Portfolio Commentary

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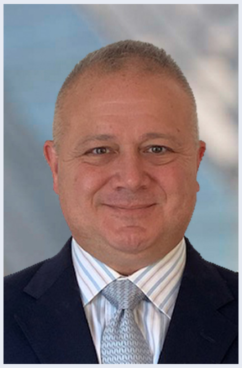
Portfolio Managers



Neal DeBonte
Portfolio Manager

Jamie Mullen
Senior Portfolio Manager

Unanswered Questions

Market Review

Municipal bonds turned in a solid performance in the second quarter of 2021. Overall supply fell in Q2 to $107 billion from $110 billion. However, issuance overall in the first half of 2021 exceeded that of the first half year measures over the last five years. That supply, as forecasted in past summaries, helped the market rally initially as price discovery increased and volatility decreased.

Overall, the muni curve flattened as record flows into the asset class continued despite rate and policy indecision: 12 weeks of uninterrupted incoming inflows helped munis to keep up with a rallying Treasury market, with 4 of those weeks eclipsing $2 billion. Surprisingly, the Fed began to jawbone the idea of increasing rates due to a solid bounce in economic metrics: the 10-year Treasury's peak yield was 1.75% on March 31st.

As expectations of a taper or a rate increase were tempered, the market spent the balance of the quarter rallying to lower yields in fits and starts, until a decidedly bullish tone emerged in June. The 10-year Treasury finished the period at 1.44%. The quarter did not answer many policy questions involving municipal bonds. The infrastructure plan is pending approval and may offer $570 billion in aid to municipalities in the form of a subsidy to fund revenue bond projects. The exact terms and amount are yet to be seen, and the bulk could be in taxable muni issuance.

That taxable issuance could cannibalize exempt issuance and create greater scarcity. Further muddying future market behavior forecasts is the Budget Reconciliation Act, which could re-introduce advance refundings on municipal bonds (a reintroduction could materially increase supply and result in relative value underperformance). Tax rate policy changes are also in play, and as a result, we believe the market has some headwinds to overcome in the coming months.

Second Quarter Performance Highlights

- We continued in earnest to exit the defensive short duration/maturity trade we entered early in the first quarter of 2021/late fourth quarter of 2020 and redeployed in a weighted barbell strategy, favoring the longer leg. Favorable ratios in the longer end and steepness at the quarter's outset supported this trade.
- Exposure to state level debt in NJ, NY, CT, and CA was maintained and opportunistically increased as credit spreads continued to compress. As per Bloomberg indices, NJ compressed over 50% in the 15-year tranche, which was a favored maturity for the book this quarter. In the case of CT, 5-year spreads remained static, but by buying longer bonds, we were able to capture nominal spread tightening. Supply particular to each specialty state and changes to the SALT Act will largely determine when/if these trades will be exited.
- Though competition was fierce for new issue allotments, we were able to secure bonds that allowed us to modestly increase our exposure in the transpor-

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tation, water and sewer, power, airport and transportation sectors. These should all benefit from an open economy as well as government stimulus.

- Cash balances increased to approximately 8%; even though ratios were nominally higher at the end of the quarter, the impressive flattening of the 5-year/15-year slope was aggressive. Competition for bonds AND lower rates left us very cautious in our investment commitments.

Positioning and Outlook

Q2 2021, like Q1, presented a dichotomy of action. From April 1st to mid-May, the market rallied. Rates and credit both benefitted from multiple pillars of support: a Treasury curve shrugging off a jawboning Fed and moving lower in rates, the Washington D.C. chatter of higher taxes, an aid package of perhaps another trillion (which has since shrunk), and four straight weeks of inflows averaging nearly $2 billion a week. Supply cooperated, as the rolling 30-day visible supply stayed under $10 billion most days.

Mid-May introduced a far more robust supply line, and some outright market fatigue. June is part of the June/July/December/January reinvestment period: a time when many municipal bonds mature, are called or pay interest. Conventional wisdom assumes that money is recycled back into the market. We tend to rally into June and plateau. The 10-year Muni/Treasury ratio on June 9th was 60%, and it traded off from there as supply and market "hangover" precluded it from staying rich. That ratio ended the quarter at 70%.

Low yields and low ratios in the front end of the muni curve offered little upside at the quarter's onset though we chose to hide there in the first quarter to avoid the dramatic steepening that occurred January through March. It was on the shoulders of this newly steepened scale that we decided to extend our duration.

Legging into this extension proved fortuitous, as from mid-May to June's end, the curve turned and began to flatten. As mentioned above, we did execute a weighted barbell trade, so even though light, the short leg did impede performance as 5-years got 6 basis points cheaper to the 15 to 20 years curve getting 6 to 10 basis points richer. Overall, on the quarter the 3s/30s curve was 24 flatter.

Bond selection, a bias to longer duration, and maintaining an overweight in local GO and school debt added edge to our performance. We increased our revenue bond holdings, but outrageously tight credit spreads in the market preclude us from straying past AA- rated debt in airports, water and sewer, transportation, and resource recovery bonds. We will buy lower rated bonds when price is reflective of value. We also have capacity to add Healthcare.

And now for the disclaimer: The market faces strong headwinds via uncertainty surrounding budget reconciliation and the aide act. Higher taxes or not? Higher supply (with the re-introduction of refundings), or not? SALT deduction reinstatement, or not? Hawkish Fed, or not?

This may be the most difficult 6-to-12-month period I have seen in terms of open questions. We believe that yield curve management will be paramount, and exempts may underperform inside 20-years if refundings re-appear, only to then grow scarcer as increased taxable issuance crowds out traditional munis. The wildcards? Taxes and SALT. If taxes do indeed get raised and SALT is not re-instated, the demand component of performance will stand.

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One Liberty Place ✦ 1650 Market Street ✦ 53rd Floor ✦ Philadelphia, PA 19103 ✦ 800.766.2264 ✦ ccmg.com