Thornburg Municipal Bond Strategies

Portfolio Manager Commentary
30 June 2022

Thornburg

Market Review

Weighed down by a litany of concerns, the fixed income markets experienced one of the worst quarters on record. The list of investor worries going into the second half of the year is lengthy: rampant inflation, hawkish global central bank policy, rate hikes, quantitative tightening, the war in Ukraine, energy costs, slowing economic growth and a potentially looming recession. Yields across nearly every fixed income asset class were up substantially during the quarter as the U.S. Federal Reserve set the pace for other global central banks by hiking the Fed Funds rate in increasing increments in March (+25bps), May (+50bps) and June (+75bps). Spurred by monthly CPI data in May that was worse than expected, June marked the first 75bps hike since 1994 and served as a confirmation that inflation has become entrenched in the U.S. The same week in June the Swiss National Bank hiked rates (+50bps) for the first time in 15 years, as did Brazil's central bank (+50bps), and the Bank of England (+50bps). The data dependent decision-making process at global central banks, akin to driving by looking in the rearview mirror, has left many behind the curve on interest rate policy which has contributed to inflation rising to 40-year highs. As central banks now play catch-up, investors are

> Muni bond yields are quickly approaching pre-GFC levels as the penalty on savers has finally been lifted.

Average Annual Returns (%, as of 30 Jun 2022)

	QTR	YTD	1-YR	3-YR	5-YR	10-YR
Limited Term Municipal Composite (Net)	-0.92	-5.13	-5.13	-0.15	0.82	1.36
Limited Term Municipal Composite (Gross)	-0.85	-5.01	-4.88	0.12	1.08	1.63
ICE BofA 1-10 Yr US Muni Index	-0.75	-5.15	-5.08	0.14	1.21	1.58
BBG Muni 5 Yr TR Index	-0.42	-5.50	-5.34	0.15	1.17	1.62
Short Duration Municipal Composite (Net)	-0.01	-2.09	-2.15	0.05	0.66	–
Short Duration Municipal Composite (Gross)	0.08	-1.92	-1.81	0.38	1.00	–
ICE BofA 1-3 Yr US Muni Index	0.20	-2.13	-2.15	0.43	0.95	–
Intermediate Term Municipal Composite (Net)	-1.61	-6.65	-6.47	0.08	1.37	2.08
Intermediate Term Municipal Composite (Gross)	-1.51	-6.46	-6.10	0.48	1.78	2.52
ICE BofA 3-15 Yr US Muni Index	-1.89	-7.65	-7.42	-0.09	1.43	2.15
Strategic Municipal Income Composite (Net)	-2.82	-8.20	-8.04	-0.46	1.07	2.22
Strategic Municipal Income Composite (Gross)	-2.68	-7.93	-7.50	0.16	1.72	2.94
ICE BofA US Muni Index	-3.30	-9.28	-8.86	-0.19	1.54	2.46

Performance data for the Limited Term Municipal Strategy is from the Limited Term Municipal Composite, inception date of 1 January 1985. Performance data for Short Duration Municipal Strategy is from the Short Duration Municipal Composite, inception date of 1 April 2014. Performance data for the Intermediate Term Municipal Strategy is from the Intermediate Term Municipal Composite, inception date of 1 November 1991. Performance data for the Strategic Municipal Income Strategy is from the Strategic Municipal Income Composite, inception date of 1 May 2009.

Each composite represents all assets under management in fully discretionary, transaction fee based accounts. Returns are calculated using a time-weighted and asset-weighted calculation including reinvestment of dividends and income. Periods less than one year are not annualized. Individual account performance will vary. The performance data quoted represents past performance; it does not guarantee future results. Net of fee returns are net of transaction costs and investment advisory fees. For periods prior to 2011, net returns for some accounts in the composite also reflect the deduction of administrative expenses. Thornburg Investment Management Inc.'s fee schedule is detailed in Part 2A of its ADV brochure. Gross of fee returns are net of transaction costs. Performance results of the firm's clients will be reduced by the firm's management fees. For example, an account with a compounded annual total return of 10% would have increased by 159% over ten years. Assuming an annual management fee of 0.75%, this increase would be 142%.

faced with the likelihood of a not-so-soft landing, and the realization has set in that the recession many feared at the end of 2019 was not avoided by massive fiscal and monetary stimulus, but instead was only delayed.

Global rate hikes left fixed income investors with no place to hide as bonds sold off along with what felt like every other financial asset during the quarter. Longer duration bonds bore the brunt of the selloff with some debt markets down double digits on the quarter and many down over 20% on a year-to-date basis. The yield on the 10-year U.S. Treasury, which began the quarter at 2.35%, rose to 3.48%, which marked the highest level since February 2011, but managed to pare its losses in the final weeks of June to finish at 3.02%. Global sovereign debt broadly experienced a similar fate as yields on 10-year debt government rose by as much as 120bps in Brazil or as modestly as 7bps in Japan. Rates hikes also took their toll on investment-grade corporates, investment grade municipals, and securitized debt which was all down substantially for the quarter and for the year. Credit sectors such as global high yield, U.S. high yield corporates and high yield municipals also had to contend with recession concerns igniting a flight to quality that led credit spreads to widen by a couple of hundred basis points during the quarter thus further compounding losses created by rate movements. The waning weeks of the quarter were surprisingly unlike the previous two months as yields fell following the Fed's June rate hike. Restored credibility in the Fed's willingness and ability to fight inflation, coupled with a looming economic slowdown, led investors to reignite a bid for Treasuries given the ability to purchase bonds at multi-year high yield levels.

Second Quarter 2022 Performance Highlights

- The Thornburg Municipal Strategies posted negative total returns during a quarter in which the ICE BofA Tax-Exempt Municipal Master Index delivered a total return of -3.30%. The Short Duration and Limited Term Municipal strategies slightly underperformed their respective benchmarks while the Intermediate and Strategic strategies both outperformed their relative benchmarks during the quarter.
- Yields rose across the municipal market as the 10-year AAA yield began the quarter at 2.33% and set an 8-year high of 2.97% before finishing at 2.75%. With the upward movement in yields, duration was the largest driver of total return during the quarter. The defensive positioning of the Thornburg strategies from a duration standpoint was a strong contributor to relative performance during quarter for all.
- The second quarter brought about performance differentiation across individual bonds based on characteristics such as sector, credit quality, coupon, and call protection. The wide dispersion that occurred led security selection to be a large contributor to relative performance during the quarter for all strategies.

Current Positioning and Outlook

Municipal bond investors endured another painful quarter of performance as rising rates has taken hold of the fixed income markets. The Bloomberg Municipal Securities Index was down -2.9% during the quarter following a challenging first quarter and total return of -6.0%. The broad market index was down as much as -11.9% on the year had it not been for a late quarter rally that allowed it to pare its losses and finish at -8.98% on the year. Policy action on the part of the Federal Reserve and rate hikes in March, April, and May totaling 150bps were the driving force behind yields moving higher across the municipal yield curve. The 10-year AAA Muni yield began the quarter at 2.24% and touched an 8-year high of 2.97% on May 18th until the Fed's 75bps rate hike in May tipped the scales of investor concerns from inflation to recession and restored the luster of fixed income.

Higher yields meant shorter maturities outperformed longer maturities as the Bloomberg 1-year Municipal Index eked out a gain of 0.38% while the Bloomberg Long Bond (22+) Municipal Index was down -6.59%. The Thornburg municipal strategies have been defensively positioned from a duration perspective, relative to their historical ranges, as market opportunities dried up and yields bottomed during the summer of 2021. Our process helped us arrive at the conclusion the market was overvalued, and municipal bond prices had risen to unsustainable levels. Our assessment has come to serve our shareholders well this year and nowhere is this more evident than in our Intermediate and Strategic Municipal strategies.

The second quarter also saw a credit sell-off which was absent in the first quarter as the Bloomberg AAA Municipal Index returned -2.52% on the quarter while the Bloomberg High Yield Municipal Bond index returned -5.61%. Mutual fund outflows surpassed $88B at the end of June, according to Lipper/Refinit data, which put pressure on high yield Municipal managers and forced the sale of lower quality, less liquid names furthering the credit performance divide. The Thornburg Municipal strategies have also been defensively positioned from a credit perspective as the yield pick-up available by going down in credit quality was vaporized by massive inflows into high yield Municipal strategies. We fought the urge to purchase lower quality and longer duration paper offering incremental yield for considerable amounts of risk despite the performance give-up at the time. The decision has since served our shareholders well as the bonds we avoided have been some of the poorest performers this year as the simultaneous rise of interest rates and widening of spreads compounded losses.

While we do feel some sense of vindication for our adherence to the process that has guided us over the last 40-years, returns in the municipal market means there can be no victory laps in such an abysmal year. Instead, we have focused our efforts on improving our strategies by selling bonds purchased at low yields, booking tax losses which can be used to offset future gains, and reinvesting the proceeds into bonds that can be purchased at 3, 4, or even 5% tax-exempt yields.

It's impossible to know exactly where interest rates go from here and a strong argument could be made for them going either up or down. What we do know is the yield that has been absent from the municipal market for the last several years has reappeared in an instant. The penalty placed on savers by the Fed's Zero Interest Rate Policy (ZIRP) has been lifted. The total return of municipal bonds over the long term has been dominated by income with price returns making up as little as 10% of the total over the last 40-years. With municipal bond yields quickly approaching pre-GFC levels investors should recalibrate their expectations and refocus on the income component. We continue to work feverously to increase the yield on our strategies to both build a larger cushion against interest rates should they move higher, but also to improve upside potential of our strategies should interest rates move lower.

Thank you again for your continued support and investing alongside of us in the Thornburg Municipal Bond Strategies.

Important Information

The performance data quoted represents past performance; it does not guarantee future results.

Unless otherwise noted, the source of all data, charts, tables and graphs is Thornburg Investment Management, Inc., as of 30 June 2022.

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A bond credit rating assesses the financial ability of a debt issuer to make timely payments of principal and interest. Ratings of AAA (the highest), AA, A, and BBB are investment-grade quality. Ratings of BB, B, CCC, CC, C and D (the lowest) are considered below investment grade, speculative grade, or junk bonds.

U.S. Treasury securities, such as bills, notes and bonds, are negotiable debt obligations of the U.S. government. These debt obligations are backed by the “full faith and credit” of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes.

Credit Spread/Quality Spread – The difference between the yields of securities with different credit qualities.

Duration – A bond’s sensitivity to interest rates. Bonds with longer durations experience greater price volatility than bonds with shorter durations.

Federal Open Market Committee (FOMC) - The branch of the Federal Reserve Board that determines the direction of monetary policy. The FOMC is composed of the board of governors, which has seven members, and five reserve bank presidents. The president of the Federal Reserve Bank of New York serves continuously, while the presidents of the other reserve banks rotate their service of one-year terms.

The ICE BofA 1-10 Year US Municipal Securities Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 10 years.

The ICE BofA 1-3 Year U.S. Municipal Securities Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 3 years.

The ICE BofA 3-15 Year U.S. Municipal Securities Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity greater than or equal to three years and less than 15 years.

The ICE BofA U.S. Municipal Securities Index tracks the performance of the investment-grade U.S. tax-exempt bond market. Qualifying bonds must have at least one year remaining term to maturity, a fixed coupon schedule, and an investment grade rating (based on average of Moody's, S&P, and Fitch).

Portfolio construction will have significant differences from that of a benchmark index in terms of security holdings, industry weightings, asset allocations and number of positions held, all of which may contribute to performance, characteristics and volatility differences. Investors may not make direct investments into any index.

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