Portfolio Commentary

Navigator® Tax-Free Fixed Income

Portfolio Manager

Neal DeBonte
Senior Portfolio Manager

Cheap Is Small, and Not Too Steep, but Best of All, Cheap Is Cheap

Market Review

The 5-year Index returned -2.03% in the third quarter of 2023. It set its highwater mark in the early going on 7/26/23 and proceeded to sell off into the quarter's close, with the low set on 9/28/23. The muni market's path was definitively influenced by the Treasury market's behavior. Suffering one Federal Reserve rate increase and a fear of sticky inflation, the Treasury bond market sold off and bear steepened. The 5-year muni benchmark made a brief run to quarter lows in July, closing at a 2.51% mid-month and then basically never looked back. It set its high of 3.39% on 9/28/23 and closed the month at 3.36% (Bloomberg data). The move was severe and took the market back to yields last seen in October 2022, and set a new decade rate high, even when including the brief and violent sell-off perpetuated by the onset of COVID in 2020.

Higher overall yields were not enough to capture retail, nor institutional interest. Institutional bids-wanted averaged a robust $1.14 billion per day through the quarter and $1.31 billion in September, which exceeded the $1.14 billion year-to-date average. Through 9/27, ICI reported $7.26 billion in fund redemptions, which was a major driver of both high bids-wanted and a move higher in rates. Sometimes, selling begets more selling in munis, and without a buying audience emerging, erosion in valuations kept sellers in control and scared buyers on the sidelines. High short-term rates, made even more attractive by an inverted yield curve, provided no impetus for investors to consider even moderate duration extension.

Third Quarter Portfolio Highlights

- Quarterly supply was 3% lower versus the third quarter of 2022, and 8% lower than the second quarter of 2023 according to BAML research. Annual supply is also suffering, down by over 10%. Higher rates have eroded the supply of refunding issues and have also kept new issues from coming to market. Lower new issue volume makes establishing clearing levels more difficult and lends itself to greater market volatility.
- Municipal bonds underperformed Treasuries when measured by percentages. Low demand and selling pressure were the main drivers. The 5-year ratio went from 62.9% to 73.3%; while the 10-year moved from 66.2% to 75.3%. While a move to higher rates AND higher ratios is frustrating for involved investors, it makes for an attractive opportunity for new purchases as 5-year taxable equivalent yields are hovering near 5.50, and municipal credit is still healthy. S&P upgraded 132 ratings and downgraded 32 (and our home state, PA, was put on positive review).

Positioning and Outlook

We are still neutral on municipal credit. While many fundamentals remain strong, challenges facing metropolitan areas such as San Fransisco merit surveillance, and any economic slowdown could impair tax collections and project revenues across the country. This is further clouded by a potential government shutdown. The strategy's

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overall rating is AA-, and new investments have favored higher grade issuers. A benefit of a selloff is the option to upgrade credit at higher rates and meaningful relative value points. We remain underweight small universities and Healthcare, as fixed overhead costs continue to pressure margins. We are finding opportunities in corporate backed munis and have added to existing positions at higher yields.

Yield curve normalization, or a return to a positively sloped yield curve, could be the next major hurdle for the market, and is one we have been proactively preparing for. In anticipation of such, we have kept durations shorter and have all but eliminated extension risk in the form of callable bonds; we favor bullet maturities at this time.

While the curve was inverted, we overweighted short maturities versus the index and barbelled them with the 5-year. If one subscribes to a "higher for longer" narrative and believes that a normal yield curve is in the offing, we feel this is prudent strategy. The slope of the muni curve from 5 to 10-years bottomed out in May at -8 basis points and currently stands at +.07 basis points. The 10-year average is +58 basis points according to Bloomberg data.

Finally, we continue to use market weakness to extract value where we can and negotiate higher, defensive coupons on new issues. Some recent purchases have a current yield of 6.00% or higher. As income has become an increasingly large part of muni returns, we intend to deliver the highest current yield that we can without sacrificing credit quality.