



Portfolio Commentary

Navigator® Tax-Free Fixed Income

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How Can You Just Leave Us Standing? Alone in a World with Rates So Low...

If Jerome Powell and the Fed took a more dovish position in the first quarter of 2019, then the June 2019 meeting signaled the return of "lower for longer" in terms of U.S. interest rates. While the line was held on key interest rate levels in the June meeting, most notable was the Fed dropping the word "patient" in its approach to policy, which in essence, propped the door wide open for the possibility of additional rate cuts for the duration of 2019 and into next year.

In fact, some market participants had viewed the word "patient" as having a bias towards rate hikes in the past. While the market appears to be pricing in four rates cuts over the next 12 months, the views from our Chief Investment Officer Sean Clark state that this may be a bit overzealous. Instead, we believe the odds are better for one or two cuts over the coming months, which are somewhat in line with where Fed officials' opinions have fallen in the latest dot plot projections.

Regardless of the amount of rate cuts, the Fed's softened language and a renewed pledge to keep the economic expansion train running have given the market a sense of comfort that a reversal in the direction of rates is of little concern at the moment. To give this most recent interest rate cycle some context, 10-Year U.S. Treasury rates are 70 basis points lower than January 1, 2019 and are on the cusp of dropping below 2% for the first time since 2016.

But the Fed is not the only factor weighing on the markets, as both domestic and international pressures have factored into investor sentiment. Since the last Fed meeting, the President has renewed his long running trade war with China, threatened tariffs on Mexico, and placed additional trade pressure on Europe and Japan.

Further, certain portions of the yield curve have actually inverted, meaning longer-term rates are lower than shorter-term options. Historically, when the U.S. Treasury yield curve has inverted, it has been a signal that the economy is slowing or that a recession may be on the horizon. The argument can be made that the Fed is going to act well in advance of any material slowdown with a view on keeping the expansion in place.

Maybe We're Just Too Demanding...Thinking That Rates Won't Remain Here So Low...

While the market has priced in their anticipated rate cuts, there still seems to be some slight divergence from those actually making the decisions. Based on the positioning of the latest Fed dot plot, eight members see the target federal funds rate in the range of 2.25%-2.50% at the end of 2019; one member see a target range of 2.50%-2.75%, which would indicate one rate hike; and the additional members see a target range of 1.75-2.25%, which would indicate slight easing.

The consensus forecast remains in place into 2021 and 2022, demonstrating the

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central bank's view that the market may be getting ahead of itself in anticipation. The fact of the matter is that despite what the rates markets actually do, our role as Portfolio Managers is to navigate the current interest rate environment while keeping income high and focusing on principal preservation.

This is What it Sounds Like...When Rates Cry...

Interest rate environments like the one we're in today make a case for active management as we look to keep the current yield of the portfolio at above market level and focus on relative value opportunities that present themselves in both credit and duration management.

Our portfolios on both the taxable and tax-exempt side continue to utilize a barbell approach, which may provide investors with the best defense should the Fed decide to sharply reverse course at any stage along the way.

While duration was one component of positive return in Q2, the other part of the success story was credit selection. Credit selection and continued negative screening within the portfolios continue to be a differentiating factor as spreads within investment grade corporates and municipal bonds continue to tighten.

In the taxable portfolio, we remain focused on sectors that are less sensitive to interest rate volatility, while on the tax-free side, we remain committed to finding additional value in revenue sectors such as healthcare and higher education.

Tax-Free Fixed Income Portfolio

After finishing 2018 as one of the best performing fixed income asset classes, municipal bonds are continuing their blistering pace with a very strong first half 2019 performance. The Bloomberg Barclays Aggregate Municipal Index posted a first half return of 5.10%, while the SMA-focused Bloomberg Barclays 5-Year Municipal Bond Index has returned 3.81%.

The market, which is largely driven by supply/demand economics, continues to feel the additional tailwind from the Tax Cuts and Jobs Act. Put simply, the municipal market issuance has been hampered by the loss of advanced refundings and to a lesser degree, an aversion to debt issuance in some municipalities.

On the flip side, demand has spiked due in part to the \$10,000 cap for SALT (state and local taxes), on individual

filers returns. These factors, coupled with a persistent rally in rates, has created a perfect storm where municipal valuations have hit the highest levels in recent memory. One way to judge the relative richness of tax-free bonds is through the use of "AAA" municipal bond/US Treasury rate ratio. The higher the ratio is, the "cheaper" municipal bonds appear, with a lower ratio flagging the relative richness of tax-free bonds.

Throughout much of the first half of this year, muni/Treasury ratios fell steadily to some of their lowest levels on record. To put the magnitude of the movement in perspective, the 10-year muni/Treasury ratio declined from a level of 88% to start the year, to a low of 72% in mid-May, the lowest level in over a decade. It is worth noting that there has been some reversal of muni ratios over the past several weeks, which has led to some better entry points for our portfolios. However, we anticipate that the trend of lower ratios should continue as we push further into the summer time.

Municipal bonds are now heading into the time of year that is traditionally known for heavy reinvestments, with large sums of cash returning to investors from both principal and interest payments. The additional cash to be reinvested will continue to absorb any new issue calendar and put further pressure on tax-free rates, especially in the SMA dominated 0-10 year portion of the yield curve. As rates continue to decline, some of the levers available for portfolio managers to pull are those of duration and credit.

Duration has been one of the drivers of additional returns, with the modified duration of the Bloomberg Barclays Municipal Aggregate bonds logging in at a full year longer than its 5-year index counterpart. Credit has also been a driver of additional returns, with the "A" and "BBB" portions of the municipal market outpacing their higher rated peers by well over 100 basis points year-to-date.

Looking ahead, we project that technicals for the tax-free sector will continue to be constructive. Using new issue supply as a measuring stick, the amount of new issue bonds sold in the second quarter was significantly lower than compared to the start of the year. As of March 30, 2019, municipal issuance was up 22% compared to the same time frame in 2018.

New issuance reversed course in the second quarter, and now stands at just over 6% increase year-over-year, further adding to our supply/demand imbalance thesis for the market. Any further rate cuts by the Fed for the remainder of 2019 would provide additional tailwinds for tax-free performance.

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However, it is important to note that municipals do not move lock-in-step with movements in U.S. Treasuries and as ratios move lower (prices get higher), the case for owning tax-frees to some individuals, especially in higher tax states, may be harder to make.

Our focus in the tax-exempt fixed income strategy contin-

ues to center on current income, managing duration, and prudent credit selection. Our credit focus continues to be on essential service issuers, as well as solidly capitalized healthcare and higher education names, which will help provide portfolio diversification away from public pension and fixed cost ratio risk that are growing trends in the tax-backed sector.

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Bloomberg Barclays U.S. Aggregate Bond Index: The index is unmanaged and measures the performance of the investment grade, U.S. dollar denominated, fixed-rate taxable bond market, including Treasuries and government-related and corporate securities that have a remaining maturity of at least one year.

The Bloomberg Barclays 5-Year Municipal Bond Index is the 5 Year (4-6) component of the Municipal Bond index. It is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies.

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A S&P 'A' rated obligation is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial

commitments on the obligation is still strong.

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