APPLETON PARTNERS, INC.

TRANSITIONING FROM TURBULENCE TO OPPORTUNITY: MUNICIPAL PORTFOLIO NOTES

MAY 10, 2022

A Repricing of the Municipal Market

- 2022 has seen a run up in municipal yields with the 10Yr AAA portion of the curve jumping from 1.03% at year-end to 2.85%.
- A change in curve structure has been notable and portfolio maturity distinctions have impacted relative performance as yields moved sharply higher. Accelerated Fed rate hike expectations pushed the short end up at a more rapid rate than longer maturities as the 2Yr AAA rose from a suppressed level of 0.24% to 2.27%.
- This produced a bear flattener illustrated by a decline in the spread between 2s and 10s from 0.79% at year-end '21 to 0.58%.
- The macro drivers of municipal repricing have been well chronicled. US Bureau of Labor Statistics data published on 4/12 revealed an 8.5% annualized US inflation rate over the 12 months ended March 2022, the highest reading since early 1982. Sustained wage pressures and demand for goods has produced considerable concern that the Fed's policy response has fallen behind.
- Fed Funds expectations have risen accordingly as the Fed scrambles to assert control. The market is now pricing in the equivalent of up to 10 hikes in 2022, with another 0.50% increase likely in June.
- Yields across the municipal curve have largely priced in these hikes in our view, particularly with Q2 remaining under considerable pressure. We feel recent front-end movement reflects near-term inflation, with a relatively flatter longer end suggesting economic slowdown on the horizon.
- Although municipals initially lagged USTs in their yield response, they have followed a similar and notable upward path over the course of 2022. From a valuation perspective, municipals are now attractive relative to USTs, with the 10-Year AAA Muni/UST ratio rising from 68% to 91% YTD.
- Retail demand for municipals has temporarily suffered in the face of inflation and rate driven price pressure. After a long period of extremely high inflows, YTD net mutual fund outflows of $44.7 billion (as of 5/9) reversed what had been an extended favorable technical environment.

Performance Impact

- Appleton's Intermediate Municipal composite returned -7.75% on a YTD basis through 4/30. By comparison, the Bloomberg Barclays Managed Money Short/Intermediate Index fell by -7.35%.
- These are very atypical results that we feel reflect the speed at which the market has repriced rather than any underlying credit or related concern.
- Tax-exempt portfolios, including our Intermediate Municipal strategy (4.52-year duration as of 3/31), were negatively impacted by the duration-based math of rapidly rising yields but have yet to materially benefit from significantly increased income streams.

Investing In a More Favorable Environment

- Market repricing has created an ability to reinvest income and new cash flow at significantly higher yields. It is our belief that income and total return potential in the municipal market is now more favorable than has been the case over the past few years. This follows a long period of extremely low yields, particularly across shorter maturities.
- Our Intermediate Municipal composite's Yield-to-Worst (YTW) has increased to 2.78%, while Yield-to-Maturity (YTM) has risen to 3.10% as of 5/9.
- AAA taxable equivalent yields are much higher than they have been for some time, with the above YTW and YTM figures equating to 4.70% and 5.24% respectively at the highest Federal bracket without factoring in any potential state tax benefit.
- Nonetheless, accruing increased carry requires time, whereas most of the performance drag has probably already been felt.
- Simulations based on Appleton's Intermediate Municipal composite produce an expectation of +2.05% total return over the remaining nine months of 2022 assuming yield levels remain flat.
- Shocking the yield curve further with another +50bps parallel shift would likely result in only modest incremental losses of +0.03% over the same period. A 100bps yield increase, an assumption we feel is overly bearish at this stage in the cycle, produces an estimated additional loss of -1.98%.
- By contrast, should a weakening economy, a flight to quality, or other factors push municipal yields down by 25bps on a parallel basis across the curve, Intermediate Municipal investors would gain an estimated +3.06% through the end of 2022.

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Volatility Creates Opportunity

- Bloomberg reports a significant increase in the number of bid wanted items this year, with a daily average of 7,363 up 78% from the 2021's average of 4,126. An increased volume of bonds out for bid is often a reflection of market volatility and we are seeing a much wider range of attractive investment opportunities.
- We are also taking advantage of recent price declines through selective tax loss selling, subject to an ability to efficiently execute a sale and subsequent redeployment of proceeds. Amid 2022's difficult environment, liquidity has been spotty and trade execution remains critical.

Appleton's Economic and Market Outlook

- With the Fed still emphasizing maintaining growth, Fed Fund rate hike expectations may be overdone. We feel that after another 0.75% of rate increases the Fed may well pause in hopes of avoiding the risk of recession.
- Given this outlook, and the extent to which Fed Funds hikes are already priced in, we see recent market repricing and the associated impact on yield levels as a significant buying opportunity. Rates should ultimately stabilize, and the curve could steepen a bit with the front-end trading lower in yield.
- Our UST trading range over the remainder of 2022 is 2.60% - 3.25%. With current levels at the middle of that range we do not anticipate a significantly higher yield move from here.
- A 10-Year Muni/UST yield ratio of 91% has above longer-term averages and we see relative value in municipals. Tax-exempt investors now have a degree of performance cushion should UST yields move higher, a new cash flow can be invested at attractive after-tax yield levels.

Our Current Positioning

- At Appleton, we collaborate with advisors to build portfolios that reflect your market outlook. By offering a range of municipal strategies across the duration spectrum - Ultra Short and VRDN, 4 Year Municipal, Short Municipal, Intermediate Municipal, and Long Municipal – along with several more specialized disciplines, we can align our separate account capabilities with a diversity of client objectives.
- We continue to recommend our Intermediate strategy as a long-term allocation to municipals.
- Credit spreads have widened off historically tight levels, thereby raising the quality premium. The AAA-A spread is currently 49bps, 27bps wider than year-end and now in line with longer-term market averages.
- With the curve flattening, we are finding more value on the "tails" of our 3 to 12-year buying range in the Intermediate strategy. This is resulting in a modest reduction in our exposure amongst 5 to 8-year maturities, as we are holding on longer to shorter bonds to offset the duration of longer maturity issues in which we are now finding greater value.

The accessibility of our portfolio managers and relationship management team is a defining Appleton attribute. We recognize that client inquiries increase during challenging times in the market and welcome your outreach.

Note: Data is as of the market close on May 6, 2022, unless otherwise noted.

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