High Yield Municipal Strategy

Market Overview

Ongoing improvements in inflation data cleared the way for the Federal Reserve to enact its first policy rate cut since the onset of Covid-19, providing further encouragement to both municipal bond issuers and investors in what continues to be an impressive rebound in market conditions.

The S&P Municipal Bond Index gained 2.7% for the quarter, while the S&P Municipal Bond High Yield Index widened its year-to-date outperformance over its investment grade analog by tacking on an additional 80 basis points to 3.5%. The S&P Short Duration Municipal Yield Index advanced 2.7%. All three lagged the 5.2% gain of the Bloomberg US Aggregate Index during the quarter.[1]

Muni Yields Pull Back on Rate Cut but Remain Attractive

The Federal Reserve kicked off its much anticipated rate-cut cycle in mid-September, announcing an oversized 50 basis point cut that was at the larger end of market expectations and brought the central bank's key policy rate to a range of 4.75–5.00%. Perhaps wanting to get ahead of any negative interpretations that could be attached to the larger-than-typical cut, Fed Chair Powell characterized the move as a "recalibration" of policy that reflected the committee's growing confidence that labor-market strength could be preserved amid healthy economic growth and further cooling in inflation.[2]

Assuming risks to the labor market and inflation remain balanced, the Fed is seeking to move gradually toward the neutral rate of interest—the hypothetical fed funds level that neither stimulates the economy nor restrains it, which the central bank currently estimates to be about 2.9%. The latest dot plot of fed funds rate projections suggests an additional 50 basis points of cuts in 2024 and 100 basis points in 2025, which would put the Fed on track to reach a neutral policy setting in early 2026.[3] Futures markets had anticipated a more aggressive pace of cuts in the immediate aftermath of the Fed meeting, but have since tempered their expectations following the early-October release of an unexpectedly strong jobs report.[4]

Anticipation of the Fed's move sent yields lower across the fixed income complex throughout the third quarter and had a steepening impact on yield curves. The 10-year Treasury rate ended the period about 55 basis points lower, while the response in municipal markets was more restrained, with yields in the high grade and high yield muni indexes compressing by 28 basis points and 22 basis points, respectively[5]. We saw spread narrowing at the muni index level, particularly in the high yield space, but—as always given the diverse nature of the muni market—dispersion across issues was significant.

Muni Issuance and Demand Continue to Rebound Amid Supportive Macro Backdrop

Despite what the Fed's large rate cut may suggest, the US economy has continued to hum along. To wit, the Atlanta Fed's GDPNow model estimates third quarter economic growth of 3.2%, up from the second quarter's 3.0% expansion.[6] The unemployment rate has bounced off its April 2023 record low but at 4.2% is well below the historical average and likely pretty close to the theoretical nonaccelerating inflationary rate of unemployment (NAIRU).[7] The latest core personal consumption expenditures price index print came in at 2.7% and probably would be even closer to the Fed's 2% target were it not for undersupplied housing markets.[8]

Muni issuer fundamentals have benefited from this environment. Tax revenue at the state and local levels remains high and continues to grow, which in conjunction with generally strong fiscal profiles has helped keep defaults very low, even by the standards of an asset class accustomed to very low default activity. Year to date through September, there has been about $1.3 billion of par value affected by a first-time payment default.[9] The upgrade/downgrade ratio has pulled back from very high levels but remains favorable.[10] We think current fiscal dynamics should support historically low default rates as well as high recovery rates.

1. Source: FactSet; data as of March 31, 2024.
2. Source: Federal Reserve; data as of September 18, 2024.
3. Source: Federal Reserve; data as of September 18, 2024.
4. Source: CME FedWatch; data as of October 10, 2024.
5. Source: FactSet; data as of September 30, 2024.
6. Source: Federal Reserve Bank of Atlanta; data as of October 9, 2024.
7. Source: Federal Reserve Bank of St. Louis; data as of October 1, 2024.
8. Source: Bureau of Economic Analysis; data as of September 27, 2024.
9. Source: BofA Securities; data as of October 11, 2024.
10. Source: Moody's Ratings; data as of August 15, 2024.

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A supply/demand imbalance helped buoy muni bond prices in recent years as interest rates crept higher, and market technicals have continued to be supportive of the asset class as rates stabilized at attractive levels in 2024. Throughout the year, we have seen increased new-issue supply being met by ample demand fueled by absolute and tax-equivalent yields that remain high relative to post-global financial crisis history.

Supply has continued to benefit from relative stability in interest rates following a period of volatility. At more than $400 billion, year-to-date issuance already exceeds full-year metrics for 2022 and 2023.[11] Stable-to-lower interest rates are likely to be an ongoing tailwind for issuance, though it would not be surprising to see the pace ease somewhat in the fourth quarter. October has gotten off to a strong start, but activity typically slows around the Thanksgiving and December holidays; further, the uncertainty around this year's presidential election likely prompted some issuers to move their planned bond offerings ahead of November 5.

In terms of demand, muni bond mutual funds and exchange-traded funds have attracted more than $28 billion in assets year to date through September, 47% of which have gone into high yield strategies. Given that muni bond strategies saw an exodus of $132 billion in 2022 and 2023 combined after peaking at nearly $1 trillion in fourth quarter 2021, it's possible we are in only the early innings of a normalization in investor demand.[12]

The Appeal of Munis Persists, in Our View

We expect muni bond prices to continue to be supported by both market technicals and issuer fundamentals in the short term. While yields have pulled back in conjunction with the Fed's pivot to easier monetary policy, they remain elevated relative to levels that have prevailed for most of the post-global financial crisis period and continue to offer investors an opportunity, in our view.

While we are constructive on municipal bonds as an asset class, we believe skilled active managers can add additional value in what is a very large and highly fragmented market. Through rigorous underwriting we seek to uncover hidden gems that we believe are well managed and well positioned in their markets while offering the potential for favorable yields and dollar prices that could compensate for the risks. Our bottom-up approach also seeks to avoid potential landmines; notably, First Eagle's municipal bond portfolios did not have any exposure to the defaulted securities mentioned earlier.

Our investment professionals have extensive experience in the municipal bond market, but First Eagle's muni strategies themselves are less than a year old. The timing of our launch and the initial small size of the portfolio resulted in an unsustainably high distribution yield earlier in the year. The appreciation of the fund's net asset value combined with the investment of new capital in a slightly lower-rate environment has exerted some moderate downward pressure on the distribution yield, which we believe has largely stabilized at this point.

11. Source: Municipal Securities Rulemaking Board; data as of September 30, 2024.
12. Source: LSEG Lipper Global Fund Flows, JPMorgan; data as of October 2, 2024.

Portfolio Review

High Yield Municipal Strategy posted a positive absolute return in third quarter 2024. The Fund outperformed the S&P Municipal Yield Index in the period.

The leading contributors to performance during the quarter were bonds connected to the Centennial Yards development in downtown Atlanta; a portfolio of senior living facilities in Texas, Oklahoma and Colorado; Brightline passenger rail projects in Florida and California/Nevada; and the Miami Worldcenter development.

Centennial Yards is a 50-acre mixed-use development in downtown Atlanta that will include apartments, hotels, retail, a data center and an entertainment district. The first phase of the project is slated to be completed ahead of kickoff of the 2026 FIFA World Cup, when nearby Mercedes-Benz Stadium is slated to host eight matches in the tournament.

Sanctuary LTC owns a portfolio of more than 20 nonprofit lifecare facilities in attractive markets in Texas, Oklahoma and Colorado. Bonds secured by these holdings have appreciated as the company continues to rebound from the volume and staffing cost challenges associated with the Covid-19 pandemic.

Brightline, which is backed by private equity firm Fortress Investment Group, is the only privately owned and operated intercity railroad in the US. It began service in Florida in 2018 and has steadily increased its footprint along the east coast the state from Miami to Orlando, generating strong revenue growth. It recently broke ground on Brightline West, which will connect the 200-plus miles between Southern California and Las Vegas with all-electric, high-speed service.

Miami Worldcenter is a mixed-use development in downtown Miami consisting of residential, retail, commercial and hospitality. These conduit bonds, issued to finance a new phase of a project that is nearly 20 years old, were sold through the Wisconsin Public Finance Authority. As tax-increment revenue bonds, these credits are highly dependent on increases in the assessed valuation of the properties in the project's footprint, which we believe is already well underway.

The specific securities identified and described are not representative of all of the securities purchased, sold, or recommended for client accounts. It should not be assumed that an investment in the securities identified has or will be profitable. Actual holdings will vary for each client and there is no guarantee that a particular client's account will hold any or all of the securities listed. See the last page for the actual performance of the Strategy.

While no bonds detracted meaningfully in a quarter that was generally strong for high yield municipal paper, a number of holdings were flattish. These included bonds connected to the aforementioned Brightline rail project in Florida, a tobacco settlement fund in the District of Columbia, Freddie Mac, a charter school in Texas and affordable housing in Virginia.

The portfolio owns a number of bond issues related to the Brightline rail project. One of these bonds with a maturity date in 2057 traded lower early in the quarter before being called in mid-August.

The announcement that 2024 payments into the tobacco master settlement agreement were to be the lowest since it went into effect due to a combination of larger-than-expected declines in cigarette sales and higher levels of inflation has weighed on the prices of tobacco bonds, including those issued by the District of Columbia. First Eagle's high yield municipal funds each have less than 1% exposure to bonds in this sector, and the credits we have selected should be better positioned to handle continued cigarette sales declines, in our view.

Multiclass mortgage participation certificates issued by Freddie Mac represent an interest in a pool of mortgages held and by that government-sponsored entity. As agency loans, the underlying mortgages tend to have low loan-to-value ratios, and the certificates themselves are fully guaranteed by Freddie.

The city of Arlington, Texas, issued bonds on behalf of LifeSchool of Dallas, which operates nine charter schools in the state. A portion of the proceeds will be used to build a new 1,200 student high school campus. Charter schools depend on state or local government payments for a large portion of their operating budgets. With funding per student set at fixed rate for each school year, increased expenses—including salaries for teachers—can weigh on charter schools.

Washington state issued municipal certificates backed by a portfolio of loans that financed the development of nine multifamily affording housing projects in Snohomish, King and Spokane counties.

Disclosures

The commentary represents the opinion of the High Yield Municipal Credit team as of the date noted. The opinions expressed are not necessarily those of the firm. These materials are provided for informational purposes only. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy, hold or sell or the solicitation of an offer to buy or sell any fund or security.

The information in this publication is not intended to provide and should not be relied on for accounting, legal and tax advice.

The portfolio is actively managed and subject to change.

High Yield Municipal Composite is a long-term municipal bond fund [under normal market conditions] that seeks to provide high current income exempt from regular federal income taxes. Capital appreciation is a secondary objective when consistent with the Fund's primary objective. For comparison purposes, the composite is measured against the S&P Municipal Yield Index. Indices do not incur management fees or other operating expenses. Investments cannot be made directly into an index.

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Results are based on fully discretionary accounts under management, including those accounts no longer with the firm.

The annual composite dispersion presented is an equal-weighted standard deviation calculated for the accounts in the composite for the entire year. The 3-year ex-post standard deviation is calculated using gross returns.

Past performance is not indicative of future results.

The US Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. The investment management fee schedule is 0.45% on assets. Actual investment advisory fees incurred by clients may vary.

The High Yield Municipal Composite was created and has an inception date of 1-Feb-2024.

Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis. **Exchange-traded funds (ETFs)** are listed investment vehicles that seek to provide exposure to a benchmark, index or actively managed strategy. **Default rate** is the percentage of loans or bonds in which the borrower/issuer failed to make scheduled interest or principal payments, typically measured over a trailing 12-month period. **Fitch Ratings** is a nationally recognized statistical rating organization (NRSRO) registered with the SEC and provides credit rating as an assessment of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality. **GDPNow** is a running estimate of real GDP growth based on available economic data for the current measured quarter. It is maintained by the Federal Reserve Bank of Atlanta but is not an official forecast of the Atlanta Fed.

Risk Disclosures

All investments involve the risk of loss of principal.

The First Eagle High Yield Municipal Strategy ("The Strategy") is new and may not be successful under all future market conditions. The Strategy may not attract sufficient assets to achieve investment, trading or other efficiencies.

The Strategy may invest in high yield, fixed income securities that, at the time of purchase, are **non-investment grade**. High yield, lower rated securities involve greater price volatility and present greater risks than high rated fixed income securities. High yield securities are rated lower than investment-grade securities because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. High yield securities involve greater risk than higher rated securities and portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Municipal bonds are subject to **credit risk, interest rate risk, liquidity risk, and call risk**. However, the obligations of some municipal issuers may not be enforceable through the exercise of traditional creditors' rights. The reorganization under federal bankruptcy laws of a municipal bond issuer may result in the bonds being cancelled without payment or repaid only in part, or in delays in collecting principal and interest. Strategies whose investments are **concentrated in a specific industry or sector** may be subject to a higher degree of risk than funds whose investments are diversified and may not be suitable for all investors. Strategies that invest in bonds are subject to **interest-rate risk** and can lose principal value when interest rates rise, while they typically increase their principal values when interest rates decline. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

S&P Municipal Bond Index measures the market-value-weighted performance of bonds issued by state and local municipalities in the US and its territories. **S&P Short Duration Municipal Yield Index** measures the performance of high yield and investment grade municipal bonds with duration range of one to 12 years maturity. **S&P Municipal Bond High Yield Index** consists of bonds in the S&P Municipal Bond Index that are not rated or whose ratings are less than or equal to BB+ by SPGR, Ba1 by Moody's, or BB+ by Fitch Ratings. **Bloomberg US Aggregate Bond Index** (Gross/Total) measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market in the US, including Treasuries, government-related and corporate securities, fixed-rate agency MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS. A total-return index tracks price changes and reinvestment of distribution income.

Indices are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

Trailing Returns (%)

Period: 1-Feb-2024 through 30-Sep-2024	Since Inception
High Yield Municipal Strategy (Gross Return)	13.29
High Yield Municipal Strategy (Net Return)	12.95
S&P Municipal Yield Index	6.32

All returns data beyond one-year figures are annualized.
Performance numbers and market values are preliminary and are subject to change.
Portfolio and index returns are shown in US dollars (USD).
Past performance is not indicative of future results.

Year End	Total Firm Assets (USD Millions)	Composite Assets (USD Millions)	Number of Accounts	Composite (Gross)	Composite (Net)	Russell 2000 Value Index	3Y ex-post Std. Dev. Composite	3Y ex-post Std. Dev. Russell 2000 Value Index	Composite Dispersion
2023	111,866	1,824	Five or Fewer	17.89%	16.89%	14.65%			N.A.
2022	101,577	765	Five or Fewer	-13.38%	-14.12%	-14.48%			N.A.
1-May-21 to 31-Dec-2021	110,254	209	Five or Fewer	3.17%	2.62%	3.76%			N.A.

	Composite (Gross)	Composite (Net)	Russell 2000 Value Index
1 Year Ending 30-Sep-2024	22.27%	21.24%	25.88%
3 Year Ending 30-Sep-2024	5.22%	4.33%	3.77%
5 Year Ending 30-Sep-2024	N.A.	N.A.	N.A.
10 Year Ending 30-Sep-2024	N.A.	N.A.	N.A.
Since Inception 1-May-2021	4.14%	3.25%	3.13%

N.A. – Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year. Composite dispersion calculated using gross returns.

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