MUNICIPAL STRATEGY: ACTIVELY MANAGING TIMES OF CHANGE

IS A CYCLICAL SHIFT UPON US?

A year of virus-induced economic restrictions and severe employment damage, particularly in the services sectors, have at long last given way to a growing sense of optimism. The Treasury market is projecting revived inflation concerns, with the 10Yr UST rising 37 bps during February. The 10Yr TIPS breakeven inflation rate, a market-based measure of expected inflation over that term, jumped to 2.15% after hovering around 1.00% for an extended period a year ago. Municipals are not far behind as upward yield pressure is finally becoming evident, most notably along the intermediate portions of the curve where the 10Yr AAA closed February at 1.14%.

While unsettling to bond investors, it bears emphasizing that recent rate spikes have come off historic lows, and we believe the pace of rate pressure has unnerved markets far more than still low yield levels. The front end of the muni and UST curves are anchored by a Fed unlikely to raise short-term rates until late 2022 or 2023, although longer maturities are subject to the influence of economic conditions and expectations. Inflation prospects are ripe for debate and many remain skeptical.

Chairman Jerome Powell has reiterated that the Fed believes that full employment remains well away and that although there could be "some upward pressure on prices" his "expectation is that it will be neither large nor sustained."[1] Nonetheless, another very large pending stimulus package and prospects for a resurgence in consumer spending as vaccination levels accelerate and normalization slowly returns are giving financial advisors and bond investors reason to pause.

TIPs Breakeven Levels Are Rising (%)

Source: St. Louis Federal Reserve

Historical AAA Municipal Yield Curves: March 2011 - March 2021 (%)

Source: MMD

CHANGE IS A CONSTANT

Conventional wisdom stresses that rising interest rates are bad for high quality bonds. While the inverse relationship between price and yield is self-evident, Appleton views market cycle adjustments as environments in which value can be found. The bond market is dynamic, and it is our belief that rising rates and other sources of volatility often allow active municipal separate account managers with research expertise to outpace passive approaches.

Municipal bonds are traded through hundreds of dealers in a highly diffuse $3.9 trillion market featuring more than 1 million bond issues.[2] Tax-exempt bonds carry distinct regional differences, varying degrees of taxing authority and revenue support, and numerous unique structures. These nuances contribute to pricing inefficiencies that can be exploited through fundamental analysis and active management.

The municipal bond market is also heavily influenced by supply/demand dynamics and investor psychology. Issuance levels, dealer inventory, fund flows, and swings in credit perceptions impact bond prices. When dislocation and uncertainty materialize, pockets of value can be identified. Let's look at a few of the tools Appleton has at our disposal.

1. NY Times, 2/10/21

2. MSRB.org, 2020

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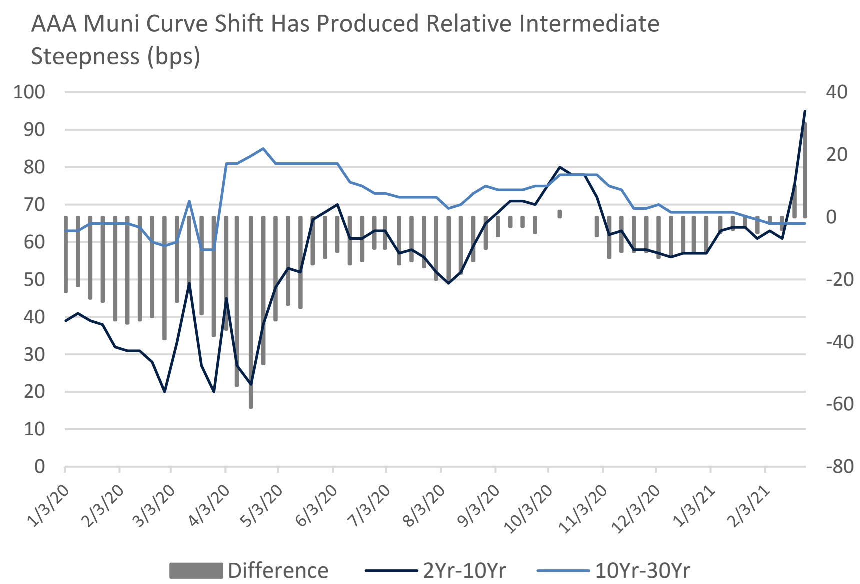
A SEARCH FOR RELATIVE VALUE

Rigorous credit research is a baseline against which we evaluate bond values. Unsettled markets brought on by interest rate pressure or other influences can be conducive to opportunistic trading, as bond prices tend to be less stable than at other times. Rotating out of fully valued bonds, and/or issues where we see increased credit risk, and into more attractive relative values may benefit investors. As active managers, we seek to capitalize on such opportunities. Doing so requires properly assessing credit quality and fair value relative to similar bonds, while also maintaining the liquidity needed for efficient trade execution.

OPTIMIZE THE CURVE

Upward pressure on interest rates need not result in parallel yield curve shifts. More often, relative steepness at different points on the municipal curve changes meaningfully over time. For example, 2 to 10Yr AAA muni spreads increased in February by 32 bps to 95 bps, whereas 10 to 30Yr spreads remained essentially flat at 62 bps, suggesting greater relative value can be found at intermediate maturities. Curve differentials allow for incremental yield pick up when extending portfolios, a potential approach that we evaluate against portfolio duration and other tradeoffs. Advantageous curve positioning consistent with account guidelines and client needs can be an asset.

Strategies of this nature may involve isolated trades made to adjust duration or other portfolio characteristics or, in other circumstances, a more pronounced barbell or bell curve structure that targets or minimizes certain yield curve exposures. Tactical flexibility comes in many forms and offers active managers tools that passive strategies often lack.



Left axis displays yield differentials in basis points.
Right axis displays spread difference between 10-30s and 2-10s in basis points.
Source: MMD

DELVING INTO BOND STRUCTURE

Bond structure can be complicated and there are material differences among issues of a given obligor. Characteristics such as callability vs. non-callability, premium or discounts to par, and put options may react very differently to changes in interest rates. Our view of rate direction is factored into how we build and manage municipal portfolios as we look to preserve capital and maximize risk-adjusted returns. Although we manage with modest turnover, Appleton portfolio managers will proactively react to changing market conditions rather than being locked into a static portfolio. Two examples are illustrative of our approach.

Premium coupon bonds can be attractive as rate pressure grows given their higher coupons and accompanying cash flow. These characteristics typically produce slightly less volatility than lower coupon bonds and offer more modest duration than par bonds with similar maturity and call features.

We also minimize exposure to callable bonds, particularly in rising rate environments. Limiting the term between call and maturity dates can help manage volatility. By avoiding bonds with short calls and long maturities we aim to limit the price volatility associated with future extension risk that can occur if yields rise sufficiently to cause a bond pricing to the call to extend and price to maturity. This can result in portfolio lengthening at an inopportune time.

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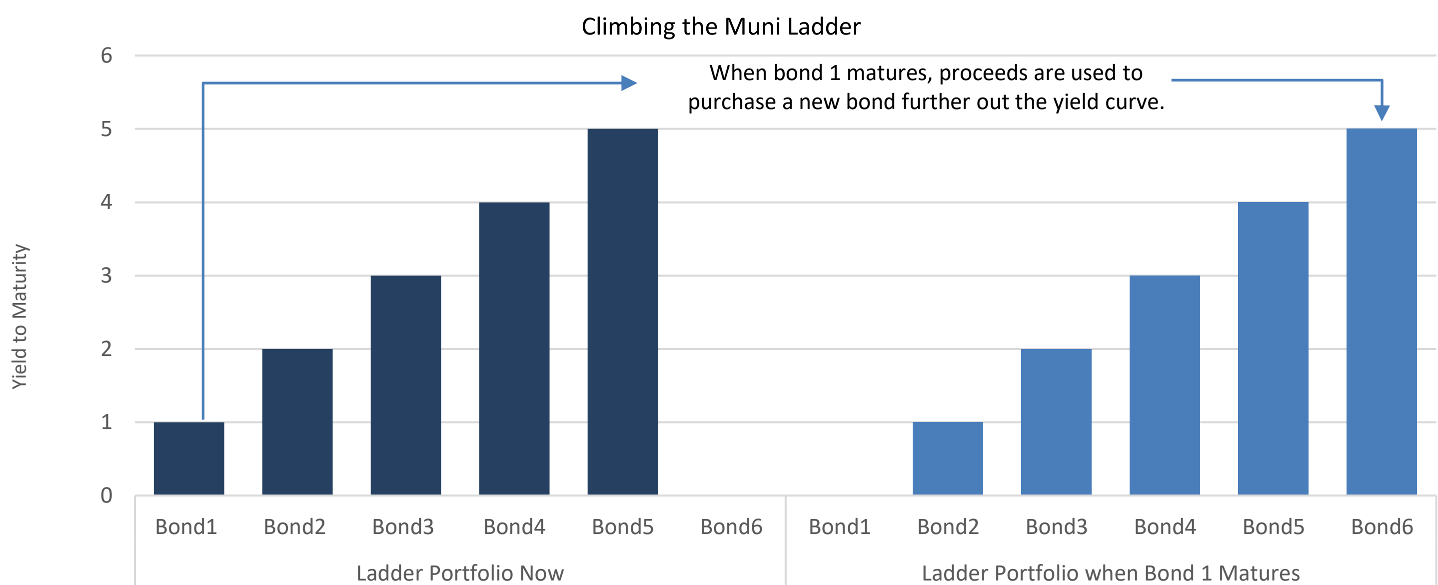
Passive Investment Limitations:

Bond ladders, indexing and other passive approaches offer low cost and highly structured implementation. These are valuable attributes, although we feel the flexibility and opportunistic nature of customized separate account management offers greater potential benefit, particularly when navigating market cycle changes.

"Buy, mature and replace" ladders can be a good solution for investors seeking simplicity and a defined process, as high-quality bonds are selected to mature sequentially. Bond proceeds are typically reinvested upon maturity at the top of the ladder, thereby effectively replacing maturity structure as bonds roll down the ladder. However, simplicity inherently introduces constraints, and "buy, mature and replace" lacks flexibility to react to changes in interest rates or curve structure. Passive strategies essential lock investors into a given investment universe and/or investment process.

By contrast, active management backed by fundamental research offers a wider opportunity set and greater flexibility to adjust client portfolios as market conditions change. Our portfolio managers may sell bonds prior to maturity if a bond's credit outlook deteriorates, better relative value is found elsewhere, or to modify duration or maturity structure. Unlike model and index-based managers, we also invest client assets in what we believe to be the best bond values at the time of purchase, not to replicate an established model.



Source: Appleton Partners, Inc.

Quality is Always Imperative

Appleton's investment process begins with fundamental credit research, the foundation of our security selection over many years and market cycles. We buy investment grade securities and believe a high-quality bias offers tax-exempt bond investors more attractive long-term risk-reward prospects than lower quality strategies, particularly when volatility increases. Every bond in which we invest must be approved by our credit research team, carries a proprietary credit rating, and undergoes ongoing surveillance.

Sector diversification is also highly valued as both a risk management and relative value discipline. Our research effort incorporates thematic analysis as we develop and monitor sector and other risk factor exposures.

Indexing and bond ladders built without the benefit of deep security specific research may be more vulnerable to credit quality deterioration. There are no guarantees, but our experience over many years has been that higher quality bonds have maintained their credit standing well during periods of economic and market turbulence, and that diversifying and periodically adjusting sector allocations has also added value.

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Don't Forget about Taxes

In an asset class where tax advantages represent a primary appeal, performance is best measured on a net basis. As the cliché states, it is what you keep that matters. Appleton exclusively manages municipal separate accounts, not mutual funds or other pooled vehicles, because it allows us to address specific client needs. Calibrating the size and timing of capital gain and loss recognition is another means by which we seek to benefit clients.

For example, should interest rates increase, certain bonds may be sold to book capital losses with proceeds reinvested in other names at recently elevated yield levels. Doing so requires a clear understanding of individual circumstances, as well as liquidity to cost effectively transact.

Looking Forward with Confidence

The Municipal and Treasury markets may finally be undergoing cyclical change. What may be overlooked amid all the debate about inflation and interest rate forecasts is that higher yields can ultimately be beneficial, as they offer greater income streams and more favorable reinvestment potential. The challenge lies in getting from here to there.

As discussed throughout this piece, we believe active managers are better equipped to manage the process than passive strategies. As in other aspects of our lives, change introduces opportunity. Appleton's fixed income team is working closely with financial advisors to serve clients. Backed by rigorous credit research, active decision-making, and the flexibility of separate account management, we remain confident in our ability to deliver for municipal investors.

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