Fourth quarter highlights

- The quarter began with news of Moody's downgrading many New York area issuers, including New York City and State GO debt.
- October followed the historical trend of being one of the most challenging months of the year for municipal performance.
- November's shift in supply/demand dynamics, coupled with the election moving mostly to the rearview and positive news around vaccine efficacy, supported a market rally.
- The long-awaited stimulus bill passed just before year-end. While the bill provided no direct aid to state and local governments, provisions within the bill should provide relief to municipalities.
- New issue supply totaled $473 billion for 2020. Per SIFMA data, this was the largest annual total on record. However, a large portion of this issuance was taxable municipals, as issuers used the segment of the market to refinance outstanding debt.
- We discuss our portfolio positioning heading into the new year.

Market update

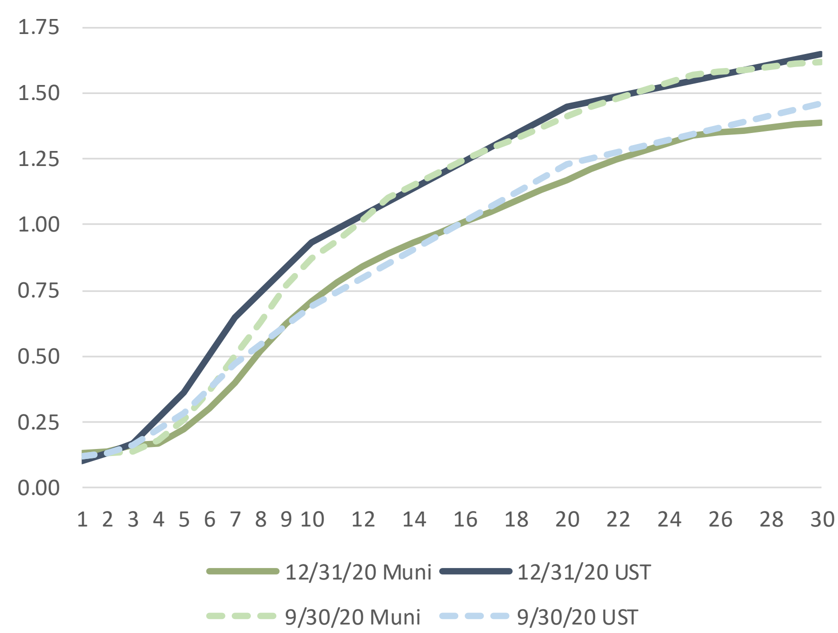
The quarter began with news of Moody's downgrading New York State and City general obligation debt, and other down revenue stream New York area issuers, citing the area's financial challenges in response to the COVID-19 pandemic. During the month, Hawaii's GO debt also saw a one-notch downgrade as Fitch cut its rating to AA from AA+. While newsworthy, market participants largely brushed aside the downgrade news as this had been well priced into the affected issuers.

During October, US Treasury yields moved higher in a steepening move. The 10-year UST yield closed the month at 0.88%, 19bps higher for the period, while the 2-10 year spread widened by 18bps. However, as hope for additional stimulus measures before the election evaporated, rates stabilized in the final week of the period.

October followed the historical trend of being one of the most challenging months of the year for municipal performance. The guidance of Treasury yields coupled with the pressure of near-record new issue supply led to municipal yields moving higher across the curve. October saw $72 billion of issuance, the second largest supply month on record, as issuers rushed to

FIGURE 1

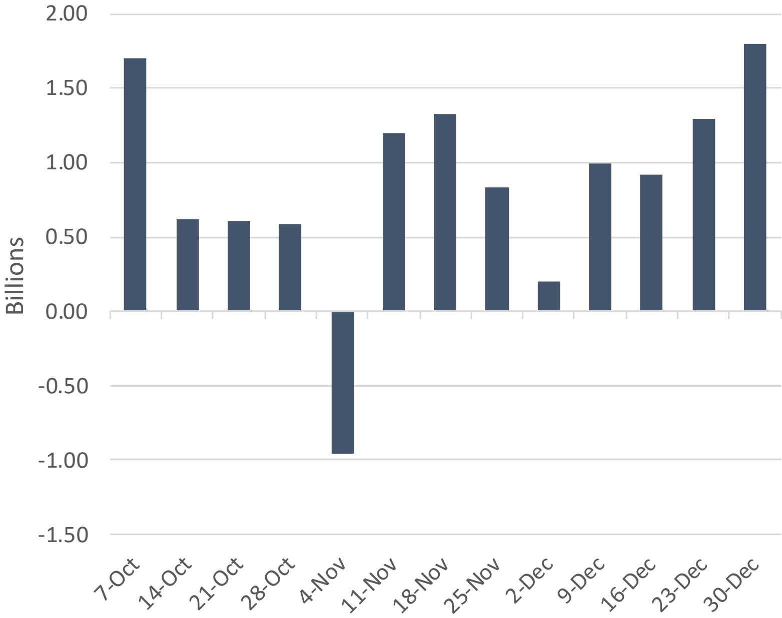
Muni & Treasury Yield Curves



Source: Municipal Market Data

FIGURE 2

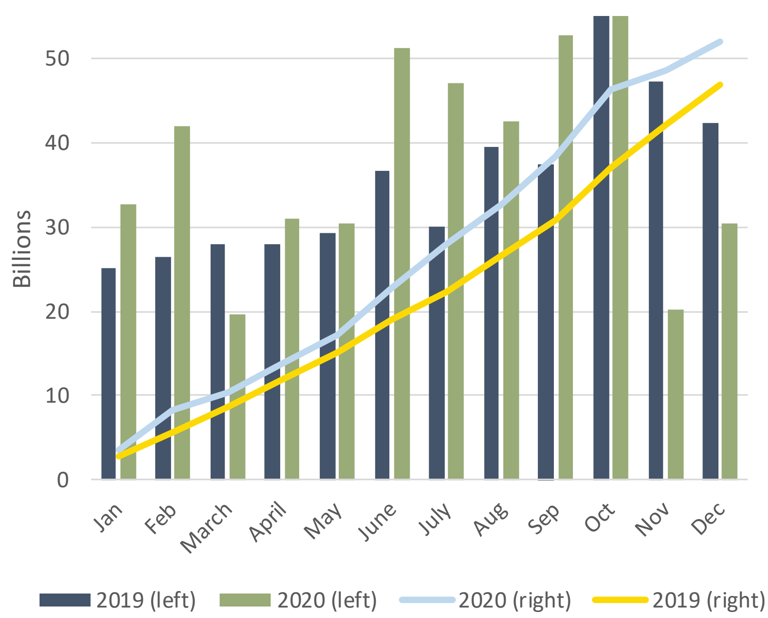
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

bring deals ahead of any potential election induced volatility.

November brought the much-anticipated US elections in which the Democrats appeared to take the White House but underperformed expectations down the ballot. The month's economic data was mixed as retail sales disappointed while housing figures came in strong. The employment report released at the beginning of the month exceeded expectations while coronavirus case numbers surged. However, these events remained in the periphery as election and vaccine details took center stage. Bonds rallied alongside risk assets for the month as election news mostly shifted to the rearview while positive news around vaccine efficacy grabbed headlines. Municipal yields fell sharply in a flattening move as the supply/demand imbalance flipped. November saw just $20 billion of issuance versus the 2020 monthly average of $39 billion. This was the lowest monthly total for the year and one of the weakest supply months on record. The paltry new issue calendar confirmed that much of the supply from prior months was from deals pulled forward ahead of the election.

The strong technical environment proved supportive for tax-exempts as municipal yields declined in a bull flattening move. Municipals outperformed Treasuries as muni/UST ratios moved lower. For the period, 2, 5, 10, and 30 year AAA muni yields fell by 6, 7, 20, and 29bps, respectively. By the close of November, the 10-year AAA muni/Treasury ratio reached 87%, down from 107% at the beginning of the period. Despite the sharpness of the AAA muni/Treasury ratio's decline, it drew closer in line with long-term historical averages.

The positive seasonality trend continued into December, as tax-exempt supply remained manageable while demand continued to be strong. Ahead of the Fed's Municipal Liquidity Facility expiration at the end of the year, Illinois

Market update (continued)

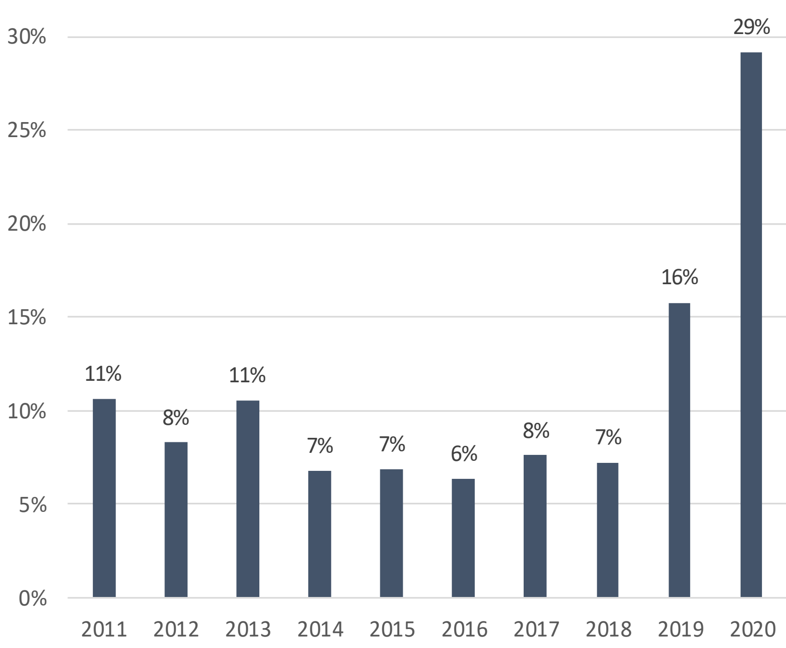
tapped the facility for the second time, selling $2 billion of 3-year notes at 3.42%.

The long-awaited stimulus bill passed just before year-end, though not without theatrics. Notably, the bill included no direct aid to state and local governments. Despite negative implications for municipal credits, the market took the news in stride. Recent reports (Tax Foundation) suggest local government revenue collections have exceeded expectations, while other measures within the bill should provide indirect relief to state and local governments. Additionally, meaningful aid to transportation entities provides a boost to one of the municipal market's hardest hit sectors. Throughout the pandemic, APA's credit research group and trading team continued to focus on underlying financials and issuers' ability and willingness to service and pay their debt, regardless of additional government stimulus.

Following a two-day meeting in December, the Federal Open Market Committee announced it would continue its asset purchase program in an effort to support the economy. However, the committee declined to extend the duration of its purchases. Treasury yields nudged higher on the news as the US Government yield curve steepened over the month while municipals continued their outperformance. AAA municipal yields were rangebound for the period moving between 0 and 1 bps (lower) across the curve. Credit spreads continued to tighten in response to positive news regarding vaccine viability. Fitch became the latest rating agency to take action on New York, downgrading the city's general obligation debt one notch from AA to AA-. As with Moody's action on New York City earlier in the quarter, this was expected and well-priced into the market

FIGURE 4

Taxable Muni Issuance as % of total Issuance



Source: SIFMA

FIGURE 5

Credit Spreads 2020

Source: MMD

Supply

The quarter began with robust issuance, as October's supply figure of $72 billion approached a monthly record. However, this was followed by one of the market's weakest supply months, as November's issuance totaled just $20 billion, in a sign that much of the October surge was from deals pulled forward ahead of the election. New issue supply for the quarter totaled $123 billion, which brought 2020 calendar year muni supply to $473 billion. Per SIFMA data, this was the largest annual total on record. However, a large portion of this issuance was taxable municipals, as issuers used the segment of the market to refinance outstanding debt. Taxable municipal new issue supply totaled $138 billion, or 29.2% of supply, versus the previous 10-year average of 8.9%. Pure tax-exempt debt came in at a more manageable $304 billion for the year.

Fund flows

Demand for municipals remains strong, as flows into municipal bond funds were positive in all but one week in the fourth quarter. Inflows totaled +$11.1 billion for the quarter, or an average of $850 million per week. Fund flows for 2020 totaled +$22.7 billion; an impressive rebound following the sharp outflow cycle in March/April.

Positioning

Typically, with the slow steepening of the Treasury curve that took place at the end of the year and the abrupt acceleration of that move over the first trading week of 2021, tax-free municipals would follow suit. However, with strong demand for tax-exempt income and a light supply calendar, the high-grade municipal curve remained grounded. As of year-end, the AAA muni 2 to 10-year slope stood at 57bps vs. the 2-10 year Treasury slope of 80bps. After the first trading first week in January, these levels stood at 63 and 98bps, respectively, with the latter being the widest level since mid-2017. With the muni curve steepness remaining less pronounced than that of Treasuries, we continue to be very defensive in our extension risk.

The 10-year AAA muni spot closed 2020 at 76% of Treasuries – slightly rich versus long-term averages. As we look to the year ahead, we believe municipal/ Treasury ratios should ultimately revert closer to historical norms. This prediction could be aided by the additional supply expected to be brought to the market over the coming months. For now, we continue to focus on relative value opportunities in a modified ladder from 1-15 years, focusing on diversification, not only from a credit perspective but from a structural standpoint, looking to add yield and defense with an emphasis on callable bonds.

We are still, unfortunately, a long way from "normal;" however, we do feel that as the year progresses and the potential for confidence to re-emerge takes hold,

FIGURE 6

Muni & UST 2-10 Year Spread

Source: SIFMA

Source: MMD, US Treasury

any further fear of large scale municipal credit deterioration should wane from investors' minds. Add to this the idea of continued fiscal support, and the reach for yield, down in credit quality, might have some room to run. Thus, as we turn to 2021, we will look to nudge our allocation to single-A rated credits back in-line with our historical target of 20% while remaining selective on credit. APA came into this shock very light on credit risk, as we believed spreads were not "paying" us to take that undue risk. But now that spreads are more in-line with historical norms (granted they arrived there in a volatile fashion), we will take the opportunity to dig deeper into the "haves and have nots" of municipal credit that have proven the ability to weather the storm with healthy coverage and cash levels.

We feel that, after all the concerns that arose in March and April, municipal bonds will go back to being a haven for safety, asset preservation, and tax efficiency. So with 2021 beginning in the existing low-rate environment, our approach is not so much for total return and the expectation of immense price appreciation, but as a continued return of total principal, minimizing market volatility. The pressures for higher rates showed at the end of the year; however, we believe any sustained move higher will be slow, up and down the curve, and that any potential sudden shifts on positive news regarding the economic recovery could be a buying opportunity.

Source: SIFMA

Source: MMD, US Treasury

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