# Portfolio Commentary

## Navigator® Tax-Free Fixed Income

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Navigate Your Future. Enjoy the Journey.

## It's All I Can Do to Keep Waiting for You...Negative Yields?

The last three months saw many ups, downs and news headlines including the untimely passing of rock and roll legend Ric Ocasik of the Cars (see if you can spot the Cars references in this quarter's commentary). We are ending the third quarter of 2019 with another news story that continues to persist—that of negative yields. In Europe, all 2-year bonds have negative rates except for in the UK. Extend it to 5-year bonds, and you'll find Italy at 0.21% and Greece at 0.69% in positive yields versus the U.S. 5-year rate at 1.54%.

There is talk if Italy even has a sustainable government, let alone people lending them money at 0.25% for 5 years! That is clearly "irrazionale esuberanza" as an Italian speaking Alan Greenspan might describe it. Don't even talk about Japan, which has been at negative yields for what seems like forever.

### Since You're Gone...

During the drop in U.S. rates in August, it was estimated at one point that $17 billion of global bond market securities had negative yields. A Danish bank was offering mortgages with negative rates. This translates into the debtor being paid to borrow money for the term of the loan. I would think that once a debtor obtained a negative interest rate loan, would there be a need to refinance in the future?

### Magic...

The flip side of negative short-term rates is the long duration 100-year bond issued two years ago by Austria (2.1% coupon due 9/20/2117). The bonds were issued at par and traded as high as $197 during the quarter or a 130 basis point rally from the issuance.

Unlike a stock that can trade at several valuations, price to sales, price to earnings, etc., these bonds are either reflecting the current view on inflation or an accommodative European Central Bank (ECB) that will continue to buy bonds. This bond is a lesson in duration and its effect on bond prices. It is not a lesson on inflation or an accommodative ECB because that will clearly be a changing scenario over the next 98 years until maturity.

### Just What I Needed...

July started out with somewhat low volatility on the 10-year U.S. Treasury bond. The July range on the 10-year was between 2.00% and 2.13% only to close the month virtually unchanged at 2.01% according to Bloomberg price data. In August, recession fears and a global slowdown in growth was reflected in the flattening yield curve.

The 10-year bond was lower by 52 basis points on the month—the biggest monthly

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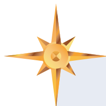

decline since January 2015 according to Bloomberg data. For bond managers, this meant you needed to be fully invested and long your duration benchmarks to drive performance.

## Shake It Up...

The August drop in rates raised the question as to whether or not the Fed was behind the curve in lowering rates. The beginning of September saw 10-year rates increase over an 8-day period and alleviate August's overbought conditions.

A debate is beginning as to whether or not the economy is slowing or stalling. Jobs data continues to be firm as the unemployment rate remained at 3.7%. August's manufacturing ISM number slipped from 51.3 to 49.1. Recall that three consecutive readings below 50 are considered recessionary. (Spoiler alert since I write the commentary after 9/30): Manufacturing for September, which was released on October 1st came in at 47.8.

As ongoing trade tensions with China continue to ebb and flow, a new grenade was lobbed into the political arena. The Ukraine is now dragged into the political sphere of possibly being influenced to investigate a democratic political opponent in for the 2020 election and Democrats have called for an impeachment inquiry.

With a Republican controlled Senate, a move by the House for impeachment seems to have little chance of being accomplished. Market pundits were immediately looking for a "Clinton impeachment bounce", which was an equity market rally after a similar situation during that past administration.

All of this is noise for sure—a wall of worry no doubt. However, the stock market does not appear ready to move lower. As the bond market continues to close at lower yields, the market is starting to price in the possibility of another 25 basis point rate cut at the Fed's October meeting. October data will be the deciding factor to, as Ric Ocasik of the Cars sang, "shake it up."

## Tax-Free Fixed Income Portfolio

The continued decline in Treasury rates added to a third quarter of positive returns for municipal bonds. The Bloomberg Barclays Aggregate Municipal Bond Index posted a return of 6.75% through the end of Q3. The Bloomberg 5-year Municipal Bond Index returned 4.37% during the same period.

As anticipated in our Q2 commentary, heavy re-investment of interest payments along with matured and called bonds were the theme throughout July and August. Ratios continued to be compressed in the traditional SMA space of 1-5 years, offering little to no value in our view. The overall mentality of buy, buy, buy is what causes overbought conditions in these periods of re-investment cash outstripping supply.

The quarter began with the Bloomberg Municipal AAA curve at 1.60% and ending at 1.46%, 14 basis points lower. 5% coupon bonds with a 10-year maturity priced at 1.46% yield equates to dollar price of over $132. A 4% coupon with a 10-year maturity is over $123. If rates were to move higher, it would be an awful lot of premium that could be lost. Remember that bonds are ultimately worth par at maturity.

In order to navigate this low interest rate environment, we have been proponents of utilizing a barbell strategy for the last couple of years. The front end of the curve provides liquidity in bullet maturities we own. We also use longer dated maturities and buy bonds with 2 to 3-year calls that provide short duration and have a high probability of being called.

The callability of municipal bonds is a key feature that we use in our portfolio to manage duration for the barbell strategy. Longer dated bonds can trade at 130-150 basis points spread to Treasury bonds on a yield top call basis. If the bonds were to extend to maturity, the ratios are even higher (maybe by 160 basis points for example).

This cheapness in the ratios in relation to Treasuries is what provides a defensive nature to the bonds. As the saying goes, "do not try this at home." Make sure you have an active manager that can navigate the nuances of the complex municipal bond market with experience and an established track record.

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Bloomberg Barclays U.S. Aggregate Bond Index: The index is unmanaged and measures the performance of the investment grade, U.S. dollar denominated, fixed-rate taxable bond market, including Treasuries and government-related and corporate securities that have a remaining maturity of at least one year.

The Bloomberg Barclays 5-Year Municipal Bond Index is the 5 Year (4-6) component of the Municipal Bond index. It is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies.

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