APA

ASSET PRESERVATION ADVISORS

MARKET COMMENTARY

Q2 2025

CARING FOR CLIENT PORTFOLIOS, BOND BY BOND.

SECOND QUARTER HIGHLIGHTS

- **Historic April Volatility:** April opened with a surge in volatility following tariff announcements, triggering the largest three-day yield spike on the AAA muni curve (up 90 bps) since the COVID-19 shock.

- **Fund Flow Reversal:** After $8.7 billion in outflows during April, municipal mutual funds saw a rebound, with nine consecutive weeks of inflows to close the quarter, including $4.8 billion in inflows in May and $2.3 billion in June.

- **Surge in Supply:** Despite a temporary slowdown in issuance amid April's market volatility, Q2 new issuance totaled $161 billion, pushing year-to-date volume to $281 billion, 15% ahead of 2024's record pace, with full-year projections of $550–600 billion.

- **Yield Curve Steepening:** The municipal yield curve steepened meaningfully during the quarter, with the MMD 2s/10s spread widening from 58 to 68 basis points and the 5s/30s slope increasing from 138 to 187 basis points, reflecting a repricing of Fed expectations, defensive SMA demand in shorter maturities, and investor caution at the long end amid inflation and supply concerns.

- **Fed Holds, Markets Price Cuts:** The Federal Reserve kept rates steady at both the May and June FOMC meetings, but weakening economic data and rising unemployment (4.2%) led markets to price in 2–3 rate cuts by year-end, supporting muni performance, especially in short and intermediate maturities.

QUARTERLY MARKET UPDATE

The second quarter opened with a surge in volatility following the April 2nd "Liberation Day" tariff announcements. Equities sold off sharply, and although there was an initial flight to quality, bond yields moved higher amid uncertainty and potential inflation concerns.

Over a three-day trading period beginning April 7th, the AAA municipal curve experienced a dramatic adjustment, with yields rising by an average of 90 basis points, marking the largest three-day increase outside the COVID-19 shock. In comparison, Treasury yields of one year and longer rose just 29 basis points over the same period, as municipal-specific supply and demand imbalances weighed on the asset class. Bid lists in the secondary market hit $3 billion in a single day, the highest total since March 2020.

Municipal mutual funds experienced significant pressure at the start of the quarter, with seven consecutive weeks of outflows, resulting in net redemptions of $8.7 billion for April. However, this underperformance improved relative value and quickly garnered investor attention, as the 10-year muni/Treasury ratio briefly reached 90%, ending the month at 80%, the highest sustained level in some time.

Following the White House's April 9th announcement of a 90-day pause on tariffs, bonds rebounded sharply into month-end. Ultimately, municipal yields moved higher by 24, 16, 9, and 14 basis points in the 2-, 5-, 10-, and 30-year spots, respectively.

Municipals staged a rebound in May, reversing April's selloff. A resurgence in demand was fueled by attractive absolute and relative yields, resulting in municipal outperformance versus Treasuries for the month. Fund flows turned positive, with municipal mutual funds receiving $4.8 billion in net inflows for the month. Meanwhile, Treasuries sold off as concerns around fiscal deficits and policy uncertainty intensified. Moody's responded by downgrading U.S. sovereign debt to Aa1.

Notably, the first draft of the federal tax bill preserved the municipal tax exemption, which eased investor anxiety and supported demand for tax-exempt securities.

At its May meeting, the Federal Reserve kept the benchmark rate unchanged, while acknowledging heightened risks to both inflation and employment, partly attributed to ongoing trade tensions.

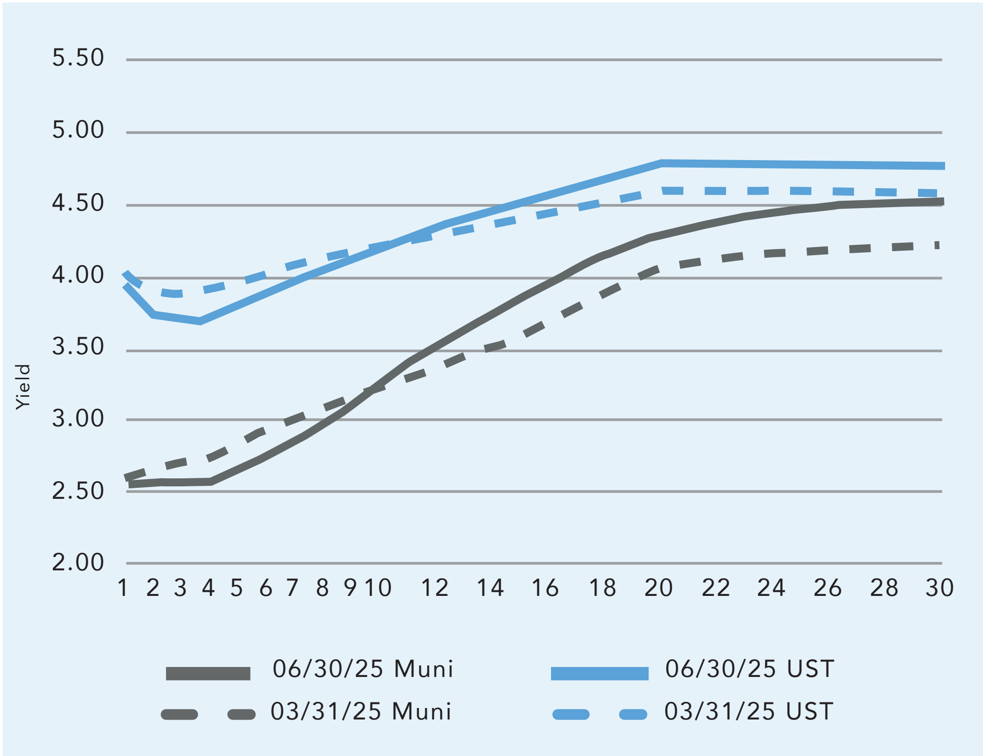
Municipal new issue supply totaled $50 billion during the month, 39% above the previous five-year average of $36 billion. The curve steepened meaningfully, as short-term rates declined while intermediate to long-dated yields moved higher. By month-end, yields had adjusted by -15, -18, -1, and +14 basis points in the 2-, 5-, 10-, and 30-year maturities, respectively.

In June, investor focus shifted from trade policy to signs of a weakening economy. First-quarter GDP was revised down to -0.5%, while inflation remained muted. The May CPI report, released in June, showed monthly increases of just 0.08% (headline) and 0.13% (core), both below expectations. The unemployment rate ticked up to 4.2%, a notable increase from January's 3.7% and reaching its highest level since November 2021.

Despite the softer data, the Fed held rates steady at its June FOMC meeting. However, market participants began pricing in greater odds of rate cuts in the second half of 2025, with futures indicating 2–3 cuts by year-end and the first expected as early as September. This shift broadly supported fixed-income performance, particularly in short- and intermediate-maturity securities.

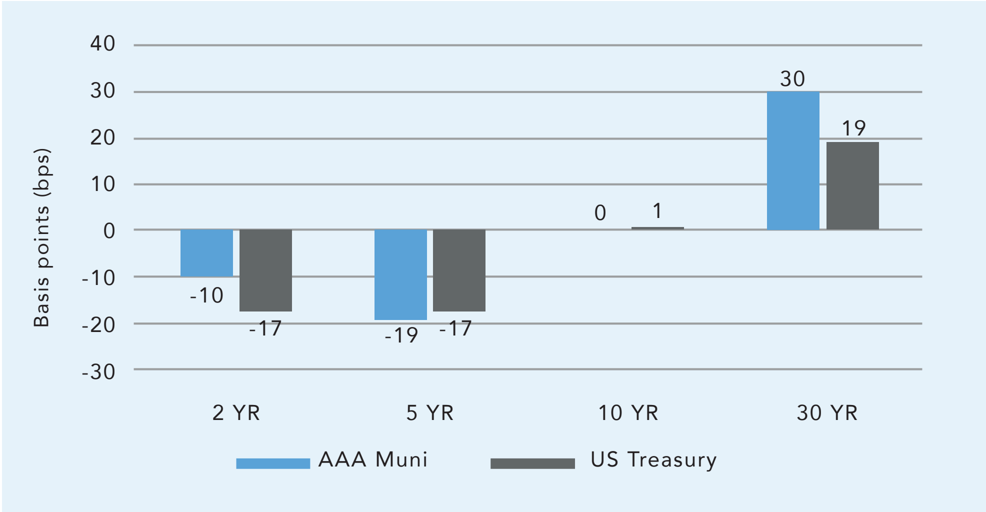
Municipals benefited from this tailwind, with yields adjusting by -19, -17, -7, and +2 basis points in the 2-, 5-, 10-, and 30-year spots, respectively. With the curve steepening that took place throughout the quarter, the 2- to 10-year slope closed the period at +68 basis points, recovering from the inversion seen through mid-2024. More meaningfully, the 5- to 30-year slope ended at +187 basis points, up 49 basis points from the start of the period.

MUNI & TREASURY YIELD CURVES



Source: Municipal Market Data, US Treasury

Q2 2025 YIELD MOVES (bps)

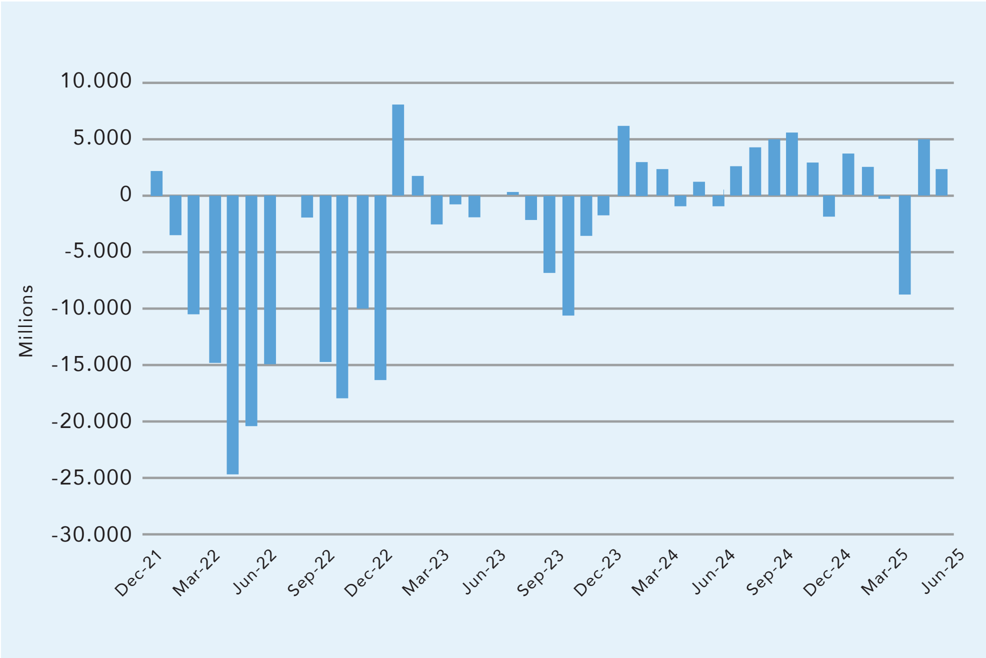


Source: Municipal Market Data, US Treasury

FUND FLOWS

Following seven consecutive weeks of outflows and $8.7 billion in net redemptions in April, municipal mutual funds experienced a rebound in demand over the final two months of the quarter. Funds recorded nine consecutive weeks of inflows to close the second quarter, including $4.8 billion in May and an additional $2.3 billion in June, which partially offset earlier weakness, resulting in net flows for the quarter of -$1.68 billion.

MONTHLY FUND FLOWS



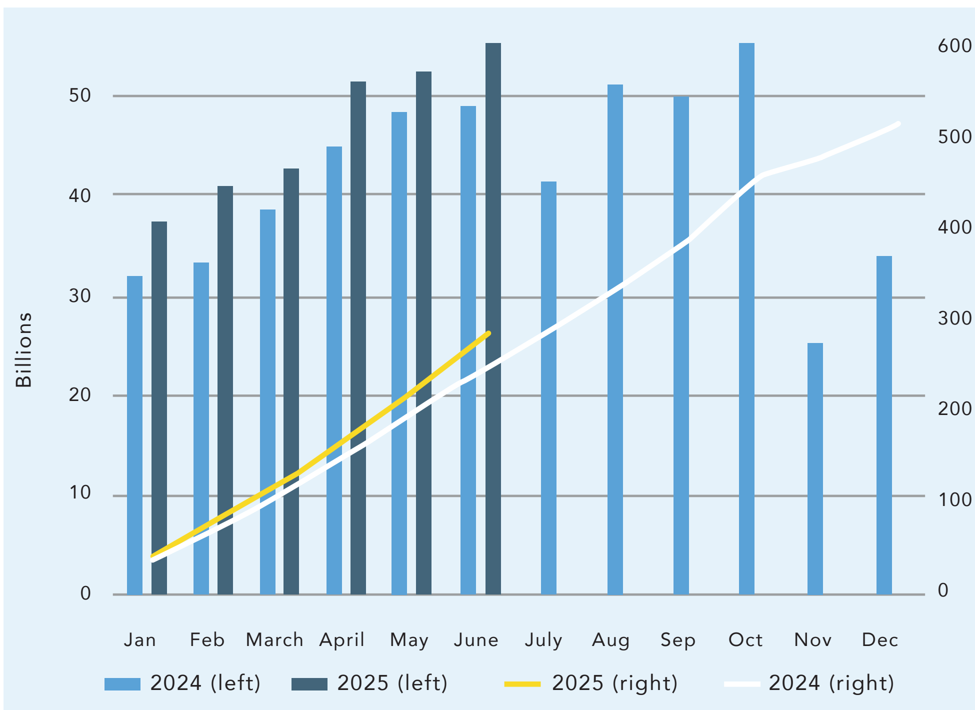
Source: Investment Company Institute (ICI)

SUPPLY

Despite a temporary slowdown in issuance amid April's market volatility, municipal supply remained at a torrid pace throughout the second quarter. New issue volume totaled $161 billion for the period, bringing year-to-date issuance to $281 billion, or 15% ahead of last year's record-setting pace. Looking ahead, the forward calendar remains robust, with full-year projections ranging from $550 to $600 billion.

This surge in issuance marks a continued expansion of the tax-exempt market, with many participants now expecting nearly $200 billion in net supply for a second consecutive year. After years of relatively flat growth, the municipal market has grown to over $4 trillion in size. While still small compared to the rapidly growing Treasury market, this expansion—along with the sector's strong credit quality—has supported tighter ratios, particularly in the intermediate part of the curve.

MUNICIPAL MARKET SUPPLY



Source: SIFMA

OUTLOOK

Despite the quarter's volatility, one theme remained consistent: a steeper municipal yield curve. As the quarter progressed, we observed a notable shift in market dynamics, whether it be a repricing of FOMC expectations, a more defensive posture from separately managed account (SMA) participants capitalizing on still-attractive short-to-intermediate yields, or investor caution at the long end amid inflation uncertainty and the potential for increased supply. This changing demand landscape was reflected in performance: the ICE 1-10 Year Index returned +1.22% for the quarter, while the ICE 10+ Year Index declined by -1.07%.

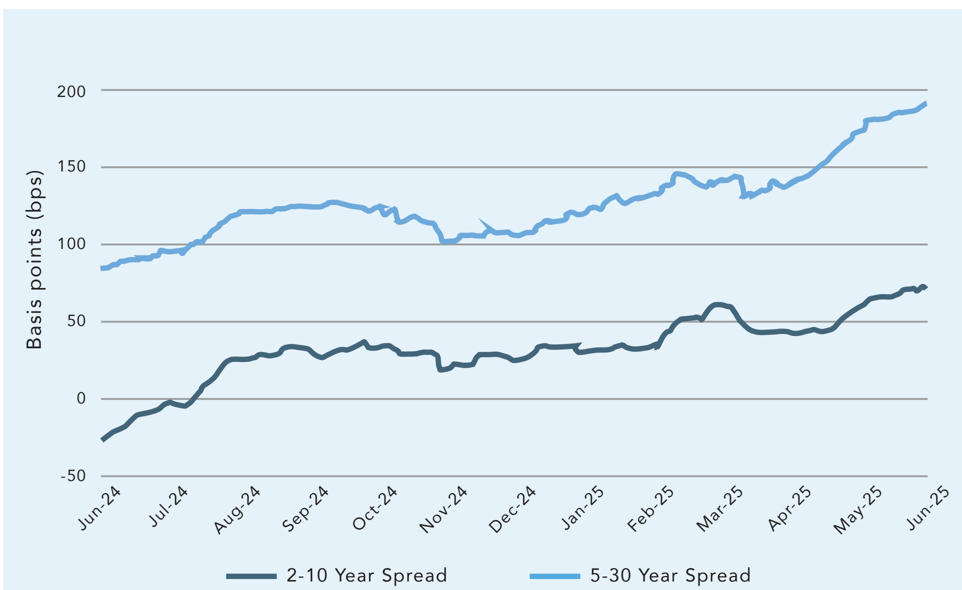
Curve steepening was also evident in MMD data. The 2s/10s slope widened from 58 basis points at the start of the quarter to 68 basis points by June 30. More significantly, the 5s/30s curve steepened from 138 bps to 187 bps—one of the most significant shifts in recent quarters.

As outlined in prior commentaries, we have deliberately positioned portfolios to withstand a steeper curve environment, employing a modified ladder structure with an emphasis on shorter-call bonds. This part of the curve has seen the heaviest secondary market activity, and we've used that dislocation to generate yield and carry, while keeping longer-term flexibility intact.

Looking ahead to the second half of the year, we believe the current shape of the curve provides room to be more constructive. Specifically, we see opportunities to build portfolios with longer bullet maturities and extended call protection as part of our defensive income strategy. Even if the rate outlook remains uncertain, our internal view is that sustained elevated supply levels could limit the potential for a strong muni rally. That said, we believe taxable-equivalent yields in the longer-intermediate portion of the curve remain compelling and worth locking in.

We expect the average effective maturity across our composites to shift modestly longer, reflecting a tilt toward these more attractive intermediate to long-term opportunities, which we believe will position clients to benefit from both customized active management and today's favorable market opportunities.

MUNI 2-10 AND 5-30 YEAR SPREADS



Source: Municipal Market Data (MMD)

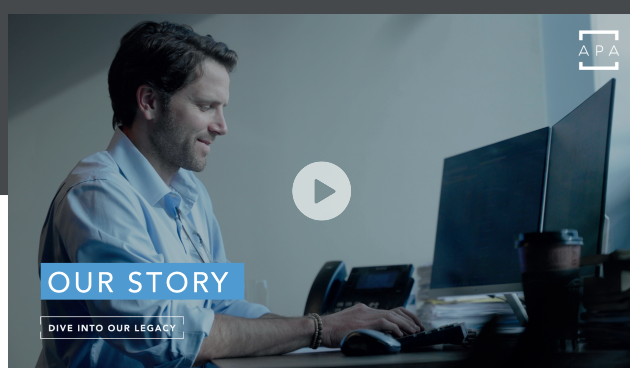
*Data presented as of 6/30/2025.

ABOUT APA

Asset Preservation Advisors (APA) is a registered investment advisor founded in 1989. APA specializes in managing high quality tax-exempt and taxable municipal bond portfolios for other registered investment advisors, family wealth offices and institutional clients.

Since its founding, Asset Preservation Advisors is committed to delivering a high level of service, quality and wealth preservation. APA believes our growth in assets under management can be attributed to a consistent investment process and corresponding trading discipline.

We value highly the trust our clients have shown in APA and remain committed to adhering to a high level of ethical, moral and business standards first envisioned at our founding in 1989. Asset Preservation Advisors (APA) is a registered investment advisor founded and specializes in managing high quality, tax-exempt and taxable municipal bond portfolios for other registered investment advisors, family wealth offices and institutional clients.



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APA-2507-17