4Q 2023

MUNICIPAL FIXED INCOME TEAM

Municipal Basis Points

Clarity May Take Too Long

The third quarter saw an array of surprising developments, including a U.S. rating downgrade, consumer resilience and a strong labor market. These contributed to new optimism about an economic soft landing, but also prompted a surge in interest rates that punished fixed income markets. Although the timing of peak monetary tightening remains unclear (if likely close), we believe that generous municipal yields, coupled with the quality of the asset class, could represent a significant current opportunity for investors.

PRIVATE WEALTH

JAMES L. ISELIN
HEAD OF MUNICIPAL
FIXED INCOME

"It is getting late early."

— YOGI BERRA

Clarity May Take Too Long

Timing a market bottom is hard. Better, in our view, to focus on the compelling yields that have emerged in high-quality municipals.

Okay, I'll admit it, I am a big Mets and Jets fan. Unfortunately, these two teams have won just one championship between them in my lifetime. I hail from Generation X, so that is very little success over a very long period! This year has provided yet another reminder of how hard it is to be a fan of these two organizations. The Mets entered 2023 coming off a 101-win season in 2022 and they had the highest payroll in the history of baseball. But from the start of spring training and throughout the season, literally nothing went according to plan. They ended up winning fewer than 80 games. When it was clear that the Mets season was over, I could fortunately pivot to the unprecedented optimism around the Jets. With a young and talented roster, they appeared to have finally solved their longstanding quarterback problem by trading for Aaron Rodgers, potentially their best play-caller since Joe Namath. Even the most jaded Jets fans were brimming with confidence after that acquisition. The Jets had an issue-free training camp and were featured on the HBO show *Hard Knocks*. Their first game was at home, and the stadium was absolutely electric prior to kickoff. Then, four plays into their first possession, Rodgers crumpled to the ground during a sack, his Achilles tendon ruptured and his season most likely over. How quickly things went from ecstasy to agony.

Paper vs. Practice

These two examples underscore the difference between how things look on paper and how they actually turn out. The world is filled with unpredictable events that lead to unexpected outcomes. A few months ago, we were saying that the Federal Reserve was probably in the final innings of the tightening cycle and that rates were likely close to a peak. While we still believe that to be true, the late summer was challenging for fixed income investors. In early August, Fitch surprised markets by downgrading the U.S. government's AAA rating. The rationale for the downgrade, namely political disfunction and runaway deficits, left no one surprised. In fact, the ratings agency simply said what everyone already knew. However, it can be jarring when something big actually happens, even if the action is understandable. Someone who matters put the U.S. on notice that poor fiscal management has consequences. While initially viewed by some pundits as inconsequential, this downgrade caused market sentiment to weaken. In addition, the continued resilience of the U.S. consumer and labor markets drove a sentiment shift from fear of imminent recession to a belief that the Fed could stick a soft landing. As a result, rates pushed higher, with the 10-year Treasury yield moving up by 73 basis points over the third quarter—in effect, another unexpected outcome.

The Same, but More So

We liked the municipal market before this backup in rates, and we like it even more now. High-quality short to intermediate munis ended the third quarter with yields pushing up against 4%. The lowest yield on the AAA municipal yield curve was 3.36% as of September 30.In contrast, at the start of 2022, the highest AAA yield on the curve was 1.50%![1]

With increased supply and market volatility, munis cheapened relative to Treasuries in September. For someone in the highest federal tax bracket, 10-year AAA munis now offer a taxable-equivalent yield of roughly 120 basis points over comparable Treasuries. Moreover, in volatile and rising rate environments, we think active management should shine amid increased selling pressure and bond mispricing. In addition, tax-loss swaps can be executed with the potential to create meaningful tax alpha for investors. Finally, munis are a highly rated and durable asset class, and in our view a good place to be if economic activity slows more than is currently anticipated.

As the sports world often demonstrates, predictions are hard. What we do know now is that yields are high and that the market is offering, in our view, a lot of potential. So, don't try to predict the bottom; it may be time to get into the game.

[1] Source: Bloomberg.

TRADING NOTES

RANDY L. GROSS
SENIOR PORTFOLIO MANAGER
MUNICIPAL FIXED INCOME

"Why does everybody stand up and sing 'Take Me Out to the Ball Game' when they're already there?"

—LARRY ANDERSON

Seventh-Inning Stretch

We see a unique opportunity for investors to capture attractive yields in intermediate maturities.

As Major League Baseball gets ready for its annual post-season classic, this seems like a suitable time to stand up, stretch out and assess this year's developments as we enter the latter stages of 2023. A big theme for this year has been disinflation, with pricing pressure moderating from the 9.1% peak in headline CPI back in June 2022. With inflation declining but still sticky, interest rates moved significantly higher during the third quarter of 2023. We attribute this movement in rates to an economy that remains strong, continued hawkish messaging from the Federal Reserve, and reduced demand for U.S. Treasury debt from the Fed, Japan and China that has caused the term premium to rise in long-dated maturities.

Municipal yields followed Treasury rates higher across the yield curve as investors digested the reality that rates could be higher for longer. Most municipal investors have been anxiously awaiting higher tax-free income since the record-low yields witnessed in the summer of 2021. In our view, the current rate environment seems like a fantastic opportunity for savers to purchase high-quality municipal bonds, whose yields are at their highest levels in over 16 years.

Historically, monetary policy tightening takes more than a year to affect the economy, given the lag time before demand destruction. Due to the aggressive rate hikes since March 2022, we believe that inflation is likely to continue to move lower, and that growth could begin to weaken.

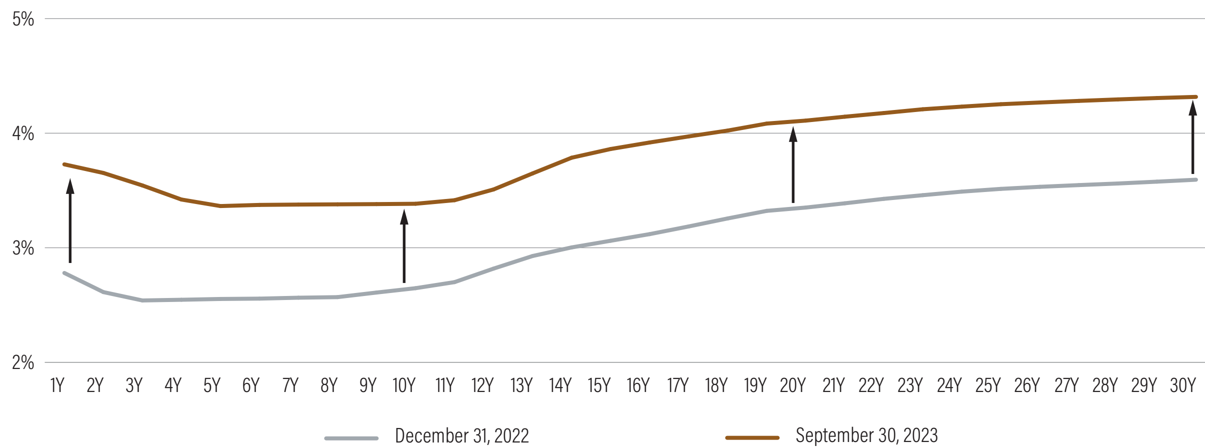
All of the above reinforces our view that this could be a time for investors to modestly extend duration to reduce reinvestment risk as the Fed nears the end of its hiking cycle. In our opinion, investors could also benefit from potential equity-like price appreciation should rates move lower due to a slowing economy.

And Lastly...Tax-Loss Opportunities

A major benefit afforded to investors in separately managed accounts is the ability to harvest tax losses. Over the last 30 years, short and intermediate muni bond strategies have experienced only a handful of negative return years. Taking losses in municipal bond portfolios is a somewhat rare opportunity for investors to offset tax liabilities arising from capital gains in other asset classes. Although harvesting is typically a year-end event, we have been actively selling bonds trading at a loss and purchasing similar maturing bonds of comparable credit and yield. This kind of swap generally leaves the portfolio in the same position, but creates a usable loss.

UPWARD MOVE IN YIELDS

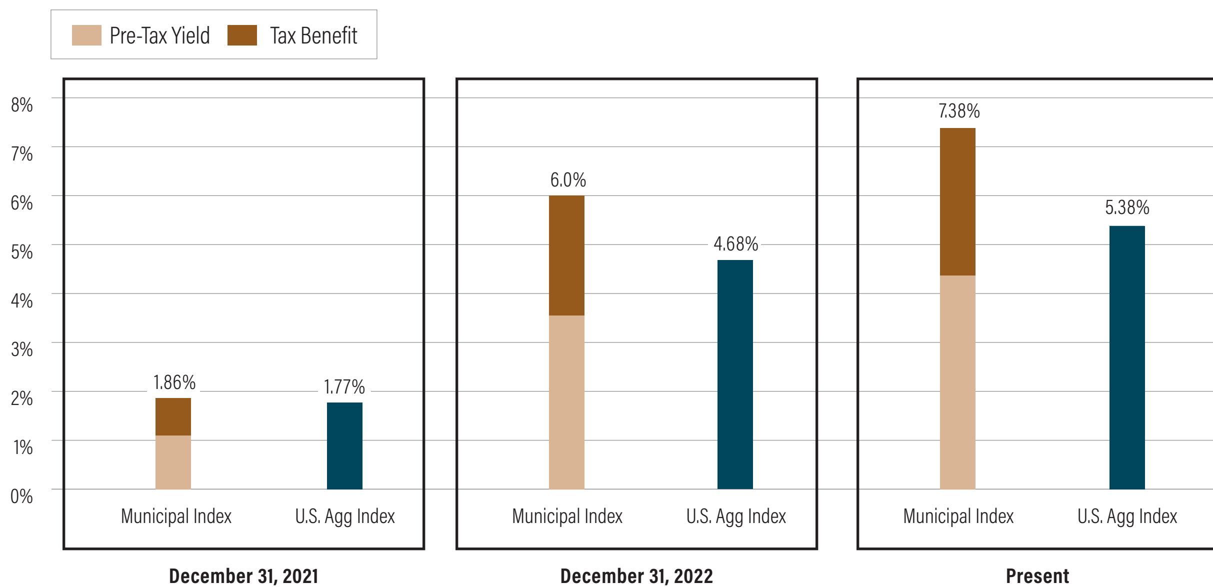
AAA Municipal Yield Curve, Year-to-Date Change



Source: Bloomberg.

OPPORTUNITY IN MUNICIPAL BONDS

Taxable-Equivalent Yields vs. Treasuries



Source: Bloomberg, as of September 30, 2023. 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

TOM COLLINS
SENIOR RESEARCH ANALYST,
MUNICIPAL FIXED INCOME

“No margin, no mission.”

—SISTER IRENE KRAUS

Nonprofit Health Care: What’s the Diagnosis?

Finding opportunities in an often-challenging sector requires patience and a firm understanding of its unique business dynamics.

Our approach to nonprofit health care has always been that bigger—and richer—is better. We’ve historically favored large providers with strong balance sheets. Such hospitals offer the most security in a sector that historically has been one of the riskiest in public finance. In conjunction with “bigger and richer,” we like providers that operate in more than one area or state so that they can benefit from business diversity. Varying economies, demographics and state regulations can help mitigate challenges that may exist in a certain region. Additionally, large providers enjoy various advantages, including economies of scale and negotiating power in relation to payors, unions and state authorities. These high-profile hospitals can also be better positioned to attract and retain top talent when it comes to physicians and nurses.

We also see opportunity in other large providers that may not have the same geographic diversity or balance sheet strength, but are still financially healthy. They may include those offering essential high-end, specialty services such as children’s hospitals and cancer centers. Also on our list are hospitals that may benefit from longstanding affiliations with, or sponsorship by, religious and charitable organizations; in many cases, these mission-driven providers are the only hospitals in the area offering essential health care services.

Appealing Yields, Distinct Risks

In our opinion, health care bonds can provide yield enhancement with risks that, in some cases, are lower than sectors traditionally viewed as more conservative, including general obligation and other tax-backed bonds. In certain situations, we specifically seek out lower-rated hospitals that provide greater yields without sacrificing those essential credit factors that make them viable investment opportunities. Such bonds, however, are only suitable for accounts capable of tolerating the elevated credit risk. Moreover, our strategy for nonprofit health care depends on regular surveillance of holdings to verify their continued appropriateness and to identify any names that may no longer meet our standards. To us, a willingness to trim or sell names that may be experiencing a decline in credit profile is just as important as adding new securities, given the substantial downside risk in the sector.

More generally, while the health care sector is largely recovering from the impacts of COVID-19, it is still too early to call "all clear." Just as ongoing review is needed at the security level, it is also important at the sector level given changes in medical technology and regulation, as well as the macro forces that impact the economic and market environment more generally. Thus, we remain patient, but cautious, on the sector.

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