Portfolio Commentary

Navigator® Tax-Free Fixed Income

Portfolio Manager

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Jane, Get Me Off This Crazy Thing!

Market Review

2023's opening quarter was a fortuitous one for municipal bonds, but it proved to be a tale of months rather than a straight line of positive returns. Considering the Bloomberg 5 Year AAA Municipal Benchmark, the period opened at 2.53%, attained a low yield early in February of 2.03%, then entered a bearish phase and printed its high yield of 2.66% on March 2, only to commence moving lower and closing the quarter at 2.22% (Bloomberg Data).

A myriad of forces were at work: continued Federal Reserve rate increases and jawboning, the threat of recession or continued inflation (depending on how the tea leaves were read), and a violent yet seemingly shallow wave of bank failures and issues surrounding the health of the banking industry. Volatility was the major theme in the broad fixed income markets, and while there were no muni-specific credit issues, the broad market did manage to push our corner of fixed income around.

Supply came in at $76 billion, down 27% versus 1Q2022, and up approximately 1% from 4Q 2022 (BAML market data). As most firms were forecasting approximately $400-$500 billion for the year, the quarter was disappointing. The lack of supply insulated munis from drastically selling off during February's easing and contributed to performance during the rallies of January and March. If we are to measure performance in munis vis-a-vie Treasuries, the Bloomberg Municipal 5 Year (4-6) Total Return Index yield was 64% of the general 5-year Treasury at the quarter's onset, hit 55% mid-February, drifted higher to 68% in late March, and then closed strongly at 62% (Bloomberg Data).

First Quarter Portfolio Highlights

- Several technical factors that help to define performance in the municipal market made decidedly bullish moves. Investment flows in the fund complex took a bullish turn. As reported by the Investment Company Institute (ICI), 1Q 2023 flows were +$9.03 billion, a departure from 4Q 2022's -$43.8 billion and 1Q 2022's -$46.6 billion. As 2022 only had one week of positive inflows, this was indeed well received news.
- The daily volume of institutional customer bids wanted also provided relief. 1Q 2023's daily average came in at $1.035 billion daily, a 25% reduction versus a one year lookback. Customer bid wanted tends to soak up available liquidity, so its absence can allow for price appreciation in absolute and/or relative terms (Bloomberg Data).
- In credit news, Illinois was upgraded by both Moody's and S&P, and now is rated A3/A-. NYC was upgraded to AA by Fitch, and Penn Turnpike's senior and subordinated debt was upgraded and are at AA- and A+, respectively.

Positioning and Outlook

What a quarter of volatility! January's strong start led to what Municipal Market Advisors (MMA) called the worst February since 1990 (though munis did outperform on a relative basis much of February when considering the 5-year, only giving back that outperformance into month end). Then, munis reversed with a rare March rally, which saw the 5-year AAA municipal benchmark yield to maturity appreciate over

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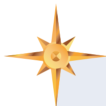

10% (Bloomberg Data), coincidently referred to by MMA as the best March since 1990.

Last quarter we opined that, "tepid issuance will continue to keep municipal bonds in a "bid" scenario in the first quarter of 2023," which held true. The market recovered, and the supply imbalance brought positive quarterly performance.

We exited our cash/intermediate maturity barbell position and invested heavily in 3 to 7-year maturities, with the hypothesis being the biggest risk facing the market would be normalization and perhaps re-steepening of the yield curve.

The flat nature of the front end makes the trade compelling: during the quarter, the 5-year/10-year slope went from +8 basis points to -3 basis points, and back to +5 basis points. So, in late February and mid-March, the 5-year yielded MORE than the 10-year. A 3-year lookback reveals that the average slope is 37 basis pointss, so there should still be meat on the bone.

We began to invest in defensive cash holdings as the one-way downside volatility of 2022 began to lift. While February gave us some pause, we still bought the weakness, but holding any cash in March's rally made index-level performance difficult to achieve.

We still favor situations where we can build block size in liquid structures and names as we believe the economies of scale are just too favorable to ignore. The strategy we have discussed here in the past—buying general obligations or large-issuance states that were addressing budget concerns during Covid is maturing. NJ, NY, CT have all tightened down versus benchmark scales, but overall, general obligation credit trends will keep us involved. California did get wider on budget deficit news and is looking attractive again to us. Our tactical purchases in transportation and industrial development bonds were additive, and we will continue to seek opportunities in those sectors.

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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.

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.

The Bloomberg 5 Year Municipal Bond Index is a capitalization weighted bond index created by Bloomberg intended to be representative of major municipal bonds of all quality ratings with an average maturity of approximately five years.

The 5 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 5 years. The 5 Year treasury yield is used as a reference point in valuing other securities, such as corporate bonds.

A+ sit squarely in the middle of the investment-grade category of the credit ranking systems. It signifies that bonds are of high-quality and have many positive qualities, but do carry a slightly higher degree of long-term investment risk.

AA/AA- National Ratings denote expectations of a very low level of default risk relative to other issuers or obligations in the same country or monetary union.

AAA is the highest possible rating that may be assigned to an issuer's bonds by any of the major credit-rating agencies.

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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