.

APA Positioning

For those that have been following APA closely for years, they have heard us speak on the barbell strategy at length. We moved into this portfolio positioning during a period of record-low, 0% Fed Funds rates, taking advantage of the very steep yield curve to lock in longer-dated positions at yield premiums over their shorter-dated counterparts, while also maintaining the high liquidity of positions due to mature inside a couple of years. We stuck with this strategy throughout the tightening cycle of the Fed, as they raised short-term rates from December 2015 through December 2018, which led to a severe flattening yield curve. We felt, however, that the Fed might have gone too far with their final hike of 2018 and envisioned possible cuts to the overnight lending rate in 2019. It has been 12 months now since APA began opportunistically transitioning our high-quality strategy to a modified ladder. We will continue to maintain that posture as we feel the Fed is on hold, or possibly being forced to cut rates further, which could lead

FIGURE 4

Spread to 10 YR AAA Muni Yield (bps)



Source: Municipal Market Data

FIGURE 5

AAA Muni 2 YR—10 YR Spread (bps)

Source: Municipal Market Data

to a further steepening of the yield curve. Historically, the barbell strategy tends to perform well in a flattening yield curve environment while a modified ladder may offer greater value in a steepening environment. And while we are always cautious of over-priced portions of the tax-free muni curve, we will look to maintain a higher percentage in the Fed-sensitive belly of the curve (3-7 years) as well as where we find comparable value versus taxable counterparts in the 10+ year maturity buckets.

We have also utilized this period of market strength to move our portfolios, across all strategies, to more high quality, higher-rated tilt. The overwhelming demand the tax-free market has seen over the last 12-months has compressed credit spreads to record tights, and we feel there are many pockets of the market where investors are not getting compensated for taking on additional credit risk. While we don't anticipate a near-term credit event, our defense is against spread widening during market volatility and potential outflows.

As discussed above, the TCJA has greatly impacted the tax-free market and the value of tax-exempt income for high net worth individuals; it has also changed the landscape for issuers, and the bond structures they are able to bring to market. The historical norm of the 10-year optional call date for municipal issuers has been set aside in favor of shorter call dates, 6-8 years, to give issuers the flexibility to re-finance outstanding debt should interest rates stay low or move lower. While this has created a shorter duration market at current evaluations, our concern is the grab for lower coupon positions that have accompanied this low-interest-rate environment. Recently, 3% and 4% coupons have taken on a more significant percentage of the overall market, and thus far have been easily absorbed by record inflows, as fund managers have been forced to turn a blind eye to the inherent risk of lower coupon debt in a rising rate environment. APA has continued to focus on high coupon bond structures for not only their defensive nature due to the higher cash flow, but also to maintain a higher degree of liquidity should we see softening demand and rising rates. Historically, the realization of the de minimus rule of tax-exempts leads to liquidity evaporating quickly on lower coupon debt until the fair discount price is achieved.

As credit spreads have tightened to historical tights and could still move tighter, we believe that the (minimal) yield pick-up of lower coupon debt could lead to further demand for some time. We have not yet, however, moved to the belief that BBB-rated bonds should trade at the same valuation as AAs, and that sub-4% coupons are the new 5s. Thus we will use this period of strength to continue to focus on individual opportunities to add defensiveness and a higher degree of liquidity for our managed portfolios.

Sector Weightings

APA's credit research group and trading team have updated their sector weightings as detailed in the table below:

Sector	Weighting	Rationale
Airports	Overweight	Cash rich issuers, an essential service, limited future debt issuance
Public Higher Education	Overweight	Affordability, increased enrollment expected; state backing
States	Overweight	Overweight in growth states, underweight in non-growth states
Hospitals	Underweight	Merger challenges, continued financial challenges, increasing costs for care, policy challenges, technology advances, shift to outpatient services
Private Higher Education	Underweight	Affordability issues, expected declining enrollment, small, liberal arts schools
School Districts	Underweight	Pension issues, high fixed costs, enrollment pressures

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