BROWN BROTHERS HARRIMAN

BBH Tax-Exempt Fixed Income

Quarterly Strategy Update / 3Q 2019

Zeroing In

The third quarter ended with an array of macro-oriented concerns — Brexit, trade wars, a Saudi oil facility attack, a Presidential impeachment inquiry, and repo market tremors. We do our best to keep macro factors to the side while we zero in on our credit and valuation work. Opportunities have narrowed as valuations have tightened amid escalating macro concerns. Usually, during periods of heightened uncertainty, attractive credits are easy to find, but this time has been different. Investors escaping zero-to-negative interest rates in Europe and Japan unleashed a global chase for yield. This has had a profound impact on all corners of the U.S. bond market, pushing rates to record lows during the quarter. U.S. municipal bonds have further benefited as high-yield fund managers, flush with inflows, chased a relatively small universe of lower-rated municipal bonds.

After peaking at $17 trillion, the volume of negative yielding bonds around the world ended the quarter at $15 trillion — nearly doubling year-to-date. The U.S. bond market has been a beneficiary of strong overseas flows as investors seek better returns on their capital. Zero-to-negative interest rates have presented headwinds for savers and retirees who must put away more, and spend less, because they cannot earn an acceptable return. One could argue that negative interest rates are analogous to a tax and are confiscatory by nature — and that is before we consider the impact of inflation. Although the empirical benefits of zero-to-negative interest rate policies have been difficult to identify, central bankers press on.

Global capital flows have acted like a quasi-quantitative easing program domestically, reducing our longer-term interest rates. Furthermore, calls for the U.S. Federal Reserve (Fed) to mimic the policies of their overseas counterparts have become louder, jeopardizing its independence and intensifying the decline in U.S. yields. The Fed responded with two eases, ending the tightening cycle that began in late-2015. Whether this was a mid-cycle adjustment or acquiescence to political pressure remains to be seen. Amid stable economic activity with a historically tight labor market and burgeoning federal budget deficits, zero rates make zero sense.

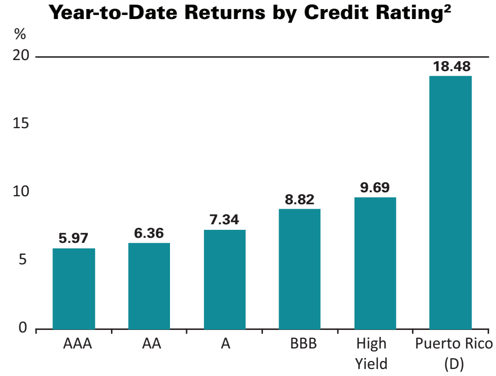
Municipal Market Winning Streaks

Time Period	Consecutive Months of Positive Returns	Period Return (%)	Yield-to-Worst (%) Beginning	Yield-to-Worst (%) End	Yield-to-Worst (%) Change
Jul 2015 - Aug 2016	14	7.87	2.33	1.66	-0.67
Jul 1991 - Jul 1992	13	15.12	6.63	5.07	-1.56
Jan 2014 - Jan 2015	13	10.98	3.15	1.79	-1.36
Nov 2018 - Aug 2019	10	10.11	3.01	1.65	-1.36
Sep 1990 - May 1991	9	9.12	7.15	6.52	-0.63
Oct 1985 - Apr 1986	7	19.11	9.17	7.48	-1.69
Nov 2008 - May 2009	7	9.34	4.84	3.91	-0.93
Jul 1995 - Jan 1996	7	7.93	5.54	4.98	-0.56
Apr 1993 - Oct 1993	7	6.97	5.19	4.85	-0.34
Sep 1997 - Mar 1998	7	5.13	5.01	4.69	-0.32

Sources: Bloomberg and BBH Analysis

Strength in global bond markets have helped drive a significant domestic rally. Municipals have been on quite a run since last October, with a 10-month winning streak that lasted until September. This was the fourth longest streak of consecutive months of positive returns during the past 40 years. During that period, the municipal market generated more than 10% return as yields declined 135 basis points[1]. This result is even more impressive considering that yields began the period at 3%. Intermediate- and long-maturity tax-exempt yields also reached all-time lows in August, with the 10-year and 30-year yields falling to 1.2% and 1.8%, respectively.

Year-to-Date Returns by Credit Rating[2]



Sources: S&P, Moody's, Fitch, and BBH Analysis

Even as yields have fallen and credit-sensitive bonds have become more expensive, demand for tax-exempt bonds has remained robust. At over $65 billion, year-to-date mutual fund inflows have eclipsed all but calendar year 2009. In an effort not to be left behind, yield-hungry fund managers invested at a furious pace. With over 30% of net flows directed to high yield funds, low quality credit returns have significantly benefited.

For many years, the high-yield corporate bond and loan markets have enjoyed a well-developed slate of issuers and industries. In contrast, the municipal high-yield market remains much

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

[2] Credit Quality letter ratings are provided by Standard and Poor's, Moody's and Fitch and are presented as the higher of the three ratings. When a security is not rated by Standard & Poor's, Moody's or Fitch, the highest credit ratings from DBRS and Kroll may be used. Credit ratings reflect the credit quality of the underlying issues in the portfolio and not of the portfolio itself. Issues with credit ratings of BBB or better are considered to be investment grade, with adequate capacity to meet financial commitments. Issues with credit ratings below BBB are considered speculative in nature and are vulnerable to the possibility of issuer failure or business interruption.

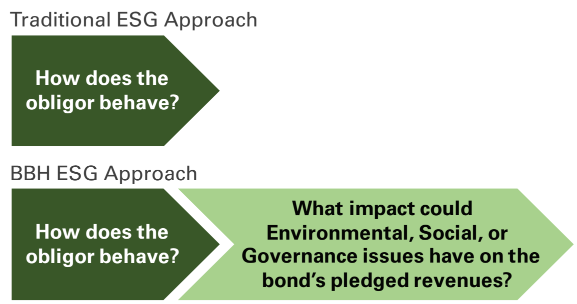
narrower, with large concentrations of continuing care facilities, economic development projects, legacy tobacco issues, and distressed issuers such as Puerto Rico. Municipal high yield comprises less than 10% of *index-eligible* bonds and less than 5% of the overall market, hence the strong tailwind from this year's fund flows.

Although municipals gave back some gains in September, the third quarter was still solid. The overall market and intermediate maturities generated 1.6% and 0.8%, respectively. We are happy that our portfolio generated about 30 basis points of excess return, though our high-quality orientation can prove challenging for performance when investors embrace riskier assets. For the quarter, long maturities led the way, with yields declining 20-30 basis points, while shorter maturity yields only fell 5 to 10 basis points. This flattening of the yield curve benefited our portfolios. Also adding to performance was the ongoing contraction in credit spreads. Performance highlights for the quarter included New Jersey floating rate debt, Detroit schools, Connecticut Special Tax, and an assortment of school district, transportation, and tobacco zero-coupon bonds.

Yield chasing is not in our DNA and we are highly selective about the credits we own. It is rare for a non-investment grade credit to satisfy our definition of durable — call it our version of "sustainable". Our criteria leave us positioned in higher quality names that can weather a wide range of economic and political circumstances. Protecting against credit losses is our first priority. To do this, we assess the strength of each obligor through four lenses: operating model, management, structure, and transparency.

Included within the scope of our four lenses are Environmental, Social, and Governance (ESG) factors that could materially impact a credit. Generally speaking, there is broad alignment between ESG and public finance since municipal bonds serve as the funding mechanism for public policy and infrastructure. Beyond that, we believe that incorporating ESG factors is necessary to develop a full understanding of credit risk.

While most muni managers with a focus on ESG will look primarily at the actions and behavior of the issuer or obligor, we take our analysis one step further and also ask "what impact could Environmental, Social, or Governance factors have on the bond's pledged revenues?" One way to illustrate this within the power utility sector is the difference between asking "Is this power plant polluting the local river?" versus "What will the impact of green energy trends have on the power system?"



For illustrative purposes only

Natural disasters rarely cause credit impairments, though they can exacerbate adverse situations. Despite multiple evaluations through the years, we never found Puerto Rico to be a durable credit because of its poor operations, corruption and years of financial mismanagement. In 2017, Hurricane Maria's devastation caused further hardship to the island's residents, many of whom were without power or clean water for months. We continue to view investments in these bonds as speculative and inconsistent with our investment criteria. In 2013, we published the Strategy Insight "Puerto Rico: Shining Star or Supernova?" which detailed our misgivings.

While ESG considerations generally align with credit strengths, there can be too much of a good thing. Just because a credit aligns with ESG concepts does not make it an acceptable investment for us — a bond may be issued for a good purpose, but that will not ensure its durability. An example of this is state Housing Finance Authorities (HFAs). These agencies are tasked with providing safe, decent affordable home financing for low to moderate income first-time buyers. Expanding home ownership is a clear ESG positive. However, if the HFA compromises on its underwriting criteria, it could jeopardize its credit quality. Likewise, a bond may be backed by revenues at odds with traditional ESG criteria but may still be a strong credit. A good example of this are Tobacco Master Settlement Bonds, which are backed by revenues from the 1998 settlement between states and the major tobacco companies. Because these revenues are tied to tobacco consumption, some investors view these bonds as negative from an ESG perspective. However, these pledged revenues represent penalty payments made by the tobacco companies to offset medical costs associated with tobacco use, which is a societal good. For a further in-depth discussion or our approach to ESG, please see our recent Strategy Insight titled "Municipal Bonds and ESG — A New Acronym, With the Same Old Risks."

Even with our high standards, low overall rates, a flat yield curve, and narrow credit spreads, we were still able to source a number of attractive opportunities during the quarter. We added to our positions in zero-coupon school districts in Oregon and California. We purchased a large block of Detroit schools, guaranteed by the State of Michigan. We remain enthused that these bonds still offer good return potential. We added modestly to our State HFA positions and also purchased a floating-rate Texas prepaid gas bond whose credit is backed by JP Morgan. We also added positions in high-quality, low-coupon, callable twelve-to-fifteen-year bonds. Examples include Aa1-rated Virginia College Building Authority and Aaa-rated State of North Carolina. These bonds offered wider spreads than many single-A rated securities.

True to our strategy, we remain focused on investing in durable credits that offer attractive yields. We are pleased that we have been able to identify individual opportunities even as broad market valuations have become more expensive. Traditional ways of enhancing yield are not attractive as there is little incremental yield for extending maturities or moving into lower-rated bonds. Instead, we continue to find that zero-coupon bonds, floating-rate notes, and lower-coupon callable debt offer much better risk-adjusted yields. As we continue to invest in this value-based manner, it is no wonder our portfolios bear zero resemblance to our benchmarks. We would not have it any other way.

Sincerely,

Gregory S. Steier
Portfolio Manager

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