Portfolio Commentary

Navigator® Tax-Free Fixed Income

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Navigate Your Future. Enjoy the Journey.

The Economy: Saved by Zero

Saved by Zero is a song from the Fixx in 1983. It has almost a meditative beat. Stark, grim and haunting imagery presents the listener with a passage into an uncertain future. Pushed past your comfort zone, you leave everything behind and start at "zero" and decisions are made with nothing left to lose.

Jerome Powell may have been listening to this song in his ear buds as by quarter end, the Fed was forced to respond to a pandemic and a historically unprecedented downturn in our economy. Trying to be Saved by Zero rates is part of the Fed's response.

Here is how the quarter unfolded:

January

In January, bullish sentiment drove stocks higher as moderating trade tensions between the U.S. and China dominated headlines during the first weeks of the month, reducing investors' pessimism surrounding a global recession. Coronavirus cases dominated headlines during the second half of the month as investors worried over the negative effects on economic growth from the virus. For the month, the S&P 500 Index finished flat at -0.16%, the Bloomberg Barclays US Aggerate Index posted a return of 1.92%, and the Bloomberg Barclays 5-year Muni Index improved by 1.22% as bonds benefited from the end of the month uncertainty.

February

February got off to a positive start, as the S&P 500 Index was up over 4.5% during the first two weeks of the month. Coronavirus concerns seemed to be restricted to China, with limited potential impact on U.S. economic activity. However, sentiment quickly soured during the second half of the month as fears increased over the spread of the coronavirus as it expanded past China's borders and Italy and Iran quickly became secondary viral epicenters. The S&P 500 Index finished the month down 8.41%. The Bloomberg Barclays US Aggregate Index and the Bloomberg Barclays 5-year Muni Index were both positive, finishing the month up 1.80% and 0.60%, respectively, as investor risk aversion quickly shifted from risk-on to risk-off, as coronavirus fears continued to increase.

March

In March, investors were hit with unprecedented volatility across all asset classes. Fear surrounding the coronavirus pandemic quickly escalated as the virus continued to spread across the globe. During the month, the United States reported its first confirmed cases and increased social distancing began taking its toll on both the U.S. and global economy. The S&P 500 Index experienced its quickest decline in history during March, taking only three weeks to reduce 35% of the index value and ending the longest bull market in U.S. history, which had started in March 2009.

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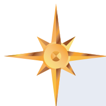

During 12 trading days during the month, the S&P 500 Index swung violently by more than 4% in either direction, as investors continued to digest quick news flow stemming from the emergence of the coronavirus as a global pandemic. The CBOE Volatility Index, which measures market volatility, reached a peak value of 82.69 on March 16th, surpassing the previous record of 80.86 occurring during the 2008 financial crisis. The fixed income market was not immune to this volatility as yields dropped substantially with the 10-year Treasury yield declining from 1.15% on February 28th to 0.67% on March 31st, as investors sought safety in the highest quality and most liquid assets.

The month of March was unkind to investors as the S&P 500 Index logged its worst quarter since 2008 and the Dow posted its worst quarter since 1987. The S&P 500 Index fell by 12.35% in March, the Barclays US Aggregate Index dropped 0.59% and the Barclays 5-year Muni Index declined 2.81% during the month as investors removed credit risk, including municipals, from their portfolios and rushed to cash and other short-term, high-quality investments in an extreme flight to safety. For the quarter, the S&P 500 Index was down 19.60%, the Bloomberg Barclays US Aggregate Index finished positive 3.15%, and the Bloomberg Barclays 5-year Muni Index dropped by 1.04%, in total return terms.

$2.1 Trillion CARES Act

In an effort to calm investor anxiety, address the economic fallout from the coronavirus, and hopefully avoid a prolonged slowdown, Congress passed the $2.1 trillion CARES Act during the month. The $2 trillion CARES Act is the largest economic stimulus act ratified by Congress and, in terms of size, is more than double the $800 billion American Recovery and Reinvestment Act of 2009 passed after the financial crisis in 2008. The CARES Act creates a $454 billion Economic Stabilization Fund to inject liquidity into the fixed income capital markets, including both corporate securities and municipal securities. This provides the Federal Reserve the ability to include municipal bonds as part of its asset purchase program. We highlight here some of the notable provisions that will have a material effect on municipal markets:

- $150 billion Coronavirus Relief Fund appropriated for direct funding to state and local government for costs associated with dealing with the coronavirus.
- $120 billion appropriated for not-for-profit hospitals, nursing homes, and other healthcare providers.
- $35 billion appropriated to transportation infrastructure, including airports and mass-transit agencies.
- Over $30 billion for education funding including higher education and K-12 school districts.

We believe markets responded positively to the Congressional passing of the CARES Act and ratification by President Trump on March 27th. The muni market saw liquidity return, pricing stabilize, and yields dropping into more traditional, yet still attractive, ranges as a result. Our view is that the CARES Act should continue to offer some pricing stability as liquidity begins to return to the market. In addition, the provisions should provide some needed relief to already stretched state and local government budgets as they continue the front-line fight against the ongoing coronavirus crisis.

As the first quarter concludes, our view is that the U.S. economy has a high potential to enter a recession stemming from the continuing spread of the coronavirus epidemic. Economic conditions will continue to deteriorate as work-from-home mandates, limitations on public gatherings, and other social distancing measures dampen economic activity. The length and severity, however, remains uncertain as investors continue to question if aggressive monetary and fiscal stimulus packages will be enough to stimulate economic growth during the second half of the year.

Navigator® Tax-Free Fixed Income Strategy

The Navigator® Tax-Free Fixed Income strategy finished the first quarter slightly down, yet ahead of its benchmark on a relative basis. The first quarter was challenging for the muni market, as extreme volatility stemming from the coronavirus pandemic and a resulting economic slowdown pushed valuations down across all asset classes.

The muni market, which is typically viewed as a safe asset class, was not immune to this panic selling, as muni bond yields observed levels of volatility not observed since the 2008 financial crisis. After experiencing 60 consecutive weeks of positive inflows totaling over $120 billion in new money, investors sentiment quickly changed in March. The asset class witnessed a record exodus during the last four weeks of the month totaling $28 billion, according to Lipper, forcing municipal funds to liquidate high quality positions into an already stressed market, sending yields soaring across the curve.

March began with the 5-year Bloomberg Municipal AAA curve yielding 0.69% and ending at 1.14%, an increase of 49 basis points. Another valuation metric, the AAA / Treasury ratio, quickly expanded as a result of the frenzied selling observed during this time period. The 5-year ratio was 73.1% on March 2nd, meaning that municipal bonds on average yielded around 73% to comparable treasuries of similar maturity. The muni to US Treasury ratio on March 31st was 298.4%. These higher yields and widening ratios create an

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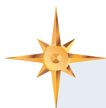

attractive backdrop for municipal bonds, especially when factoring in the tax-exempt income stream received when owning municipal bonds.

Municipal Outlook

In our view, municipal bonds continue to provide some of the best credits in the global fixed income arena. The recent repricing in the market has created an attractive backdrop for municipal bonds as we observed yields rising from 0.69% at the beginning of March to 1.14% at the end of March, using the 5-year Bloomberg AAA curve as a reference point.

These higher yielding municipal bonds may become attractive for cross-over buyers, such as banks and insurance companies, as yields in the municipal market start to compete with other high-quality markets such as investment grade credit. We believe the return of these cross-over buyers would help stabilize the market, increase liquidity and constrain future volatility, and potentially drive positive returns as more participants enter the municipal market searching for attractive yields.

We believe state and local governments will continue to experience revenue shortfalls as social distancing guidelines are enforced during this time period. As result, we anticipate credit downgrades as we move through the next phase of the coronavirus cycle, particularly for municipalities with high debt burdens and lower credit ratings. In this environment, we believe active management will help add value to municipal fixed income portfolios. In our strategy, we are focused on adding high quality and essential service revenue bonds and are avoiding what we believe are troubled, lower quality credits such as airports, stadiums and tobacco bonds.

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Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in market value of an investment), credit, payment, call (some bonds allow the issuer to call a bond for redemption before it matures), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase)

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 a capitalization weighted bond index created by Bloomberg Barclays intended to be representative of major municipal bonds of all quality ratings with an average maturity of approximately five years.

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S&P Global Ratings issue credit rating is a forward-looking opinion about the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program (including ratings on medium-term note programs and commercial paper programs). It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated. The opinion reflects S&P Global Ratings' view of the obligor's capacity and willingness to meet its financial commitment as they come due, and this opinion may assess terms, such as collateral security and subordination, which could affect ultimate payment in the event of default.

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