1Q 2023

MUNICIPAL FIXED INCOME TEAM

Municipal Basis Points

Seeds of Opportunity

The last year has seen a wave of market turbulence tied to inflation and monetary policy, affecting virtually all segments of the fixed income universe, including municipal bonds. Today, however, we see a changed landscape. Tax-exempt yields are far higher than post-Global Financial Crisis norms, even as credit fundamentals remain relatively strong in a slowing economic environment. In our view, this creates a compelling opportunity for return potential emphasizing quality and security selection.

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PRIVATE WEALTH

"Optimism doesn't mean that you are blind to the reality of the situation. It means that you remain motivated to seek a solution to whatever problems arise."

— THE DALAI LAMA

JAMES L. ISELIN
HEAD OF MUNICIPAL
FIXED INCOME

Seeds of Opportunity

In the shadow of 2022, we see reasons for optimism about yields and return potential moving forward..

As rates rose dramatically in 2022 due to the Federal Reserve finally recognizing that inflation was not going back to 2% as quickly as it thought, municipal bonds were pulled along on a wild ride. Despite a decent rally in the last two months of the year, municipal bond yields rose on average by close to 200 basis points across the yield curve in 2022. This dramatic move in rates pushed bond prices down significantly, particularly for securities with longer maturities. Declining bond prices caused record outflows from muni mutual funds, which only further weighed on market sentiment as many funds had to sell large quantities of bonds to meet those redemptions.

With a year as rough as 2022 for munis (and for that matter just about every other asset class), it is easy to focus solely on the negatives. We think there is actually cause for some optimism as we head into 2023. Investors have been clamoring for higher yields for a long time. With the Fed going into overdrive to combat stubbornly high inflation, we not only have higher rates, but we got them quickly. For much of the time since the Global Financial

Crisis (GFC), zero interest rate policies from central banks forced investors to either accept modest compensation for the risks they were taking or take on more risk in order to produce an acceptable return. Neither option was particularly appealing. In today's rate environment, which is more reflective of the "old normal" conditions in place prior to the GFC, investors can generate what we consider attractive returns in municipal bonds without having to take on too much credit or interest rate risk. Case in point: Intermediate munis ended 2022 yielding roughly 3%, a far cry from the sub-1% yields that they provided at the end of 2021.[1] On a taxable-equivalent basis for an individual in the highest federal tax bracket, the 3% yield equates to roughly 5%—not too shabby, in my opinion.

Going forward, while we don't expect rates volatility to be as elevated in 2023 as it was last year, periods of choppiness should persist as markets digest inflation data, the future path of Fed policy, geopolitical issues and divided U.S. government, to name a few issues. With the economy slowing and rates no longer at artificially low levels, security selection decisions should have a much more meaningful impact on returns in the new year. Modestly extending duration may also make sense as it may be wise to lock in these new higher rates before an eventual decline.

We recognize that 2022 was a tough year for municipal bond investors. While our up-in-quality approach and focus on intermediate and shorter duration strategies helped mitigate the downside, no one has been immune to this market environment. That said, we do believe our disciplined approach to security selection and duration management was well suited to navigating through this volatile period. We are excited to be investing in this new environment, given the opportunities that lie ahead now that markets are free from artificially low interest rate policy. We continue to favor an active approach, looking to add value through security selection and realization of tax losses where available. We thank you for your support and wish you a happy, healthy and prosperous New Year!

[1] Source: Bloomberg.

TRADING NOTES

RANDY L. GROSS
SENIOR PORTFOLIO MANAGER
MUNICIPAL FIXED INCOME

"An optimist stays up until midnight to see the new year in. A pessimist stays up to make sure the old year leaves."

—BILL VAUGHAN

The Municipal Sweet Spot

We believe today's muni market offers compelling characteristics to fixed income investors.

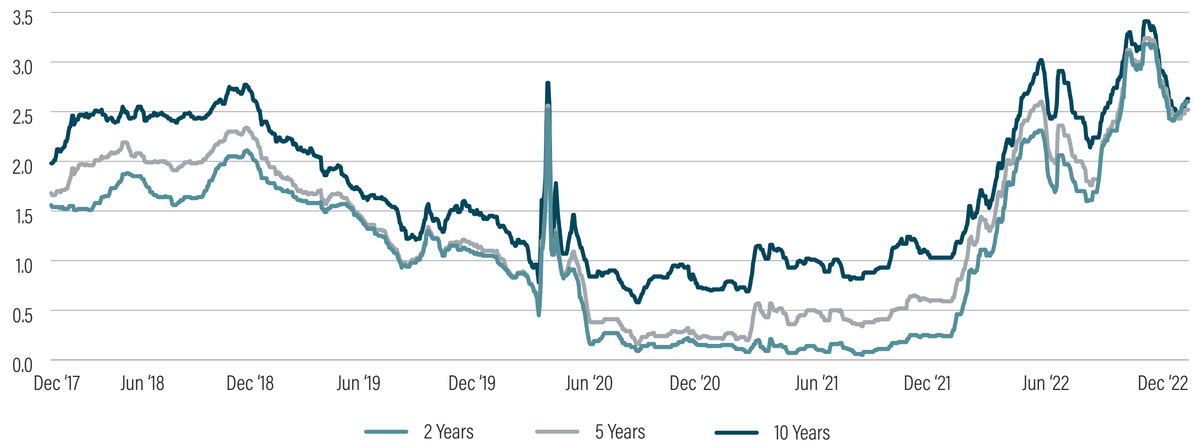
Fixed income securities across sectors encountered negative returns in 2022 as the Federal Reserve raised its target interest rate on overnight loans between banks from 0.25% to 4.25%—an unprecedented amount of tightening in such a short timeframe from the 109-year-old central bank.

A major theme for the municipal market throughout 2022 was the record-breaking outflows ($120 billion) from municipal mutual funds as the Fed aggressively hiked rates to fight inflation. To meet these redemptions, funds were forced to sell large quantities of bonds to limited buyers, resulting in periodic, hefty drops in prices.

In our opinion, the muni market enters 2023 in a "sweet spot" as investment grade municipal yields seem particularly attractive, individual tax rates remain relatively high, credit fundamentals (which most likely peaked) remain solid, and inflation is beginning to moderate. In our view, this should help pave the way for better days—with potential for price appreciation as the economy struggles with bouts of slower growth, and the Fed eventually makes its way to the sidelines.

MUNICIPAL YIELDS ARE NEAR MULTIYEAR HIGHS

Yields on General Obligation Bonds by Maturity (%)



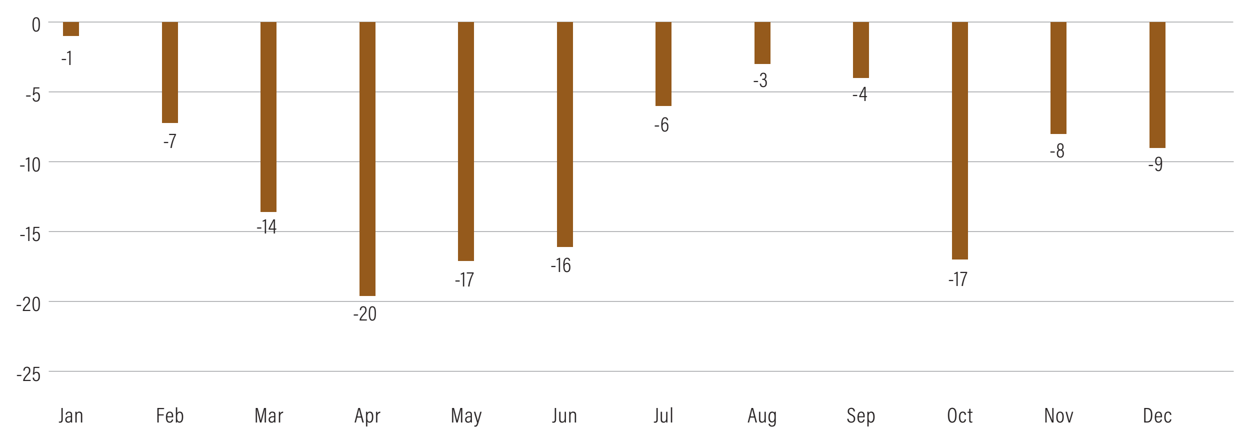
Source: MMD.

November Was Historic for Munis

November 2022 was one of the strongest single months for municipals bonds in history, with the Bloomberg Municipal Index returning 4.7%; December continued the price momentum to close out the year on a strong note. These positive developments came on the heels of what we would consider attractive entry points, a view that the Fed was closer to its final rate hike, and moderation in municipal mutual fund outflows. Looking ahead, a sustained reversal of these negative fund flows could be crucial in providing strong technical support and robust market sentiment for municipal performance.

COULD FUND OUTFLOWS BE EASING?

2022 Municipal Mutual Fund Flows ($ Billions)



Source: Lipper.

And Lastly...Divided Government Could Have Its Benefits

The 188th Congress will have slim majorities in both chambers, which usually portends minimal passage of major legislation. This structural constraint should idle any chatter as to changes in tax policy for the foreseeable future, keeping tax rates relatively high while maintaining the value of tax-free municipal income for investors.

FUNDAMENTAL FOCUS

STEPHEN COWIE
SENIOR RESEARCH ANALYST
MUNICIPAL FIXED INCOME

> *"A mile of highway will take you a mile. A mile of runway will take you anywhere."*
>
> —AUTHOR UNKNOWN

Airport Munis See Clearer Skies

Aviation and airports are leaving pandemic-era headwinds behind.

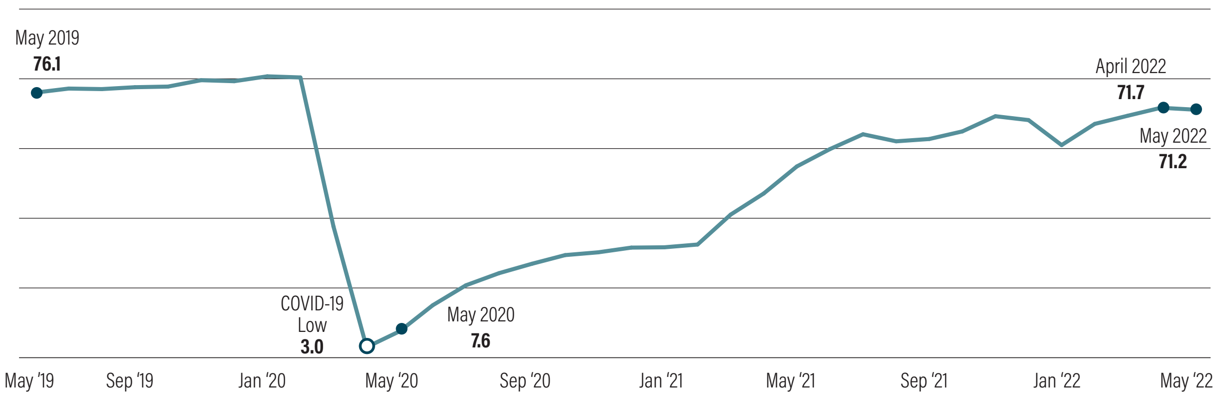
Despite recent "turbulence" in the aviation and airport industries due to flight cancelations over the holidays, our outlook for the airport sector as a whole is now stable after the industry experienced unprecedented disruptions and challenges due to the pandemic.

While an economic downturn or recession could slow these growth trends in the near term, we believe airport operations have become more predictable and in general able to handle the normal flow of travelers. In fact, many airport operators have turned their focus to the future and are now addressing terminal expansion and modernization plans, as well as addressing appropriate rate-setting agreements with airlines.

Although the World Health Organization has not declared an official end to the pandemic, the U.S. airport industry has in many ways done so. Airport travel has been increasing and many estimates now have the industry back to pre-pandemic levels of travel by the latter months of 2023. We expect the airport industry to lead other travel sectors in its timeline of recovery.

AIR TRAVEL IS BOUNCING BACK

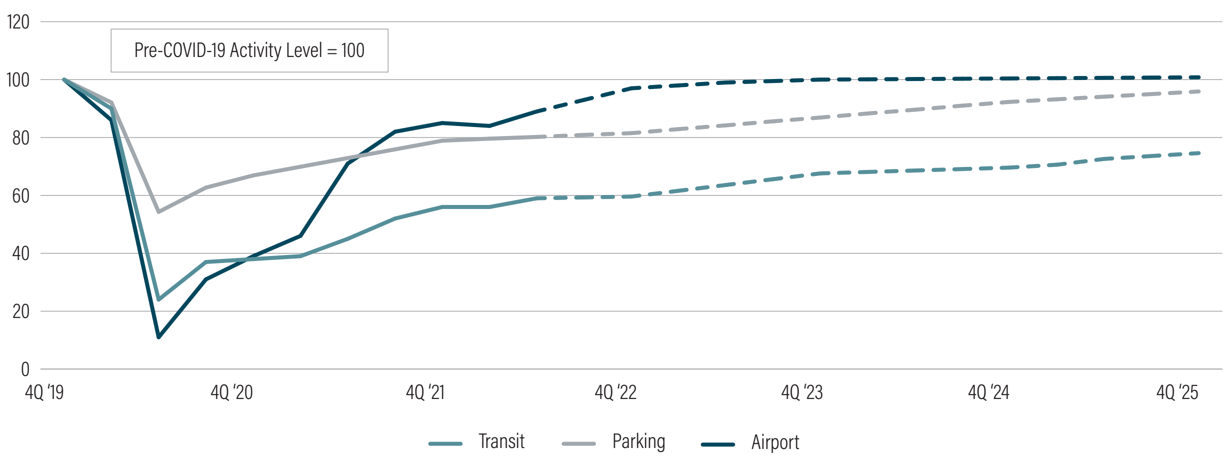
Monthly Passengers on U.S. Airlines (Millions)



Source: U.S. Department of Transportation. Consists of "scheduled" service passengers for both domestic and international travelers.

AIRPORTS ARE LEADING THE TRAVEL SECTOR RECOVERY

S&P Global Ratings' Baseline Activity Level Estimates Relative to Pre-COVID-19 Levels



Source: Standard & Poor's Financial Services LLC. As of July 2022. Figures after June 2022 are estimates.

From a financial perspective, it's important to note that the more than $100 billion in federal COVID-related aid provided to the aviation and airport industry was the largest in U.S. modern history and greatly helped airports weather the storm. This federal aid exceeded the $6.6 billion received by airlines after the 9/11 terrorist attacks and also the $94.2 billion provided to the auto industry under the Troubled Asset Relief Program in 2008. As such, this funding afforded airports the financial flexibility to operate and make prudent decisions while travel demand recovered.

Getting Into Specifics

An important consideration when evaluating individual airports is revenue composition. In general, an airport's largest sources of revenue are airline agreements, parking and retail concessions. While all three components correlate to travel at that specific airport, they are unique and can individually help insulate impacts in other areas when revenues are reduced. As per Moody's Investors Service, in fiscal year 2021, airline revenues averaged 27.5% of all airport revenues, 33.9% at large hubs and 19.5% at smaller and non-hub airports. More specifically, we believe the type of rate-making agreement between the airlines and an airport (i.e., residual, compensatory, hybrid) is very important when evaluating the financial condition of an airport. Under a residual cost approach, airlines collectively assume the financial risk of the airport by agreeing to pay any costs that is not covered by other sources of revenue. In this scenario, drops in travel demand are less concerning to bondholders. In contrast, the compensatory approach has the airport operator assuming the brunt of its financial risk and often involves its setting rates on airlines and rentals high enough to generate excess debt service coverage and liquidity.

We recognize the risks that a global economic slowdown or recession could have on both domestic and international travel markets. Additionally, elevated and prolonged inflationary trends could reduce discretionary income otherwise intended for travel purposes. Finally, job losses could also hurt travel recovery levels and timeframes. That said, these risks are somewhat within scope of normal operating decisions for airports, such that recent enplanement and financial trends should generate optimism.

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