Portfolio Commentary

Navigator® Tax-Free Fixed Income

Portfolio Manager

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When the Well Runs Dry

Market Review

The Bloomberg Municipal 5 Year Index returned -0.72% in the second quarter of 2023. The quarter's performance was not a straight line, but rather marked by brief rallies and sell-offs. Munis continued to be influenced by the Fed, economic releases, and market activity driven by the late-date passing of the federal budget.

Yields carried forward their March move lower, defying traditional seasonals and set a low on April 13, at 2.01%. Usual spring market paradigms emerged, which were made softer by a weaker Treasury market yearning for Federal budget resolution, and yields increased as the lone wave of supply overwhelmed the investor and dealer communities.

The 5-year municipal maturity peaked at 2.74% on May 26. The Fed's timing for a rate-increase break was well-executed for tax exempts and coincided with the June 1 coupon and redemption date; the market was able to hold the May 26 high rate and rally from there, and closed the quarter at 2.59. This provided a 0.70% June index return (Bloomberg data).

Shortages continued to plague the market. Year to date, supply stands at $170 million, which is 21% lower year over year and well short of widely published estimates of $200 million. Supply shortages are especially acute in high tax and core states including NY, NJ, CA, and PA. If we consider that 10% of the issuance was taxable, it made finding options for traditional tax-exempt investing even harder.

Conversely, institutional selling, as measured by bids wanted ($1.2 billion a day), grew in the second quarter, about 15% above levels in 1Q 2023. Thankfully, selling did not approach the massive volume seen in 2Q 2022, which saw on average $1.6 billion a day in for-sale bonds.

Second Quarter Portfolio Highlights

- Supply was a popular theme driven home hard. As of June 30, only 7 states had a positive supply number (30-day supply less amounts called or maturing) according to Bloomberg data. NY and CA combined for over $5 billion in negative supply, and the top 15 states in negative supply scenarios (including NJ, CT, MA, AZ, and PA) totaled nearly $20 billion. Adding in coupon payments only makes the numbers more dramatic. We believe this supply imbalance could be a lasting tailwind.
- The FDIC completed its portfolio sales of munis from failed banks: the operation commenced in mid-May and ended on June 30, and was sized at just under $7 billion. The fear of the list was able to beat up the market at first, but the reception to the bonds and the orderly fashion of the sales allowed for ample customer participation and became a source of bonds that could not be found in primary markets. Low coupon/high grade bonds originally bought at par or premium prices could be had for prices around $90, with yields 90-100% of Treasuries. We did make several tactical purchases for the portfolio as we believed the yield, duration, and convexity profiles were additive.
- Munis reached overbought conditions when measured by the muni/Treasury ratio in mid-April, carrying forward March's euphoria. It settled at 57% on April 17 according to Bloomberg data. From there, munis underperformed and the ratio climbed to a high of 72% in May, driven by a brief supply wave, FDIC bond list sales, and U.S. budget uncertainty. Ratios then started to grind lower and did not look back, closing the quarter at 63% (5-year data according to Bloomberg), and considered neutral on a 3-month and 3-year lookback (BAML research).

Past performance is not indicative of future results.
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Positioning and Outlook

Our outlook on municipal credit, while still optimistic, is certainly more cautious. With Covid-era aid dwindling, threats of a future recession, and budget shortfalls being forecast in states like CA and NJ, it behooves us to remain vigilant. Especially, as trading spreads on Il, NJ, NY, CT (just about everywhere) have tightened and in some instances have become exacerbated by supply/demand imbalances.

Simply put, too much demand shrinks spreads too much, and mitigates value propositions. We have tactically begun to reduce exposures in CA and IL General Obligations (GOs), as credit spreads in those states narrowed far faster than we modeled at our entry point. Indeed, CA GOs are trading at yield levels below stand-alone AAA credits in other states. We have sold the bulk of our CA GO holdings in general market accounts and re-invested in high grade bonds at higher yields than where CA was sold.

Hospital spreads inside 5 years are one of the few spots where credit spreads have been wider. We have been short hospitals in our overall allocation for more than a year given headline risk, shrinking post-Covid margins, and our belief that we have better opportunity in corporate-backed muni bonds where we can better define credit exposure and taxable equivalent yields are higher than their taxable corporate counterparts.

Municipal bonds' reputation as a non-correlated asset to stocks and taxable bonds, their stoic performance in past recessions (aside from 1981 and 2008), and higher yield entry than in the past 2 years, should keep assets flowing in even though ratios are in a neutral band. As coupon income has been a prime driver for muni returns over the last 5 years, we continue to use any leverage we can to negotiate full coupons on our newer purchases to maximize current yield, and in some instances, securing taxable equivalent current yields in excess of 8.00%.

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, and 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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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.

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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