Portfolio Commentary

Navigator® Tax-Free Fixed Income

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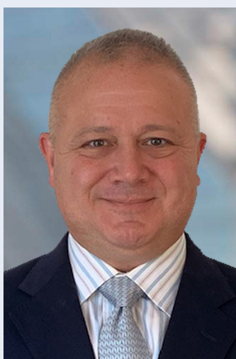

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Comfortably Numb?

The third quarter fixed income themes were dominated by positive macro data in July, accommodative Fed commentary in August, and heightened political uncertainty in September. During the quarter, COVID-related news returned to the front burner as both Europe and the U.S. experienced a significant uptick in new cases. At the beginning of the quarter, the yield on the 10-year U.S. Treasury bond was 0.66%; it finished the quarter on September 30th with a slightly higher reading of 0.69%.

Investment grade credit spreads compressed by 14 basis points and high yield spreads declined by 109 basis points during the quarter as both markets experienced positive fund flows with investors adding over $110.4 billion to investment grade funds and over $5.6 billion to high yield funds. Fund flows contributed to the positive performance for the corporate bond credit markets during the third quarter.

The Bloomberg Barclays Intermediate Corporate Bond Index finished the quarter up 1.33%. Municipal bonds finished the third quarter slightly higher. Using the Bloomberg Barclays Municipal Bond Total Return Index as a reference, the muni market appreciated 1.23% on a total return basis during the quarter.

The 5-year MMD scale experienced a 17 basis point drop during the quarter ending on September 30th with a reading of 0.26% as positive fund flows for the asset class drove municipal bonds yields lower during the third quarter. According to the Investment Company Institute (ICI), the municipal bond asset class experienced positive fund flows totaling over $26.2 billion during the third quarter (as of 09/23/2020), continuing a positive inflow trend from the prior quarter.

Below is a monthly recap of the third quarter:

July

In July, a tailwind from Central Bank policy, coronavirus vaccine optimism, positive expectations surrounding a fifth coronavirus relief package, and positive earnings surprises, were all cited as factors supporting optimistic investor sentiment during the month. The U.S. Central Bank responded to the corona virus pandemic by proposing a financial asset purchase program, increasing its balance sheet by over $3.0 trillion from February to July to sustain market liquidity. This unprecedented policy response has suppressed interest rates, compressed corporate bond spreads, dampened volatility, and smothered bearish positioning. Bond yields continued to fall during July as the U.S. 10-year Treasury bond yield dropped by over 0.12% finishing the month with a yield of 0.53%.

Muni yields followed suit, decreasing by 18 basis points and finished the month with a 0.23% yield on July 31st, using the 5-year MMD scale. The muni market finished July with an impressive 1.16% positive performance as referenced by the Bloomberg Barclays 5-year Municipal Bond Index. The corporate bond market experienced a noteworthy positive performance of 1.50% during the month, as referenced by the Bloomberg Barclays Intermediate Corporate Bond Index.

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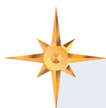

August

The risk-on rally continued in August as investors continued to push equity markets higher. U.S. Treasuries finished lower as the yield curve steepened during the month. The 10-year U.S. Treasury began August at 53 basis points and finished the month higher with a yield of 71 basis points. The primary performance driver in August was attributed to continued massive monetary and fiscal stimulus implemented as a result of the of the coronavirus outbreak, with many investment strategists predicting the Fed's balance sheet could eventually exceed $20 trillion.

The FOMC announced at the end of month its intention to implement further policy accommodation if inflation continues to fall short of expectations. The corporate bond market performance was flat with the Bloomberg Barclays Intermediate Corporate Bond Index returning 0.00% in August. Municipal bonds performance was negative during the month following the sell-off in the U.S. Treasury market.

The 5-year MMD scale finished up 3 basis points in August, finishing the month with a yield of 0.26%; the Bloomberg Barclays 5-year Municipal Bond Index declined by 0.04% during the month. Despite investor worry over the inability of the White House and Congress to reach a deal on a fifth coronavirus relief package, municipal bond mutual fund lows remained positive in August as investors added over $10.5 billion into the asset class during the month, according to ICI, continuing a positive trend from the spring.

September

U.S. Treasury yields were mostly stable during September. The 10-year U.S. Treasury started the month yielding 71 basis points and finished the month relatively flat with a yield of 69 basis points. The coronavirus pandemic remained an overhang during the month as many European countries observed a significant increase in positive cases and the U.S. death toll eclipsed 200,000. The White House and Congress continued to differ on the size and scope of a possible fifth round of coronavirus fiscal stimulus.

The September FOMC meeting minutes indicated that the Fed has no intention to raise rates until at least 2023, and reiterated their August guidance towards a flexible inflation target. Election and political uncertainty were consistent throughout the month. The death of Supreme Court Justice Ruth Bader Ginsburg increased political uncertainty as Democrats resist President Trump's Supreme Court nominee, potentially lowering the likelihood of a Congressional agreement towards an additional round of coronavirus stimulus. At the end of the month, the presidential candidates squared off an in raucous debate that was filled largely with more interruptions than policy positions, leaving investors unclear on the candidates' plans as we march into the November election.

Positive fund flows continued in September as investors seemed to ignore the political uncertainty during September by adding over $6.2 billion (as of 09/23/2020) to municipal bond mutual funds during according ICI. The 5-year MMD scale finished September relatively flat, yielding 0.26%. The municipal bond market logged a modest rise in September as the Bloomberg Barclays 5-year Municipal Bond Index improved slightly by 0.16%. Corporate bonds posted a modest decline during the month as the Bloomberg Barclays Intermediate Corporate Bond Index declined 0.18%.

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The Bloomberg Barclays Municipal Bond 5-year Index turned in a 1.32% return for the quarter ending 9/30/2020. Nearly all of the quarter's performance can be traced back to the period of 7/1 to the peak on 8/10, with the index up 1.51%. After a small retracement, the markets basically traded sideways for the balance of the quarter.

While one could celebrate the returns for the quarter overall, performance through mid-August is nothing new. Seasonal patterns leave the market flush with cash, taxes have been recently paid, leaving the populace wanting to shelter more of their hard-earned money, and new issues are slower coming in as bankers, underwriters and the market in general enjoys what's left of summer. 2020's performance was enhanced by the bounce from the March/April liquidity crunch at the onset of COVID. More interesting is the performance following 8/10 in each of the last 5 years:

The Bloomberg Barclays Municipal Bond 5-year Index (8/10-10/1 performance)	
2020	-0.17
2019	-0.94
2018	-0.55
2017	-0.24
2016	-0.34
2015	0.50
2014	0.42

Source: Bloomberg as of 10/1/2020

2020's tail end went dormant. The traditional municipal ides of fall: when investable cash dries up, deals accelerate, the weather chills as does the traditional muni demand model. In five of the seven periods above, the market experienced losses. This effect becomes magnified with the institutional-

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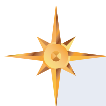

ization of the market. With so many following similar protocols, the market falls into a numbing slumber... *Hello? Hello? Hello? Is there anyone out there?*

Just nod if you can hear me...

The market did steepen in the 3 to 30-year measure by approximately 11 basis points, with the overall market experiencing the strongest gains 3 to 7 years. What was once a paltry 0.29 yield in 3 years currently stands at around 0.16. Munis out-steepened Treasuries by 4 basis points and it was all front end loaded. *Is there anyone home?*

Yes, plenty are home and doing what they usually do in times of uncertainty—running to the earlier maturities. This demand took the front end on a wild ride if we use ratios to Treasuries as a surrogate to measure muni demand.

In the 3-year tranche, the yield as a percentage of Treasuries went from 150% on July 1st, to 56% on August 11th to 101% to close the quarter. I believe ratios would be even lower if not for the level of absolute yields. 16 basis points of yield is, well, just 16 basis points of yield. Talk about numb... the move in muni yields in 10 years was a whopping 1 basis point, and 30 years only moved 2! Complacency in a market should always be suspect, as should outsized moves, both of which were displayed in the most recent quarter. Drifting markets tend to drift lower, so it will be interesting to see how the coming weeks behave.

Well I can ease your pain, get you on your feet again...

The move lower in yields overall was driven by economic data, a supportive broader fixed income market, and a multi-year low in market volatility. But remember, the ides of fall are upon us... and the market is abuzz with fear of outsized supply concerns, political uncertainty and a coming election, and a general malaise in activity at these levels.

By many measures, the argument can be made that the front end is overbought. But the wave of supply as broadly quoted is missing one vital piece of information... *Relax, I'll need some information first*... and that information is that 30% of the third quarter supply came as taxable municipal debt. If one considers AMT tax paper, that number grows to 35%.

Any severe price depreciation in the coming quarter may be nominal, as "real" munis, the triple tax-exempt ones, are not experiencing the massive growth the pundits would lead us to believe. To that point, the closing week's supply in California was 90% taxable— 90%! That does hurt an investor in a high tax state that is seeking to protect themselves from taxes. Remember the complacency we referenced earlier in the longer end of the curve? At least the complacency is reflected in more appealing relative value to Treasuries, as 10 years currently stand at 125%. That ratio alone is an indicator of value versus the front end. Further, the lack of steepness in the curve was finally cured this quarter, by the exact move in the front end we are referencing.

Just the basic facts, can you show me where it hurts...

Well, if you are residing in New Jersey, higher taxes will hurt, especially for those in the top bracket as it will be increased to 10.75%. This just when the state also announced $5.4 billion (yes, billion) in borrowing to meet shortfalls. The Governor did make brief mention of perhaps borrowing from the MLF facility, administered by the Federal Reserve for municipal borrowers.

Tapping that facility this past quarter was New York's MTA, as traditional issuance proved price-prohibitive for them. While we are discussing NY, the fourth quarter is usually outsized in issuance for city and state-level agencies, and this year will not be different as NYC is on pace to issue over $1 billion, DASNY will issue $2.5B in mixed taxable and exempt, and the TFA has about $500 million on tap. All are names that can cheapen the New York market while at the same time making differentiating credits in NY dearer.

There'll be no more, AHHH! But you may feel a little sick...

So, we leave the third quarter behind— a roller coaster of ratios, increased credit fears and an intense focus on new issue supply, or lack thereof, depending how it's measured. We also leave behind an extended period of rate stagnation, as liquidity became tighter and price fluctuations narrowed. All of these factors lead to a cautious entry into the fourth quarter.

I caught a fleeting glimpse, out of the corner of my eye...of some of the factors that may help ease these coming headwinds. In reviewing data since 2014, it's interesting to note that in the 5-year maturity tranche, the benchmark 7-year rate fell 7 times and went up 7 times. Its ratio to Treasuries fell 3 times, but went higher 11 times. Further out, the curve the 15-year maturity moved lower 10 times and higher only 4. Its ratio shrunk 9 times and increased 5. So, while there is perceived safety in the front end, history shows that may not always be the case. Moving forward, we will stay our course and continue to purchase bonds that meet our credit requirements, including, but not limited to: tax-backed school districts including those with recourse to state aid, regional school districts and colleges with solid financials and stout endowments; revenue backed bonds with a performance

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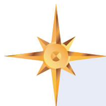

history; and essential service bonds in identifiable municipalities.

We have reduced our holding of credits that have been under pressure financially as well as those that face headline risk. To that end, we have reduced our exposure in Healthcare as spreads for the last year have pointed to underperformance and have a higher risk of widening. As new deals begin to come with longer maturities and 2031 calls, we feel the "roll-down" effect in our position of bonds with calls ranging from 2026 to 2029 will appreciate as their term rolls down at the new year. Further, buying callable bonds in lieu of solely buying bullet maturities allows us to lock in better percentages of Treasuries while still managing duration. Considering estimates show that only 10% of callable bonds, or less, ever make it to maturity, we believe it is an attractive option to lock in better yield.

We have not become comfortably numb.

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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.

The Bloomberg Barclays Municipal AAA Index is the AAA component of the Bloomberg Barclays U.S. Municipal Bond Index

The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

The Bloomberg Barclays US Intermediate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers that have between 1 and up to, but not including, 10 years to maturity.

The Bloomberg Barclays US Treasury: 10-Year Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 10 years to maturity.

Municipal securities can be affected by adverse tax, legislative or political changes and the financial conditions of the issuers of the municipal securities.

Municipal bonds can be significantly affected by political and economic changes, including inflation, as well as uncertainties in the municipal market related to taxation, legislative changes, or the rights or municipal security holders. Municipal bonds have varying levels of sensitivity to changes in interest rates. Interest rate risk is generally lower for shorter-term municipal bonds and higher for long term municipal bonds.

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