

Quick Hits from the Muni Trading Desk

A LOOK AHEAD - WEEK OF 10/31/2022

Note of caution on municipal closed end funds:

We usually use this space to comment on municipal treasury ratios, MMD levels, supply and demand, fund flows, as well as deal activity in the municipal market. This week, we want to deviate somewhat and provide readers with what we see as a warning sign for retail investors. In our opinion, the municipal closed end fund market, often a mainstay in municipal retail portfolios, is poised for some excess downside volatility. While this is not a market we traffic in - we prefer cash bonds - we expect this to become a driver of performance in the near term.

To many investors, municipal closed end funds may look attractive based on the stated dividend yield and the current discount to NAV. Municipal closed end funds have a few unique features which are often not appreciated, and we think will play an outsized role in the coming weeks. Many municipal closed end funds borrow money primarily through the auction rate preferred market. The cost of this leverage is calculated at a multiple of taxable short rates, often 1.25 times commercial paper or a similar rate level. With taxable short rates expected to go to 4% next week, and higher in December, the cost of leverage could approach 6% or higher, creating a negative carry cycle. In addition, municipal closed end funds cannot have leverage levels exceed 50% of their assets. Taken together, in situations where short-end rates are rising as dramatically as we are currently seeing and asset prices falling, closed end funds will likely be forced to reduce their leverage through selling bonds and/or repurchasing auction rate preferreds. We believe we are in a deleveraging cycle which will continue to put pressure on the funds' ability to maintain its current dividend pay-out. Cutting of the dividend could continue to add negative price action to the NAV of the fund further causing deterioration of capital.

We think this might be a good time to take a tax loss on the closed end funds and recycle that cash into direct bond purchases.

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