Portfolio Commentary

Navigator® Tax-Free Fixed Income

Portfolio Manager

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I'll See Your Barbell and Raise You a Butterfly!

Market Review

The 5-year Index returned -0.42% in the second quarter of 2024. The Index entered the period at its quarterly high and steadily drifted down as much as 1.50% into late May before a June rally of over 1% to close the quarter down 0.42%. June's recovery was impressive, given that muni issuance for the month totaled $45B, higher than the $43B 5-year average and resulting in net positive issuance of $11B (Barclays data).

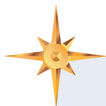
It would appear the quarter was one where the stage was set, and concessions had to be built in during the first two months to accommodate the heavy supply issued towards the quarter's close. The strength of 2023's fourth quarter rally still presented a challenge to the market, as much of 2024's expected performance was realized then, making concessions duly required to place the large supply.

Issuance has been a key touchstone for the market this past quarter and year to date, with most market participants and pundits keenly focused on it, as supply can be one of the primary market disrupters. Continued focus on supply will remain, especially given the volatility an election year can present. Year-to-date issuance as of 6/26 indicates supply is up 37% year over year, with nearly 90% of it being exempt, a far cry from the 75-80% of years past (BAML data).

Second Quarter Portfolio Highlights

- Muni credit remains robust: JPMorgan research indicates rainy day funds remain at or near record highs, despite total reserves trailing off moderately (which conventional wisdom dictates given their growth during the "Covid-years"). Positive ratings trends still exist according to Bloomberg, with the upgrade/downgrade ratio coming in at 2.1x.
- The inverted 3-year/5-year curve discussed last quarter reversed, as investors came to see the value propositions highlighted in our prior missives. The curve was nearly -30bps coming into the quarter and closed at -7bps. 3-year/7- year spreads made similar directional moves (Bloomberg data).
- We also put a spotlight on longer maturity spreads last quarter, indicating that while the herd was busy buying 5-year maturities, greater opportunities began presenting themselves in February and March in the long end. The 5-year/10-year slope in fact moved from 0bps to -9bps, and the 5-year/15-year slope moved from 50bps to 9bps (Bloomberg data).
- Supply, inversion avoidance, and comfort with duration all led to mixed relative value performance: short ratios of muni to Treasuries yields increased, signifying underperformance versus Treasury counterparts. The 30-year ratio decreased, as buyers saw value in higher absolute and taxable equivalent yields. Overall, the value of the exemption in a higher rate environment is magnified versus periods of low rates, further increasing appetite for max yields in either duration or credit.

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

To stave off “performance bleed” discussed previously, where duration rolled down, but yields increased (because of inversion), we invested in the butterfly idea outlined in earlier communications in greater earnest. We allocated to 1-year, 5-year and 12–17-year maturities to lock in book yield, index representation, and max yield/roll down profile, respectively.

From mid-2023 until commencement of the 2023 fall rally, we were large buyers of high-grade bonds on market weakness. While we are off the price highs seen in early 2024, that war chest is still valued richer than purchased on both an outright and percentage of Treasury basis. That war chest is now ready to swap into higher yielding industrial development (IDR), pollution control (PCR), and undervalued revenue bonds when the opportunity presents itself. As we also have established a strong foothold in income producing bonds (income being a large driver of overall returns) over the last few years, we also now can look for opportunity in discount bonds and the greater yields that accompany them.

We continue to “right-size” exposure in IDR and PCR bonds; our less favorable credit outlook in Healthcare keeps exposure light. In contrast, we see spread opportunity without extensive credit risk in AA-rated state housing bonds and AA and A-rated Utilities and have been increasing our exposures there moderately. For example, A-rated Utilities can be purchased at +42 versus a 5-year average of +32; AA-rated housing bonds are +60 versus 5-year average of +46 (JPMorgan data). Our overall higher coupon profile will prevent allocations to these sectors from diluting income.

Lastly, the election looms and with it the uncertainty about controlling parties and attendant tax law including TCJA tax cuts and brackets as well as SALT limitations. Our short-term investment allocations should lend flexibility to reacting to outcomes.

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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.

Standard & Poor’s (S&P) is a company, a leading index provider, and data source of independent credit ratings.

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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