Portfolio Commentary

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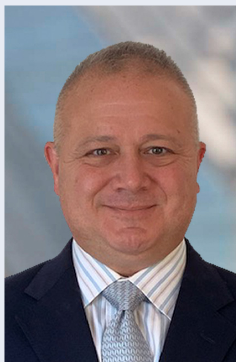
Portfolio Managers



Neal DeBonte
Portfolio Manager

Jamie Mullen
Senior Portfolio Manager

The Ides of Fall for Municipal Bonds

Market Review

Municipal bond performance was weak in the third quarter of 2021; 5-year yields increased 4 basis points, 10-year yields increased 14 basis points, and 30-year yields increased 16 basis points. The quarter's issuance was marginally lighter than the previous one, coming in at $120.5 billion vs. $121 billion, which was well behind last year's third quarter at $144.7 billion. The year-to-date supply of $353 billion is nearly a match to last year's tally of $355 billion. The tailwind of healthy inflows stemmed steeper losses as weekly Lipper inflows averaged +$1.4 billion. However, flows took a steep dip at quarter end, adding to an already cautious tone.

Headwinds were numerous, and of a magnitude the market could not shrug off. First and foremost, as we mentioned in last quarter's missive, was the uncertainty surrounding the Infrastructure and Reconciliation Acts, both of which have significant implications for the municipal bond market. The uncertainty was twofold: content and passage.

Each plan offered potential pitfalls as well as boosters for the market's composition and demand model. With all the legislation in partisan limbo, traders and managers stepped back and away from activity. Further headwinds presented themselves in market technicals: low rates and low ratios to Treasuries conspired to drive trading volumes to near-term record lows.

By August's close, trading volumes were down 34% from the year prior and average daily volumes of $8.9 billion traded represented lows not seen since 2001. In the broader fixed income context, Federal Reserve discussions surrounding tapering asset purchases and tightening versus a mixed bag of economic data weighed on a muni market already trading rich, especially in the front end, and left rates little choice but to trend higher. The Fed's actions were ripe with ambiguity as timing and scope are up in the air as well. We are bearish on the uncertainty, but bullish when it all resolves.

Third Quarter Performance Highlights

- Bonds purchased reflect our belief in superior relative value and more importantly, greater real yields offered in the intermediate and longer end of the curve. We positioned the portfolio for continued flattening, which didn't materialize. While the new issue market remains crowded, we have taken advantage of price concessions presented in the secondary market, as limited liquidity eliminated recent high-demand premiums.
- We increased exposure to PA, CA, NJ and NY general obligation credits as research indicated that they remained cheap or neutral as compared to recent spreads of benchmark yields. Further, these states could bear the brunt of any tax increases presented in potential code changes, ergo increasing the value of their exemption. While the portfolio focused on A rated bonds or better, we have started to consider Baa1 holdings as credit spreads have started to make more sense.

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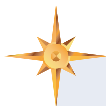

- We continued to look for opportunity and added to sectors that we felt had correlation to an improving economy and/or we were underweight versus the benchmark index. Bonds purchased during the quarter were in the Transportation sector including toll roads, port facilities and airports, as well as sales tax/special tax revenue bonds.
- We added to our exposure in Healthcare in specialty states such as NJ and CA, where every bit of incremental yield is additive: it helps fight lean supply, robust demand, and high taxes.
- As the muni yield curve steepened in earnest at July's close into August, we suspended adding to longer duration and began to buy cushion callable, new money bonds—longer maturities priced to shorter calls. This structure is defensive in nature and trades at greater yields than bullet maturities of similar duration as measured to the call. With well over 75% of the muni-verse never making it to maturity, this strategy seeks to achieve higher yields with limiting extension.

Positioning and Outlook

We believe Q3 2021 may go down as one of the sleepiest quarters in municipal bond history, only to be ripped from that slumber violently by Q3's end and Q4's open. Last quarter, we warned about the effects of uncertainty and complacency in the market; the par amount of bonds traded during the quarter had tumbled by 34% so far this year to $1.43 trillion, a 22-year low, according to data compiled by Bloomberg. Broad, positive technicals including record inflows into exchange traded and mutual funds and a lack of market disruption despite Ida's landfall or West Coast fires were not enough to stem the uncertainty surrounding Washington's inability to pass the Infrastructure and Reconciliation Acts, both of which have far reaching implications for municipal bonds (oh, and the newly energized hawkish Fed stance kept rate hike fear in place).

The market entered the quarter with a bullish flattening bias in place, but the sanguine trading attitude and lack of conviction reversed the trend in quick fashion, with the 5-year/30-year muni curve steepening 19 basis points from mid-July to the quarter's close. This is in stark contrast to the Treasury market's 5 basis point flattening. In fact, since 2016 and through 2020, the muni market curve flattened three out of five periods from August to year end, and the steepening years of 2018 and 2020 saw only single digit increases.

From August 1st until this writing, the curve is 12 basis points steeper. Also, consider we are entering the "Ides of Fall," as we discussed here in the past—inflows grow slower, supply grows faster, and the herd runs for the perceived safety of the front end. 3-year and 5-year munis saw inter-quarter ratio lows of 33% and 48%, respectively. It is our belief that these ratios indicate a market that is overbought and unsustainable.

It's as if the rest of the curve and ratios became directional with rates, and the front end was frozen. The Ides of Fall are real, and oddly enough, looking at 2006 to the present, the 5-year benchmark saw rates go down and up equally, while the 15 and 20-year both moved lower 10 times and up only 4. Similar moves can be observed in muni percentages of Treasury yields. The "safety" of the front end can be an illusion at times. Oh, and what of the Fed? Our research shows in the last five hawkish Fed regimes, the 5s/30s curve flattened in grand fashion in all but one (April 1997 was unchanged).

We extended maturity and duration via outright longer bonds as well as in weighted barbell trades favoring the longer end. These trades were entered into early Q2 and into Q3. The steeper market negatively impacted those trades, and ergo performance. Our conviction remains that the short end of the yield curve offers little reward, is overvalued, and seasonally speaking, is an unfavorable part of the curve to focus on. Given higher volatility and seeking a balance between duration risk and return, we have once again returned to purchasing long dated cushion callable bonds as well as a more evenly weighted barbell strategy.

We have purposely reduced long duration risk in lower coupon holdings and non-specialty states. Although the long end presents rate risk, I believe we have nominalized excess liquidity risk. Finally, our studies indicate the muni curve tends to flatten significantly in hawkish Fed regimes. This tendency, combined with favorable demand metrics in pending Washington DC policy, keeps us focused on a patient trade which includes investment quality bonds with final maturities 12 years and longer.

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