Portfolio Commentary

Navigator® Tax-Free Fixed Income

Portfolio Manager

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Light at the End of the Tunnel

Market Review

Overall, the muni market traded with a positive bias in the fourth quarter and outperformed the Treasury market. Despite a daily average of $1.6 billion in institutional bid wanted versus Q4 2021's average of $592 million (Bloomberg data), outflows from municipal funds totaled $39.8 billion versus Q4 2021's inflows of $8.8 billion (ICI data), and liquidity challenges normally associated with year end, munis ended on a positive note. The Federal Reserve did not pause, and exercised two additional rate increases, with targets set for 4.25% to 4.50% and jawboning that a pause in rate hikes was not in the offing.

When we look at rates, despite headwinds, the move lower was impressive. Using the Bloomberg AAA callable curve as our data points, the 3-year moved 51 basis points lower in yield and ended the quarter at 2.56%; the 5-year ended at up at 2.53% (-57 basis points); the 10-year at 2.62% (-62 basis points) and the 30-year at 2.57% (-31 basis points).

Attractive rates and a realization that tax exemption is indeed meaningful brought households back to the market. Households tend to buy in the first 10-years of the maturity curve, hence the overall curve steepening through 30-years; the curve did invert through 3-years, and maintained flatness through 10-years (Bloomberg data). Paltry new issuance in the fourth quarter also buoyed municipal bond prices. For example, fourth quarter issuance was only $66.1 billion versus a year ago at $86.8 billion (Bloomberg data). In fact, issuance for the year was the lowest since 2018 (Municipal Market Advisors data).

Fourth Quarter Portfolio Highlights

When looking at the ratio between Treasuries and municipal bonds, we see that munis outperformed in the 3, 5 ,10, and 30-year tenures. Notably, the 3-year benchmark outperformed, moving from 72% at the start of the quarter to 61% at the end. The 5-year ratio moved from 76% to 62%, the 10-year ratio declined from 85% to 69%, and the 30-year moved from 103% to 90%. (Bloomberg callable muni benchmark yields versus Bloomberg closing treasury yields). The 10-year bonds stand out as a benchmark, as well as the incremental yield it offers, which aided its outperformance.

Muni ratios compressed mainly due to positive supply/demand conditions in the tax-exempt space. Muni bonds did not sell off as heavily during the quarter compared to Treasuries as investors continued to adjust to a more hawkish Fed and the increased likelihood of higher rates. In addition, a notable decreased tax-exempt supply helped keep tax-exempt yields in check over the quarter.

Positioning and Outlook

We think tepid issuance will continue to keep municipal bonds in a "bid" scenario in the first quarter of 2023 as cash returned to investors in the form of coupons, calls, and redemptions should overshadow overall new issue deal size. Though rich muni ratios to Treasuries may indicate an overbought situation, the richness can persist given too many dollars chasing too few bonds. We won't chase the market – instead,

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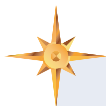

we will cautiously add exposure in sectors we believe are sound including mature transportation systems, large metropolitan utility authorities, viable and geographically instrumental public/private partnerships, and industrial revenue bonds backed by strong corporations.

While we will continue to invest in general obligation bonds, we will be sensitive to changes in tax receipts, property value and issuers' ability to levy higher taxes, especially if a recession is on the horizon. Credit wise, we believe the muni market is still on sound footing overall, enjoying the tailwinds of Covid-era federal aid and the federal government's funding of many infrastructure projects, which alleviates the need to issue new bonds. We will maintain a cushion in cash, as new issues will come eventually. Funding needs should be clear near the quarter's end, which coincides with traditional seasonal weakness in munis – as a supply bubble is the market's biggest risk, we want to be prepared to play to any market dislocation.

As long end rates haven't flattened in the same context as Treasuries, and the scale is especially steep past 11 years, we will continue to look for opportunities in longer duration, but we will stick with bonds with a desirable convexity profile (no short calls) and limit purchases to larger, more liquid names, or bonds that offer some type of geographic importance. We will seek to manage duration through the use of barbells, avoiding the poor convexity profile of overvalued short call bonds and offset longer duration with short bullets and cash.

We began positioning the portfolio for flattening in the second and third quarter, choosing to invest on weakness. We continued to eliminate many one-off positions, bonds with poor call structures, and amalgamated trading in more desirable blocks, which provided an edge in liquidity. These trades helped us achieve positive results in 2022's fourth quarter. We added to existing positions at attractive levels in the odd lot market and continued to add high coupons while at the same time used the weakness in the low coupon sector to establish some tactical duration investments.

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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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