Portfolio Commentary

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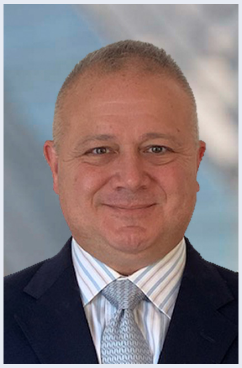
Portfolio Managers



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Muni Supply and Demand Dynamics Remain Unchanged

Market Review

Given maturity, either the muni market giveth or taketh away in 2021's fourth quarter. Overbought front-end conditions were unsustainable— yields increased by 8 basis points in 3 years and 5 basis points in 5 years. The long-end fared better— yields fell 8 basis points in 10 years and 19 basis points in 30 years.

The flatter muni curve paled in comparison to the 65 basis point Treasury flattener. Ergo, the ratio to Treasuries plummeted: the 3-year sank from 52% to 35%. 2021 issuance was approximately $473 billion, up just over 1.5% versus 2020. December issuance was strong, with more than $31 billion before the holidays and up 12% from last year according to Bloomberg.

Inflows into municipal bonds helped support performance as the asset class experienced an amazing 51 weeks of inflows and 1 week of outflows year to date. Weekly inflows in the fourth quarter averaged $600 million according to Lipper.

Watered down political policy has been neutral for municipal bonds as the Infrastructure Act did not contain any bond-centric policy. The Reconciliation Act also failed to pass in 2021. This Act was somewhat muni neutral—a potential increase in the SALT deduction would be offset by a surcharge tax on the wealthiest Americans. Many states have unspent COVID aid and are reporting higher revenue collections (income, sales, and property tax), so any loss of further Federal funding would not prove fatal.

The fourth quarter experienced the most volatility since the start of the COVID outbreak, reaching a crescendo in November's close and remaining in the higher end of the recent trading range. The Fed's hawkish announcements concerning the end of quantitative easing and tightening provided the impetus for higher volatility.

Fourth Quarter Performance Highlights

- The theme we discussed last year, The Ides of Fall, played out again this year as the front-end got crowded, underperformed, and forced participants to either consider lower rated paper, or move out the curve in search of yield. Inflows tend to fall after August, and this year the pattern continued, lending itself to late Q3 and early Q4 weakness.
- As we posited earlier this year, in times of a Fed rate tightening regime, the curve may initially steepen, but as the path to higher short-term rates becomes clearer, the muni curve usually flattens, favoring longer-dated positions. While we sold longer, low coupon positions to weed out underperformers, we continued to favor longer-dated maturities based on our observations.
- Recent new issue spreads in NJ, CT, and IL reinforced our decision to hold positions built in 2020/early 2021, as spreads to muni benchmark AAA curves continued to move tighter. We are willing to buy or sell, depending on where

we are in the credit/rate cycle.

- We added to pre-paid natural gas bonds and transportation bonds to better mirror the index. The index has heavy weights in BBB bonds; the sector is rich, and our rebalancing is dependent on a sound entry point and issuers we are comfortable with.
- During the quarter, we bought cushion bonds (long final maturity with shorter calls). We believe they are becoming scarce, but aren't yet fully trading as such, and their convexity profile/refundability offers more protection in a softer market. We also continued to buy 1yr/9-15year barbells—short percentages of Treasuries were better on the short leg, and curve steepness directed the long leg.

Positioning and Outlook

The fourth quarter closed a year characterized by declining trading volume. Uncertainty surrounding central bank policy could be blamed, but we were firm believers that the Fed would adopt a hawkish stance in previous missives. We further posited that gridlock in Washington DC would produce much ado about nothing, and policy proved neutral.

Low yields, ratios and competition for bonds could be blamed for decreased volume. Customer purchases as a percentage of par value traded was the highest it's been in six years, with monthly totals exceeding all but two previous months' highs, set in October and November of 2020 (the same months munis saw some of 2021's worst performance). Any downside should be limited given the breadth and depth of the customer base. With declining coupon structure becoming the norm, we believe some headwinds may arise: any market sell-off would increase duration faster on these newer bonds, and it's for this exact reason that we have harped on buying fuller coupon structures throughout the year.

Most pundits forecasting 2022 supply, whether more or less than 2021, all agree that the volume of traditional investment-grade exempt bonds will be limited. Some are calling for 8% of muni bonds to be called or mature next year, and 30% within 5 years. Combined with taxable munis cannibalizing exempt issuance, the universe of exempt bonds is growing slower than headline supply estimates infer. In the short term, we believe supply pressure will be particularly acute during the first quarter of 2022.

As stated last quarter, we were bearish on uncertainty, but bullish on clarity surrounding the Fed, policy, and muni supply. As the curve approached its 3rd and 4th quarter slope and volatility nadir, we added longer final maturity, callable bonds, 8 to 10-year bullets, and weighted barbells in anticipation of the coming flattening. October saw bear flattening and another great buying opportunity we took advantage of while November saw aggressive bull flattening. December was quiet with a marginal nod to muni high yield performance as demand is still very deep. Our buys in August and September hurt us in Q3, but continued shopping in October and the market's about-face proved fortuitous in later Q4.

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