Portfolio Commentary

Navigator® Tax-Free Fixed Income

Portfolio Manager

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March: In Like a Lion, Out Like an Anvil?

Market Review

The 5-year Index failed to capitalize further on its record-setting performance in 4th quarter 2023 and experienced a sell-off of nearly 1% from its January high to the January low, resulting in a return of -0.37% in 1st quarter 2024. Typical seasonal patterns emerged following the low, and the market rebounded by 0.6% to close out February. Momentum, coupled with somewhat misplaced euphoria, sustained market demand into mid-March, where the Index reached its peak before experiencing a sell-off driven by overbought metrics, ultimately closing the quarter on a downward trend.

Issuance for the quarter was over $100 billion, signifying a 25% year-over-year increase, but a fall of 3% from 4th quarter 2023 (BAML data). The slightly lower trailing supply helped contain losses in the quarter, but still proved a challenge despite seasonal fundamentals. This included, among other factors, an increase in net negative supply. A weaker Treasury market also underscored performance. Based on Fed comments and inflationary data, the Treasury 10-year Treasury note yield rose approximately 32 basis points during the quarter (Bloomberg data).

Despite higher rates, higher issuance is perhaps a sign that infrastructure funding needs are growing as Covid-era federal aid wanes. The demand-side component was resilient and behaved normally, if not overly positive, in the context of seasonality throughout the quarter, as the Investment Company Institute (ICI) reported inflows of $12 billion into the market.

First Quarter Portfolio Highlights

- Muni credit proved resilient as Standard and Poors upgraded 86 credits and only downgraded 39 through February. New Hampshire, Louisiana, Detroit, the New York Metropolitan Transportation Authority (MTA), and New Jersey were amongst those upgraded.
- The inversion of the municipal yield curve continued, reaching a quarterly and one-year record of the quarter's closing day of -30 basis points as measured by the 3-year/5-year curve (Bloomberg data). The one-year average came in at -15 basis points. The yield spread between the 5-year and 10-year tranches also compressed; after setting an 8 basis points high on February 14th, it closed at 0 basis points on March 28th.
- Interestingly, it appears that the "herd" is buying the front end and the belly of the curve exclusively. If we consider the slope of the 10-year/30-year muni curve, it closed the quarter at one-year wides, in direct opposition to the front end. Investment mandates among the quarter's bigger buyers (SMAs, ETFs, Trusts) were clogging the front end's plumbing.
- When considering relative value using the 5-year muni/Treasury yield ratio, it's apparent that though there was movement through the quarter, it remained within a narrow range, which is in line with supply. We entered the quarter at 58%, reached a peak of 63% in January's sell-off, and reverted back to 57% by mid-March. Favorable economic news, increased selling pressure, a healthy supply pipeline, and shrinking cash reserves contributed to a weakening of the

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ratio to 60% by the end of the quarter. Taking into account a look-back period longer than three months, municipal bonds appear to be overbought.

Positioning and Outlook

The persistent inverted curve continues to challenge returns; if we are to remain in equilibrium with Index duration, we need allocations to shorter maturities. As securities "roll down" the maturity curve, they "roll up" in yield. To combat this dilemma, we are: 1) maintaining our search for superior current income and 2) beginning to consider/execute barbells.

We continue to leverage market weakness to structure high coupon/high grade bonds in the new issue market, acquiring coupons from 6.00%-8.00% this quarter. The coupon makes up most of the total return, and we believe taking a defensive stance in income-driven securities is prudent, especially when we can avoid callable bonds that come with extension risk and other unfavorable quantitative properties.

Barbells offer exposure to the higher yields in the front end of the inverted muni curve, and the better roll down profile and enhanced opportunity for total return in longer maturities. This is particularly notable as cross-market ratios are higher (indicating fairly sponsored versus overbought conditions) and potential price appreciation is greater when rates fall. The 3-year muni yield captures 93% of the 15-year yield, offering solid yield for lower duration exposure. The 10-to-15-year part of the curve should compress when rates move lower, and yields are more than 65% of Treasuries, which we believe would be an advantageous entry point.

We remain underweight Healthcare broadly as the sector is still under margin pressure. We have liquidated several of our corporate muni positions as well. Spreads to taxable counterparts tightened, as have outright spreads to generic curves. For example, Waste Management's muni bonds outperformed their corporate counterparts by as much as 60 basis points since YE 2023 (JPMorgan muni research). The proceeds will be redeployed in essential service and fee-driven revenue bonds as available. We are comfortable with escalated cash as a defense to rates trending higher.

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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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