3Q 2023

MUNICIPAL FIXED INCOME TEAM

Municipal Basis Points

Pressure May Change the Game

The U.S. has thus far proven resilient in the face of higher interest rates. But as shown by banking pressures earlier in the year, we could see more cracks appear as businesses and consumers grapple with the impacts of tighter financial conditions. In our view, now could be a good time to revisit municipal bond exposure to capitalize on the sector's sturdy credit quality and tax advantages.

PRIVATE WEALTH

JAMES L. ISELIN
HEAD OF MUNICIPAL
FIXED INCOME

"If he'd only known himself half as well as he knew his game, he might have been the best."

— THOMAS BOSWELL ON BILLY MARTIN

Pressure May Change the Game

The impacts of monetary tightening are only beginning to appear.

I love baseball because, in every game, you see something new. With so many rules and different scenarios, it is truly a thinking person's pastime. As a result, every fan has an opinion as to how the manager should be moving the chess pieces across the board. It is also a game that is filled with interesting stories and characters. One of the most fascinating characters was Billy Martin, who was a scrappy, overachieving player and a true genius of the game as manager of multiple teams, most notably the New York Yankees.

Several years ago, I read Bill Pennington's amazing biography on Martin, called *Baseball's Flawed Genius*. While the book includes many takeaways, including that Martin did his best work in the stadium and not at the saloons he liked to frequent after games, there were two things that stuck with me. First, like any genius, he was able to see things on the field that others could not. Second, he believed that even professional baseball players were susceptible to faltering when put under pressure. He believed that you should constantly apply pressure to the opposing team, even in moments when conventional wisdom said you would be better off doing nothing. His players were frequently instructed to take off and challenge a fielder to make a throw. While being overly aggressive sometimes led to outs, more times than not Martin surprised his opponents, and the pressure that he applied led to errant throws that ignited big innings for his team. The ball clubs he faced could never sit back and relax. I often wonder if, in today's game, which

is devoted to following the book and going where the data leads you, there would even be a place for such a genius as Martin. If there were, how would his style fit in?

The concept of pressure is quite relevant to today's markets. Unlike the 13 years after the Global Financial Crisis, today, the Federal Reserve is applying significant pressure to the broader economy in the form of aggressive monetary policy tightening. So far, the U.S. has proven to be incredibly resilient despite the Fed's best efforts to slow things down. However, not everyone was prepared to deal with the pressure, as the banking stress in March demonstrated. Even if the Fed is successful in delivering a soft landing for the broader economy, we expect other things to break along the way—just as Billy Martin understood, not everyone and everything can take the pressure.

In an environment in which the Fed is actively trying to slow the economy, and the potential for things to break is elevated, we believe the municipal bond market will be an increasingly important part of investors' asset allocation decisions. First, absolute and tax-adjusted returns are quite attractive. As of quarter-end, the full investment-grade tax-exempt municipal market, as measured by the Bloomberg Municipal Bond Index, was yielding 3.52%, or a taxable-equivalent yield of 5.95%.[1] In addition, the investment-grade municipal bond market is a highly-quality asset class with average ratings in the AA category. With the Fed in the final innings of the rate tightening cycle, now is a very good time for investors to be looking closely at the municipal bond market.

[1] Assumes 37% federal tax rate and 3.8% Affordable Care Act surtax for a 40.8% tax rate.

TRADING NOTES

RANDY L. GROSS
SENIOR PORTFOLIO MANAGER
MUNICIPAL FIXED INCOME

"Someone asked me, if I were stranded on a desert island what book would I bring. [I said,] How to Build a Boat."

—STEVEN WRIGHT

Short Maturities Could Lose Their Luster

We see an attractive entry point to lock in yield with duration.

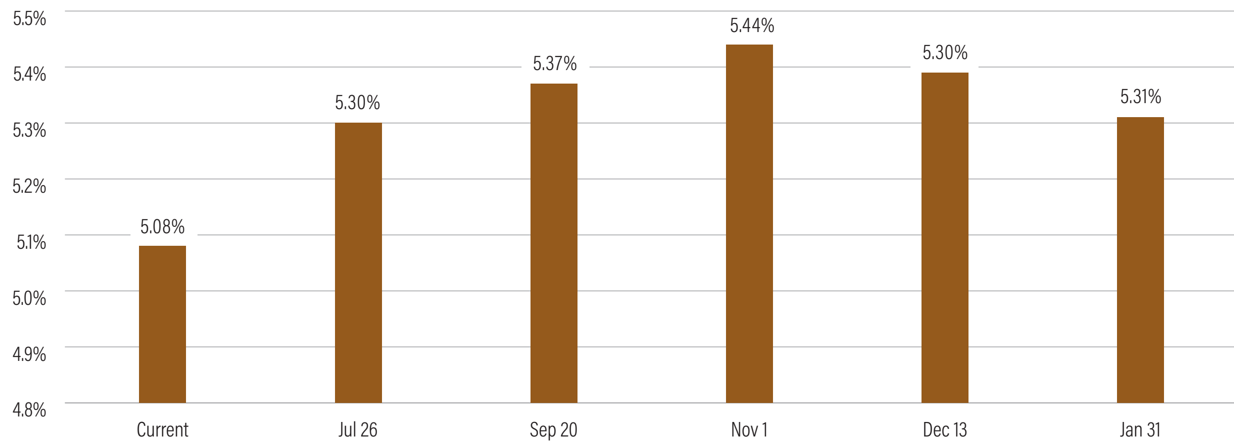
With the Federal Reserve remaining hawkish on future rate policy, U.S. Treasury bills and money market funds have been a temporary solution for some investors. However, since the market is forward-looking, there is a degree of risk that these cash-equivalent securities could roll into lower rates.

As such, we believe the time has arrived for investors to modestly extend duration in order to reduce reinvestment risk. Despite still above-target inflation, the Fed appears to be near the end of its hiking cycle. Investors would also benefit from potential price appreciation should rates move lower due to a slowing economy.

Short-term rates, which are most sensitive to Fed policy, are currently reflecting the view of a Fed fighting inflation. We have all learned from experience that interest rates can move lower in a swift manner should economic data or unknown events (e.g., the banking sector volatility in early March) make investors more cautious. A possible scenario of moderating inflation and higher unemployment could cause the Fed to change course and lower rates in the next 6 – 12 months.

THE FED CONTINUES ITS INFLATION FIGHT

Market-Implied Fed Funds Rate (%)



Source: Bloomberg; As of July 11, 2023.

Security Selection Remains Key

Negative-yielding global debt reached a historic $18 trillion in late 2020, pushing investors into lower credit quality and longer-maturity securities in a reach for yield. Last year, to fight inflation, the Fed aggressively hiked interest rates and ended its bond-buying program via quantitative tightening.

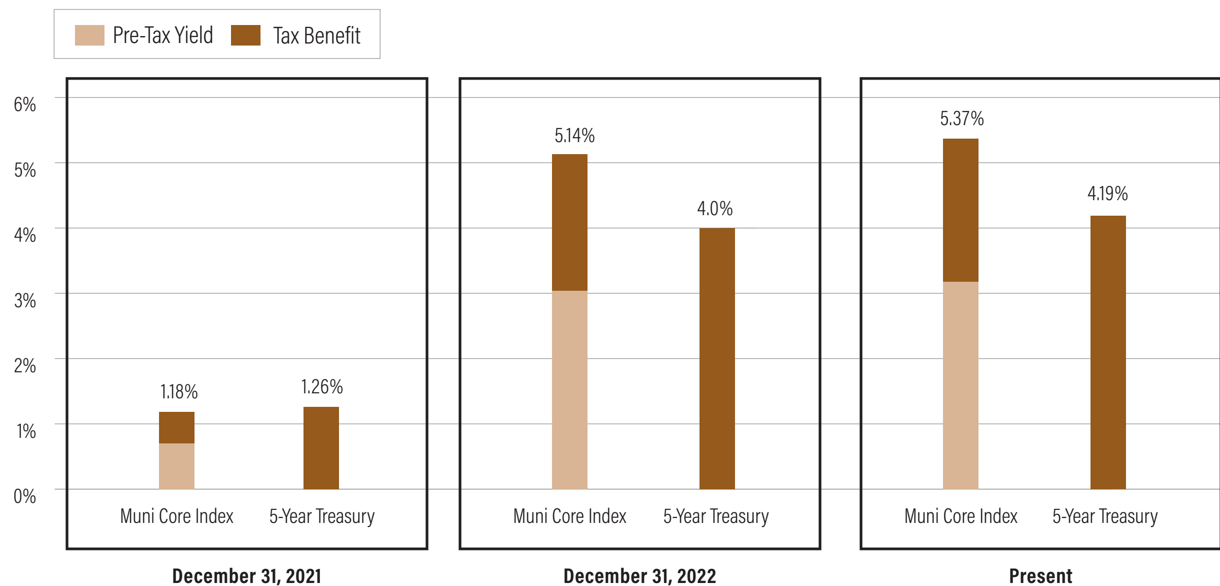
Given this backdrop, investing in the next decade could be much different from the last 10 – 15 years, when rates were at historic lows and money was cheap. In our opinion, security selection remains essential in distinguishing between issuers from both credit quality and pricing standpoints. As bonds are priced based on fundamentals, bond picking becomes much more important.

And Lastly...Seasonal Technicals Bear Watching

In our view, the dual themes of the peak reinvestment season and reduced new-issue supply should bolster support for municipals during the summer months. Scarcity of bonds coupled with the possible end of the Fed's hiking cycle should help increase the potential for positive performance.

ATTRACTIVE ENTRY POINT FOR MUNICIPALS

Taxable-Equivalent Yields vs. Treasuries



Source: Bloomberg, as of June 30, 2023. Municipal yields are a blend of 33% ICE BofA 1-3 Year U.S. Municipal Securities Index, 33% ICE BofA 3-7 Year U.S. Municipal Securities Index and 33% ICE BofA 7-12 Year U.S. Municipal Securities Index. Taxable equivalent yields assume a 37% marginal tax bracket and an additional 3.8% Affordable Care Act tax for a total rate of 40.8%.

FUNDAMENTAL FOCUS

STEPHEN COWIE
DIRECTOR OF MUNICIPAL RESEARCH

"Plain question and plain answer make the shortest road out of most perplexities."

—MARK TWAIN

Looking Past the Headlines

Careful research can help distinguish credit challenges from fundamental credit risk.

Whether you believe the economy will enter or avoid a recession, we remain optimistic that there are many sound investment opportunities within the municipal market. Despite the continued headlines about sticky inflation and recession risk, we believe the investment landscape for municipals is constructive, with many solid opportunities. Our fundamental, bottom-up research approach allows us to find those securities with superior credit fundamentals that can withstand economic volatility in the near term. These investments strengthen our conviction that municipals as an asset class are suitable for investors to preserve capital in various economic and financial environments.

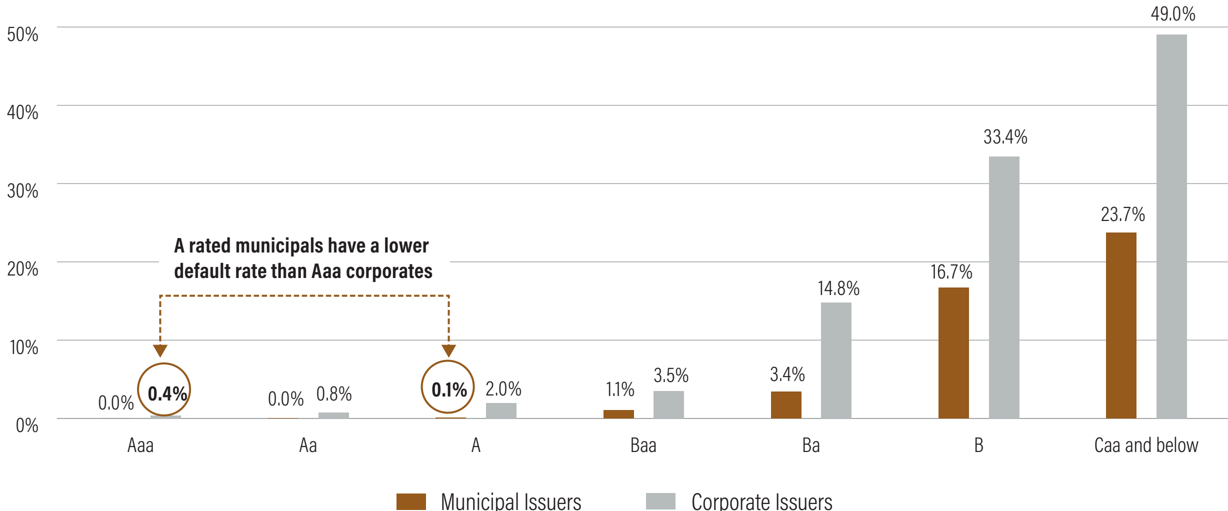
Despite the negative headlines, rigorous analysis of issuer fundamentals often uncovers important credit fundamentals that are not necessarily highlighted in the market. One example of where a bottom-up research process can help is in analyzing the slowdown of the commercial real estate market and its potential impact on larger cities across the country. In New York City, for example, much has been written about the negative financial impact the new hybrid working environment is having on the city's revenue base. While offices account for 20% of its property tax revenue and ultimately 10% of overall revenues, the potential weakening of the city's financial position may not be as acute as the headlines imply, at least in the immediate term, given the size of its budget, which is in excess of $100 billion.

Significantly, City Comptroller Brad Lander recently projected that a worst-case scenario of a 40% decline in the value of office properties from 2023 to 2029 would result in a $322 million shortfall in 2025 and a $1.1 billion shortfall in 2027. While these are significant numbers, the latter would account for only 1.4% of city tax revenues. As a result, we continue to favor New York City general obligation debt, factoring real estate prospects into our analysis and price consideration.

We recognize that some sectors may experience unique and elevated credit pressures if the economy enters a recession and financial risks increase. That said, these risks do not necessarily translate into default risk. In fact, the municipal market has experienced extremely low cumulative defaults, for example, with A rated municipal bonds defaulting at a lower rate than AAA corporates between 2010 – 2021.

A CONSERVATIVE RISK PROFILE

Cumulative Defaults: Municipals vs. Corporates, 2010 – 2021



Source: Source: Moody's Investor Services.

We remain constructive on municipal credit, given the sector's overall financial strength and ability to withstand an economic downturn. States and cities, in particular, have various tools in their arsenal to adjust revenues and expenditures for any material changes, while prudent budgetary management is an important credit factor that we research and value. Our research points to many states and local governments that have adjusted their fiscal 2024 budgets to better reflect a slower economic environment. California, for example, faces a nearly $32 billion deficit in 2024, but recently passed a budget that addresses this deficit while also maintaining its nearly $38 billion in reserve balances. In short, our bottom-up research approach allows us to dig deeper into the specifics of a credit and often points to stronger credit strengths than what may be depicted in the news.

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