Portfolio Commentary

# Navigator® Tax-Free Fixed Income

## Portfolio Manager

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# Relief Rally Spawns Gains for Municipal Bonds

## Market Review

The 5-year Municipal Bond Index returned +5.22% in the 4th quarter of 2023. It languished near its lows for much of October, having set its low midmonth. October's rate increases were precipitated by a weaker U.S. Treasury market and selling pressure in municipals did nothing to insulate the asset class from the broader rates market.

Indeed, institutional bids wanted for much of October's second half, which was near or over $2 billion a day. Entering November and the favorable seasonal reinvestment period associated with early winter, the market appeared to be oversold. If we consider municipal ratios to Treasuries as an indication of demand, the 5- year ratio entered October at 73% and entered November at 76%. This was after spending most of September in the mid-60% range (Bloomberg).

The narrative swung wildly upon October's close in a move reminiscent of 2022's late fall relief rally. Higher rates, attractive relative value, and renewed retail interest in the asset class brought buyers in, which drove the market for the balance of the quarter. The return on the index was up 5.4% from October's close through year end.

Though the Investment Company Institute's (ICI) muni fund redemption report climbed during the quarter, (-$15.9 billion vs. -$8.37 billion) the market seemed to shrug that off as retail trading volumes surged and SMA accounts put cash to work. The euphoric tone and hopes of a sidelined Federal Reserve can be seen in the path of the benchmark 5-year muni rate, which opened November at 3.56% and closed the quarter at 2.22% (Bloomberg).

## Fourth Quarter Portfolio Highlights

- Supply pressures were nominal in the fourth quarter as issuers remained on the sidelines given high rates and volatility. Approximately $90.8 billion in tax-free new issues came to market in the quarter, vs. $93 billion in q3 (Bloomberg).
- Municipal Market Analytics, a research firm, noted that their price index posted a 2.26% gain in December, which was the largest for a December since 2000. They also note the gains seen in their index in the year's final two months were the strongest since February 1986.
- Using the ratio of the muni 5-year bond to the Treasury 5-year as a gauge of demand, the velocity and breadth of the rally is impressive. As per Bloomberg data, the ratio set its 2023 high at 76% on November 1st, and closed the year at 58%, a move of 18 ratios.
- Prior to the rally, we executed our largest single trade in municipal bonds. Using the proceeds from selling carefully selected tax loss and rebalancing candidates and one-off holdings, we secured our largest block of a highly liquid index eligible general obligation bond. We believe the trade was beneficial to our investors.

*Past performance is not indicative of future results.*
*This is not a recommendation to buy or sell a particular security. Please see attached disclosures.*

## Positioning and Outlook

Preparing for a possible re-normalization and re-steepening of the yield curves, we did keep our duration targets slightly lower than the index coming into and throughout the quarter. Indeed, as rates were rising through October, the 2s-10s Treasury curve set its least negative slope for the year.

However, the ensuing violent rally did re-invert the Treasury and muni curves and we believe that the buying maybe a little overdone. In lieu of a wholesale rebalancing to longer duration, we are patiently holding higher yielding shorter bonds. We are also opportunistically swapping into longer bonds or securing marginally longer new issues on market weakness.

We continue to search for essential service revenue bonds as well as industrial development backed munis (IDRs) and have found some success in the secondary market, especially concerning IDRs. The year's overall weak tone made buying in early Q4 possible at compelling taxable equivalent yields, often in excess of 7%. Concerning A or A+ rated revenue bonds, a dearth of supply is forcing the credit spread tighter. As a result, we don't see a real advantage chasing that market and will add when spreads permit. Using a 2-year lookback, Bloomberg's A+ 5-year revenue index spread to the 5-year AAA index is 37 basis points versus an average of 63 basis points (Bloomberg).

We spent most of 2023 improving portfolio dynamics, which included scaling up in lot size, using tax-loss harvesting to improve duration or convexity profiles, and reducing one-off positions.  Also, as we are cautious looking at the market risks ahead, we realize the coupon will continue to compose a considerable portion of total return. As a result, we remain focused on using our bargaining power to negotiate attractive current income on high-grade bonds.