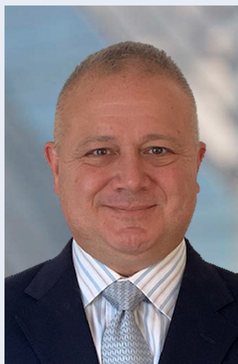
Portfolio Commentary

# Navigator® Tax-Free Fixed Income


Portfolio Manager



**Neal DeBonte**
*Senior Portfolio Manager*


## So Much for "In Like a Lion and Out Like a Lamb"

### Market Review

The relative respite of February's market action was reversed in March, with the pressures seen in January resurfacing. While most expected supply to increase from 2021's totals, no one forecasted the incredible volume of redemptions the market experienced nor the Treasury market's painful grind to higher yields.

Redemptions in the muni market year to date total approximately $15 billion, whereas in 2021 the first quarter saw inflows of $18 billion. The overall move in levels was spectacular: using the Bloomberg BVAL AAA callable curve, 3-year muni yields rose 5x from their 2022 starting point (0.32 to 1.87); 5-year bonds rose 3x; 10-year bonds rose just over 2x and 30-year bonds rose 1.7x.

With Treasury bonds providing direction, the 3-year/30-year muni curve flattened again, moving 49 basis points versus last quarter's 27 basis points. Pressure was not only felt in outright rates, but was seen in muni relative value, as the asset class as a whole saw underperformance versus its Treasury counterparts.

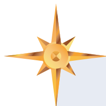
Washington was mute on any municipal bond related legislation, as any increased spending was shelved due to lack of sponsorship and the advent of the war in Ukraine. However, late in March discussions began to emerge regarding higher taxes on the very wealthy.

Credit spreads widened over the course of the quarter, though the move wider can be attributed more to the overall cost of liquidity rather than an erosion of fundamentals. This was a classic example of more sellers than buyers across the credit curve, and the selling was across the full spectrum of market participants: retail, institutional, and issuers themselves. Issuance through the quarter was below expectations ($83 billion year to date), which was down 17% versus last year's first quarter, but was ill timed in that most of the larger supply came in waves when the market was at its weaker moments.

### First Quarter Performance Highlights

- We continued to add to our industrial revenue bonds in the pre-paid gas space as spreads and outright yields moved higher on escalated customer swapping and selling activity. The portfolio continues to re-balance holdings in the Industrial Development sector to get back towards index weight. As of March 31st, our positioning in the Industrial Development sector was slightly underweight the benchmark at 4.33%.
- We believe the financials from Connecticut continue to be favorable as the comptroller's office is now forecasting a fiscal 2022 surplus in the general fund, which is 17% higher than last forecasted. This could bode well for additional paydowns in the state pension plan. These developments reinforce our desire to continue to own the state's general obligation bonds and add to positions on market weakness.
- Speaking of state names, New Jersey was upgraded in March based on improved financials. While we still own New Jersey general obligations, we did sell a considerable amount in the tightening move leading into the upgrade.


*Past performance is not indicative of future results.*
*This is not a recommendation to buy or sell a particular security. Please see attached disclosures.*



- As noted in past commentary, we have favored the transportation sector on positive post-Covid dynamics and increased reliance on systems amidst the current supply squeeze. During the quarter, two of our core holdings were both upgraded.
- The front-ended nature of the sell off had a negative effect on performance in that our shorter call cushion bonds suffered lower evaluations as rates rose. During the sell off, we swapped 4% coupons for 5% coupons to become more defensive, increased current yield, and added to the barbell approach in what we believe are better structured bonds.

## Positioning and Outlook

So much for "March, in like a lion and out like a lamb." The pressure on rates throughout the quarter accelerated in March on the shoulders of a more hawkish Federal Reserve and increased inflation data and expectations. The 3-year/30-year AAA muni curve bear flattened 49 basis points. While it seems like an impressive move, it pales in comparison to the Treasury market's 100 basis points, and at the time of this writing, inversion.

Challenging news was not relegated to rates, but relative value as well, as munis underperformed as compared to Treasury bonds. Entering the new year, the 3-year AA muni ratio to the 3-year Treasury Note was 50%, and now resides at 79%. While the 3-year increased the most overall, we believe compelling value propositions are further out the curve, as the 10-year ratio exceeded 100% on AA muni credits and in 30 years, the measure exceeded 115% on AA bonds compared to a 90% ratio at the start of the year.

Making matters harder, credit spreads and more importantly, trading spreads, got wider as well: while fundamental credit was static, liquidity has a price, and that price made a strong move higher. In 10 years, the move was more than 10 basis points. While these moves are painful as they occur, they do create opportunities that haven't presented themselves for some time.

Buying municipal bonds in excess of 100% of Treasury Notes means the investor is receiving a higher yield in absolute terms versus the comparable Treasury bond, before taking into account the tax-exempt status of the coupon. For example, on a recent AA+ security, the 10-year maturity, at the time of pricing, yielded approximately 114% of 10-year Treasury Notes. While that alone broke all recent trading trends, the spread to the municipal market 10-year benchmark was wider than its traditional bands, offering a chance for additional returns should rates stabilize and normal trading spreads re-emerge.

*Past performance is not indicative of future results.*

*This is not a recommendation to buy or sell a particular security. Please see attached disclosures.*

The views expressed are those of the author(s) and do not necessarily reflect the views of Clark Capital Management Group. The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. There is no guarantee of the future performance of any Clark Capital investments portfolio. Material presented has been derived from sources considered to be reliable, but the accuracy and completeness cannot be guaranteed. Nothing herein should be construed as a solicitation, recommendation or an offer to buy, sell or hold any securities, other investments or to adopt any investment strategy or strategies. For educational use only. This information is not intended to serve as investment advice. This material is not intended to be relied upon as a forecast or research. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Past performance does not guarantee future results.

This document may contain certain information that constitutes forward-looking statements which can be identified by the use of forward-looking terminology such as "may," "expect," "will," "hope," "forecast," "intend," "target," "believe," and/or comparable terminology (or the negative thereof). Forward looking statements cannot be guaranteed. No assurance, representation, or warranty is made by any person that any of Clark Capital's assumptions, expectations, objectives, and/or goals will be achieved. Nothing contained in this document may be relied upon as a guarantee, promise, assurance, or representation as to the future.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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 or an investment), credit, prepayment, 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).

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.

Treasury yield is the return on investment, expressed as a percentage, on the U.S. government's debt obligations. Looked at another way, the Treasury yield is the effective interest rate that the U.S. government pays to borrow money for different lengths of time.

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.

Treasury notes are interest-bearing securities that have a fixed maturity of not less than 1 year and not more than 10 years from date of issue. Treasury currently issues notes in 2, 3, 5, 7, and 10-year maturities. Treasury notes pay interest on a semi-annual basis. When a note matures, the investor receives the face value.

S&P's AAA rating is the highest that can be assigned to any issuer of debt. It is the same as the Aaa-rating issued by Moody's. This rating is assigned to investment-grade debt that has a high level of creditworthiness. Debt issuers with the highest ratings have the strongest capacity to repay investors. Their strong financial positions give them the lowest chance of default.

The AA+ rating is issued by S&P and is similar to the Aa1 rating issued by Moody's. This rating is of high quality and falls below the AAA ranking. It comes with very low credit risk, even though long-term risks may affect these investments. The AA+ rating is considered one of the rankings for investment-grade debt. Because they are financially strong, investments that are rated with an AA+ rating have a strong likelihood of repaying their debts, making the chance of default very low.

S&P's AA rating denotes expectations of very low default risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.

Clark Capital Management Group, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill or training. More information about Clark Capital's advisory services and fees can be found in its Form ADV which is available upon request.

CCM-508