Portfolio Commentary

Navigator® Tax-Free Fixed Income

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Stay Nimble, Stay Quick

Market Review

The Bloomberg Barclays 5-Year Municipal Index lost 2.71% in the third quarter. The quarter was broadly characterized by excessive liquidity demand in the form of elevated institutional bids wanted, continued mutual fund redemptions ($13.9B for the quarter; Investment Company Institute (ICI) data) and a move to higher rates. Barclays noted September's performance was the worst since the 1990's in a recent market commentary. The 3-year yield wrapped up September at 3.09%, up from June's 2.09% close - a 100 basis point move; the 5-year increased 86 basis points (closing at 3.13%); the 10-year increased 51 basis points (closing at 3.26%); the 30-year increased 70 basis points (closing at 3.95%). As the actions of the Federal Reserve exerted pressure on shorter Treasury rates, so too did that bleed into municipal bonds. The curve bear flattened in dramatic fashion through 7 years, while there was a more parallel shift higher in rates further out the curve (Bloomberg data).

When looking at the ratio between Treasury and municipal bonds, we see that munis underperformed their Treasury counterparts in 3, 5 and 30-year maturities. Surprisingly though, we believe the underperformance was not extreme: in the case of the benchmark 5-year, the ratio only moved from 75% to 77%. The 10-year maturity outperformed Treasuries, shrinking to 85% from 91%. The 30-year benchmark held tough, which is impressive given the risks associated with the longer duration: it moved to 104% from 102% (Bloomberg data).

Though fund redemptions, institutional selling, and an active and resolutely hawkish Federal Reserve posed headwinds for the market, those same headwinds created a pause in issuance that we believe held deeper market losses in check. Third quarter issuance is coming in near $90B, versus the second quarter's $112B. September's issuance was 41% lower than September 2021. Year to date issuance is 14% lower than last year. Deal flow was stable though as the Bond Buyer's 30-day supply announcements, at $11.7B for the quarter, was squarely on the trailing 1-year average (Bloomberg data).

Third Quarter Portfolio Highlights

- Our efforts to reduce extension risk continued throughout the quarter, as the embedded call option in many municipal bonds has reduced liquidity and magnified value erosion throughout the year.
- Cash remained a viable alternative, both as an outright position as well as being the short leg of a barbell trade, the longer leg of which was composed of intermediate maturity bonds with higher liquidity profiles.
- Duration continued to be an outright issue in and of itself, as the market rolled over through the quarter's end. Bonds initially thought to be defensive eroded in value as the world of fixed income gravitated to higher yields. We stayed on course and systematically sold positions that we felt posed a duration trap for us. Our modified duration to worst was reduced to approximately 4.03 from 4.27.
- Overall, price discovery remained difficult as selling in markets suffering from reduced liquidity has a price of its own, beyond the credit or structure constructs, and we carefully and diligently chose sale candidates and took

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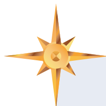

advantage of any opportunity we could create. Overall, though, muni credit remained solid.

- We remained focused on current yield, and our cash position and patience proved fruitful, as we were able to begin sourcing bonds with coupons more than 5.00%, in both short and intermediate maturities. Even though we are heavier in cash, our current yield closed the quarter at approximately 4.21% versus 4.05%.

Positioning and Outlook

The flattening we expected last quarter in the municipal market did materialize, as the 3-year/30-year muni curve ended the quarter 32 basis points flatter (Bloomberg data). The more compelling flattening happened down the curve though, as the 3-year/10-year slope bear flattened 50 basis points. From our observation, many forces were at work: the Fed's activity re-shaping curves via rate increases, heavy customer selling on shorter bonds where they perceived greater liquidity and lower price variance (mistakenly by the way, as the flood of selling created its own value erosion), and low cross market relative value which is proving unsustainable. Also, if we drill deeper into the quarter itself, and consider the 5-year index as a surrogate of market performance, the market was appreciating until August 3rd, when the index began to blow off its intra-quarter high. Real selling then took over with September's Federal Reserve announcement and the market didn't turn back. We sold bonds and exited a large volume of underperforming structures before the market blew off the high and took advantage of September's bottoming to redeploy into barbells, index-related bonds, and high coupon bullets.

While ratios are lower than we would like, we do see opportunity perpetrated by the sell-off, as amongst the fund selling one can find high grades, high coupon bonds and extension-friendly structures due to increasingly less disciplined selling by the masses. While we are maintaining a healthy cash position, we are sifting through offerings and bid wanted scenarios to find value, and doing so cautiously as we aren't convinced the downside volatility is over.

While October's open offers some promise, October, seasonally speaking is an enemy of the muni market; supply often outstrips demand and creates a fundamental supply/demand imbalance. Further, we still have a very hawkish Fed to deal with, as well as myriad global fiscal and political issues. In our view, any increased or continued volatility should provide for excellent investing opportunities in the coming months.

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The Barclays Capital 5 Year GO Municipal Bond Index represents the performance of long-term, investment grade tax-exempt bonds with maturities ranging from four (4) to six (6) years.

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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