BBH Tax-Exempt Fixed Income

Brown Brothers Harriman

Quarterly Strategy Update / 2Q 2019

Something Happened on the Way to Normal

As recently as nine months ago, we quietly rejoiced that conditions in the U.S. bond market were normalizing. No, not 10-year Treasury yields at 5%, as was normal before the Financial Crisis. But *more normal* from the perspective of the gradual removal of the emergency monetary policy measures in place for much of the last 10 years. But then something happened. A late-year equity swoon upended the Federal Reserve's (Fed) normalization plans. The Fed's conversation soon shifted to overseas growth concerns and the potential negative implications of a trade war. By the time the second quarter ended, investors priced in 100 basis points[1] of rate cuts. While we look forward to an eventual return to normalcy, we recognize that navigating abnormal markets will likely be our baseline for a while.

Continuing their trend from the previous five months, municipal yields fell sharply during the second quarter. Across the curve, yields ended the quarter 25 to 30 basis points lower and now stand 100 to 120 basis points beneath their November 2018 peak. The rate rally has driven abnormally high market returns thus far in 2019. For the quarter, intermediate maturities generated a 1.6% return, bringing the year-to-date total to 5.5%. Long maturities have now generated a whopping 8% year-to-date. Credit-sensitive bonds have done even better — the lower the rating, the better the result.

Similar to the first quarter, we are pleased that this quarter our returns exceeded our market benchmarks. Normally, in a spread tightening environment with indiscriminate credit demand, our portfolios often struggle from a relative performance standpoint because of our higher-quality bias. In retrospect, we were fortunate to take advantage of late-2018 market weakness to build establish positions in the prepaid gas and tobacco sectors. These positions generated strong performance, as did our intermediate- and long-maturity California and Oregon school district zero-coupon bonds. A couple of individual positions in Connecticut Special Tax and MEAG (Municipal Electric Authority of Georgia) Project One bonds also stood out for us.

Connecticut Special Tax securities are backed by an array of taxes including a motor fuel tax, an oil company tax, motor vehicle registration fees, license fees, and a half-cent sales tax, among others. These pledged revenues provide debt service coverage of over two times. This implies that our bonds could sustain an annual decline in revenues of over 10% and remain intact, notwithstanding the debt service reserve fund that provides added safety.

Often tainted by construction delays and cost overruns for the construction of Vogtle Three and Four powerplants, MEAG bonds offer attractive yields. Our MEAG bonds are backed by long-term take-or-pay contracts with 48 cities and one county in Georgia. The contract payments that support our bonds are viewed as operational expenses of these entities and enjoy a backstop from the property taxing capacity of each participant.

The technical support for municipal debt remained strong throughout the quarter. Relatively modest supply was met with enthusiastic demand, with most new deals well-oversubscribed. The Tax Cut and Jobs Act of 2017 all but assured that municipal supply would decline significantly. Like last year, new issuance is poised to barely break $300 billion. This stands in stark contrast to pre-reform issuance averages of $400-450 billion. Investors are struggling to replace their maturing debt and reinvest their coupon payments. These tight market conditions have been compounded by record-paced inflows into municipal mutual funds. Through mid-year, funds have received a net $30 billion in new capital. Approximately one-third of this cumulative flow has been directed to high-yield funds that have had a voracious appetite for long-maturity, low-quality credit. These funds raced to invest their new capital to avoid the impact of a cash drag as the market appreciated.

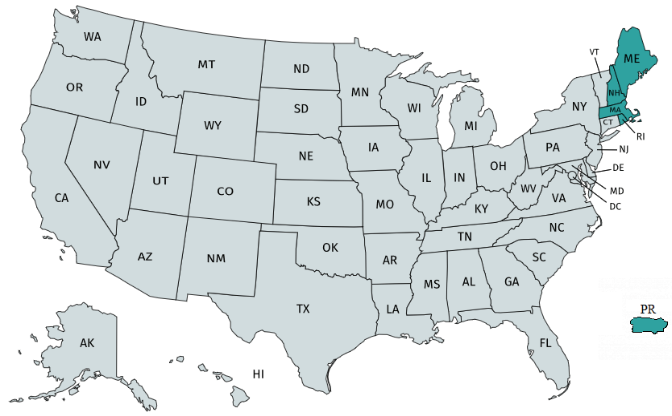
Amid falling rates and tightening credit valuations during the quarter, our investment activity declined, but our focus and selectivity did not. We continued to find value in floating-rate notes, initiating a position in Cleveland Clinic and augmenting our position in New Jersey. We are not surprised that investors turned their attention to longer-dated debt as their expectations of Fed rate cuts grew. Within intermediate maturities, we purchased new positions of a Toronto-Dominion Bank-backed prepaid gas bond and Georgia Power-backed pollution control bonds. In longer maturities, we maintained our pattern of purchasing zero-coupon school bonds, State Housing Finance Authority (HFA) term bonds, and other lower coupon callable debt.

Our overall portfolio positioning remained similar to that at the end of the first quarter. Portfolio durations remain neutral to our benchmarks, with an emphasis on floating-rate securities and intermediate-to-long maturity zero-coupon bonds. We continue to own relatively few traditional fixed-rate bonds with less than five years of maturity. Our largest sector positions continue to include School Districts, State HFAs, and Prepaid Gas. We do not foresee significant changes in our portfolio construction. Compounding today's lofty valuations, many of our positions possess significant unrealized gains. When considered as funding sources, these bonds' potential tax liabilities raise an already high bar for future purchases.

[1] A unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument.

In another departure from normal, the U.S. 1st Circuit recently ruled that the Puerto Rico Highways and Transportation Authority could withhold payments on their special revenue bonds — a stark contrast to precedents set for similar debt in other municipal insolvencies. Although we do not expect this ruling to stand, it introduces significant uncertainties to the revenue bond sector — a broad area in which we are heavily invested. The 1st Circuit currently stands alone in its interpretation of "Special Revenues". Its ruling is contrary to prior court decisions involving several other municipal bankruptcies. Currently, the 1st Circuit's ruling will apply for Maine, Massachusetts, New Hampshire, Puerto Rico, and Rhode Island, which are under its jurisdiction. The risk is that this ruling could serve as precedent for other cases and potentially complicate future municipal bankruptcy outcomes.

U.S. 1st Circuit Jurisdiction

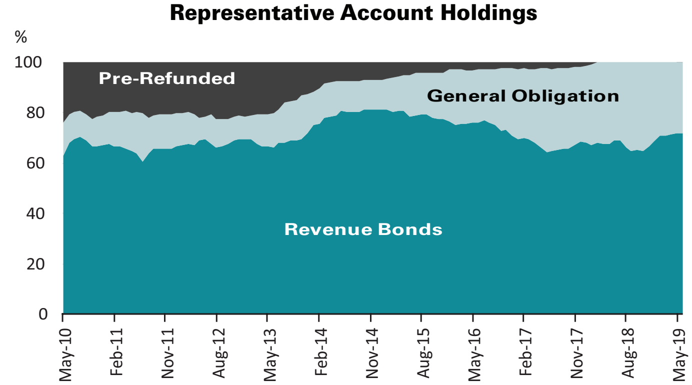


Source: U.S. Supreme Court

The 1st Circuit's ruling is troubling for municipal bondholders. However, we feel that our credit research process helps protect us from the potential fallout surrounding the decision. Core to our process is that a credit is both durable – its operating model can withstand a wide variety of economic and political circumstances; and is structured appropriately – it has an appropriate amount of leverage relative to its operating variability, in addition to other factors. In practice, we view special revenue status as an additional margin of safety for the credits we own. Protecting our clients' capital remains our top priority and we rely on our research to avoid managing any of our bonds through a bankruptcy workout. We will be watching from the sidelines to assess the impact of the 1st Circuit's Puerto Rico decision, and we expect that Puerto Rico Highways and Transportation Authority (PRHTA) creditors will not go down without a fight.

We stand ready to take advantage of any opportunities that might arise from this case or other exogenous events. We have long preferred revenue bonds to governmental obligations (GOs) for several reasons. There are over 20 revenue sectors and many different types of security structures that have reliably offered us opportunities. We believe the preference for GOs by individual investors further enhances the attractiveness of revenue bonds. We appreciate the specificity of the sector's pledged revenues and that the bonds are much more insulated from the political process than GO-backed debt. Revenue bonds also regularly feature covenant packages with a protected flow of funds not commonly found in GOs. Finally, the pledged revenues supporting the bonds often qualify as "special revenues". This provides bondholders some added protection should the issuing enterprise ever file for bankruptcy. Special revenue status has traditionally been interpreted as meaning payments of net revenue for debt service would not be subject to an automatic stay should a payor be engaged in bankruptcy proceedings.

Representative Account Holdings



Representative Account is a typical holding for an intermediate, fairly unconstrained account. Index is the Bloomberg Barclays 1-15 Year Blended Index. One cannot invest directly in the index.
Data reported monthly from May 31, 2010 to June 30, 2019
Sources: Bloomberg and BBH Analysis

We have long disavowed our ability to accurately forecast changes in interest rates. The last nine months have served as a good reminder of why we remain focused on identifying value in individual securities and building our portfolios bond by bond, rather than speculating on rate calls with our clients' capital. Although we are always trying to enhance how we assess credit and valuation, our evaluation standards are high and will remain so. When investors are enthusiastic, as they are today, our criteria help us avoid the fear of missing out. When the next downturn occurs, our criteria will help us avoid fear, when others are running for the exits. Whether markets are behaving normally or not, our investment criteria will remain a steady guide for us.

Sincerely,

Gregory S. Steier

Portfolio Manager

The securities do not represent all of the securities purchased, or sold, for the portfolio and you should not assume that investments in the securities were or will be profitable.

Past performance does not guarantee future results, and current performance may be lower or higher than the past performance data quoted. The investment return and principal value will fluctuate, and shares, when sold, may be worth more or less than the original cost.

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