Portfolio Commentary

Navigator® Tax-Free Fixed Income

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Back to the Future: A Return to the 80s

Market Review

The 10-year U.S. Treasury Note closed the fourth quarter with a yield of 0.92%, up 24 basis points during this time. According to ICI data, fund flows for the quarter also continued a positive trend dating back to first quarter 2020, as investors added over $26.9 million to municipal bond funds.

Steady investor demand and rising Treasury rates compressed muni ratios as the 10-year AAA muni to Treasury ratio decreased from 122.9% at the start of the quarter to 74.9% on December 31st. The 5-year AAA muni to Treasury ratio followed suit, declining from 105.4% to 59.4% during this same time.

Accommodative monetary policy stemming from the Federal Reserve's coronavirus response kept interest rates low. This, along with improving vaccine developments, positive prospects from the Biden presidency, Congressional agreement on a fifth round of fiscal stimulus totaling over $900 billion, and improving economic data, strengthened investor confidence during the quarter. As a result, muni investors enjoyed another quarter of solid positive performance.

Fourth Quarter Performance Highlights

- During the fourth quarter, the strategy had overweight exposures to local school districts, Healthcare, and Utilities, which positively contributed to strategy performance.
- Underweights in various purpose and tax-revenue supported bonds also aided strategy outperformance for the quarter.
- The strategy maintained a high-quality orientation with an average credit rating of AA- with the strategy's focus on generating tax-exempt income producing a 3.92% current yield during the fourth quarter.

Positioning and Outlook

The fourth quarter of 2020 presented a unique set of circumstances to the municipal market: lower anticipated supply (made even lower due to 35% of supply being taxable), an incredibly strong bull market flattening move, and a relative value appreciation of the asset class most evident in the 7 to 20-year part of the yield curve (an incredible 50 basis point move in the 7-year from 109% to 57%).

The portfolio was well-positioned for this outsized move, with an average maturity at the quarter's start favoring longer-term bonds (greater than 12 years) and a modified duration of 4.4 years. As the need to buy began to defy traditional market metrics, and the tidal wave of investible cash normally associated with December sought a home, we chose to sell into the demand, and focused on shortening duration with new purchases.

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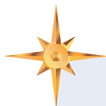

Currently, the portfolio's modified duration stands at 4.0, and many of our longer-maturity bonds held comply with this duration target, as they are priced to shorter-than-average call dates. We further increased our exposure in the "barbell" trade, choosing to straddle the 5-year and 7-year maturities that offer little in the way of total return and relative value, and sought refuge in what we believe are the more attractive 3-year and 12-year maturities.

We continue to seek attractive situations in the revenue space, including in industrial development bonds as well as essential service revenue bonds. We believe revenue bonds should recover as we emerge from COVID. Hospitals will face continued stress, and we are focused on major health systems in recognizable locales. The yield curve has a risk of bear steepening as the economy recovers, but the scarce supply of exempt bonds, especially in high tax states, should console those who focus on ratios. This is your grandfather's bond market, as ratios from the 1980s make a bold return, especially given the expectations of higher taxes.

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