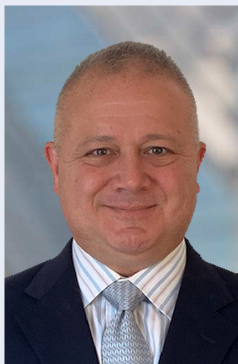
Clark Capital Management Group

Portfolio Commentary

Navigator® Tax-Free Fixed Income

Portfolio Manager



Neal DeBonte
Senior Portfolio Manager

Municipals Behave in Bear Fashion

Market Review

The municipal market has behaved in a record-setting bear fashion so far in 2022; that theme characterized both the first and second quarters. The Bloomberg BVAL AAA Municipal Yield Curve benchmark moves throughout the quarter illustrate a market that bear steepened as rates increased across all maturities, more so on the longer end. The 3-year yield increased from 1.87% to 2.06%; the 10-year moved from 2.21% to 2.73%. On the long end, 30-year maturities swelled to 3.19% from 2.54%, a whopping 65 basis point rate move.

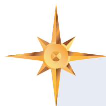
Considering relative value, or how municipal bonds performed relative to their Treasury bond counterparts, municipal bonds could be considered the victor, albeit marginally so. Comparing Bloomberg's BVAL AAA Municipal Yield Curve versus Treasuries, 3-year ratios declined to 69% from 75%, 10-year ratios fell to 91% from 95%, and 30-year ratios fell to 102% from 106%. While the action was a bright spot, these high ratios imply investor disinterest. However, the historically high percentages are an indicator of value, because the exempt nature of munis offer a not-readily-apparent kicker in value.

Inflation fears, a hawkish Federal Reserve, new issue supply and investor liquidations were strong headwinds for the market. 30-day supply, reported by the Bond Buyer, averaged $14 billion daily, versus Q2 2021's $11.2 billion. Flows, as reported by the Investment Company Institute (ICI), offer quite a dichotomy: Q2 2021 saw $23.4 billion of positive flow into the asset class. The same period in Q2 2022 experienced $58 billion in outflows. Institutional sales, as measured by par value of bids wanted, set records throughout the quarter according to Bloomberg data.

Second Quarter Performance Highlights

- We made a concerted effort to shorten duration as we felt the market would continue to consolidate lower; to that end, modified duration to worst ended the quarter at 4.27, lower than the 4.48 at the start. Given the duration extension inherent in a market moving higher in yields, we are happy that we were able to fight the move and net/net reduce duration.
- Although we raised cash holdings mid-quarter and shortened duration, we were able to maintain a coupon in excess of 4.00 overall.
- Duration was the Achilles heel over the quarter, as defensive, shorter call bonds extended in duration during the selloff. 4% coupon bonds with marginally longer maturities crossed from premium to discount bonds and yields overall continued to grind higher.
- The quarter was marked by poor liquidity, stubbornly low evaluations, and benchmark measures that were established on thin trade in distressed conditions. These factors contributed to underperformance as the cost to alter the portfolio remained elevated throughout the quarter. The lack of trade data to form a robust evaluation of any one bond hampered broader evaluation measures.

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



Positioning and Outlook

The current shape of the municipal curve offers barbell opportunities: the 3-year/10-year curve, after putting in a bottom April 5th (38 basis points), steepened considerably through the remainder of the quarter, peaking at 93 basis points in mid-June and closing the month at 86 basis points (Bloomberg data). Coincidentally, we believe muni relative value versus Treasuries remains attractive in the 10-year tranche, as seasonal investing is crowding out opportunity in 3-5 years. While this move hurt our existing positions, it created a trade we favor - reducing long duration to better mirror the index as well as selling the richer 4-year paper and barbelling trades by purchasing short bonds or staying in cash and buying 10-ish-year high grade bonds. Not only can we take advantage of ratios, but we also seek to consolidate holdings into more tradeable, well-structured blocks in a duration neutral fashion. Bonds sold consisted of low coupons and credits we felt were at risk of further poor performance if the current dynamic persists. We also cleaned up one-off odd lots. Though losses were monetized, we feel we are moving to a more nimble and predictable portfolio structure.

As stated in previous summaries, we are in a Fed tightening regime, and with that, a flatter curve may materialize (or even invert). A front-end selloff or long-term rally, or a mix of the pair, could flatten the curve. Eventually though, flattening should give way to a steeper curve as the Fed completes its actions. We are still holding some long paper and less 3-year/4-year bonds to capture flattening and will redeploy when the Fed is near completion. We are also "playing the middle" by buying intermediate bonds. We still prescribe to our thought that when the Fed finishes, and Fed funds turn lower, inflows will be robust and meaningful, leading to stronger performance.

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Bloomberg BVAL AAA Municipal Yield Curve s a standard market scale with non-call yields up to year 10 and callable yields thereafter. This curve assumes a normalized 5% coupon and is plotted as an offer side yield to worst.

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.

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