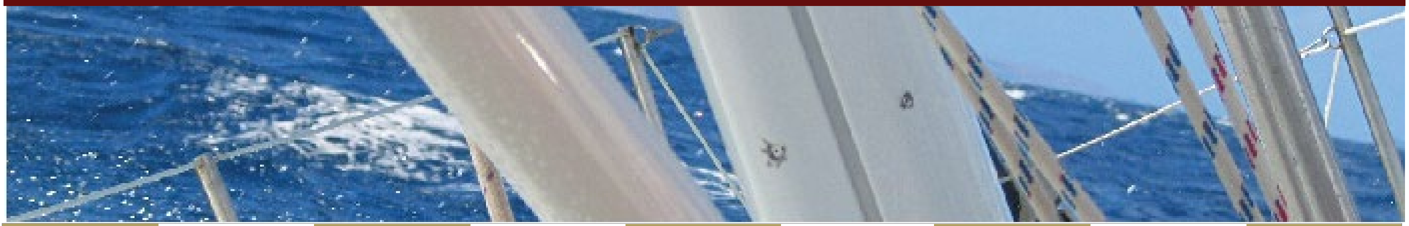
CARRET Asset Management

July 2023

Carret Credit Insights



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Firm AUM

$3.064 Billion

Firm Fixed Income AUM

$2.206 Billion

The start of 2023 has proven to be a period of notable resilience and stabilization in the fixed income markets. Despite initial concerns over rising interest rates and inflationary pressures, the market experienced a gradual recovery as central banks worldwide adopted a more cautious approach to tightening monetary policies. As a result, government bonds displayed improved performance, despite yields rising steadily throughout the year. Investors found solace in reduced uncertainty and higher yields, leading to increased demand for fixed income assets.

The corporate bond market saw positive developments during the Q, as economic growth showed signs of rebounding and credit spreads remained attractive. The municipal bond market experienced steady growth and demand in the second Q, with investors increasingly seeking tax-advantaged assets. As local economies began to recover from the pandemic's impacts, municipal issuers witnessed improved revenue streams, bolstering their creditworthiness.

During the Q, the Federal Reserve took a cautious approach to its monetary policy actions. The Fed closely monitored inflationary pressures and the labor market's recovery. With a focus on data dependency, the Fed opted to raise interest rates once during the Q but paused at the June meeting. Chairman Powell emphasized the central bank's commitment to supporting the economy while assuring markets that any policy adjustments would be gradual. The Fed’s measured approach aims to strike a balance between addressing inflationary pressures and providing sufficient support to sustain economic growth and stability.

As investors sought safety and yield in a dynamic market environment, they remained cautious but optimistic, setting the stage for potential opportunities and challenges in the Qs ahead. We would like to share more details on our fixed-income strategies in the commentary below.

Key Market Levels	6.30.23	12.31.22	12.31.21
Fed Funds Rate	5.00% – 5.25%	4.25% – 4.50%	0.00% – 0.25%
3 Month U.S. T-Bill	5.31%	4.41%	0.05%
10 Yr U.S. Treasury Bond	3.81%	3.88%	1.51%
5 Yr AAA Municipal Bond	2.70%	2.52%	0.59%
5 Yr A Corporate Bond	5.33%	5.22%	1.86%

Source: Municipal Market Data (MMD) and FactSet

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Data as of June 30, 2023	Taxable Fixed Income	Municipal Fixed Income	Opportunity Fixed Income	Enhanced Cash
Maturity	3.7	6.0	3.0	0.3
Duration / Dur to Worst	3.5	5.0 / 3.6	2.7	0.3
YTM / YTW	5.37%	3.44% / 3.06%	7.08%	5.22%
Taxable Equiv YTM/YTW		6.65% / 5.92% [1]		5.45% [2]
Coupon	3.61%	4.52%	5.25%	2.71%
Credit Rating	A-	AA	BB+	A+

[1] *Assumes a combined federal and state effective tax rate of 48.30%* [2] *Assumes a state tax rate of 7.50%*

Sector Allocations:				
U.S. Treasury	11%	2%	5%	45%
Government Agency	3%			9%
Corporate - Inv Grade	79%	2%	36%	32%
Corporate - High Yield			48%	
Preferreds	6%		8%	
Convertible				
Municipal		95%		9%
Cash	1%	1%	3%	5%

Taxable Fixed Income Strategy:

- During the 2nd Q of 2023, 5 Yr U.S. Treasury (UST) yields increased 52 bp from 3.61% to 4.13% as yields across the curve climbed.
- Investment Grade (IG) corporate bond yields increased while the curve remained inverted during the 2nd Q.
- IG spreads, as measured by the 3-5 Yr A rated FactSet Index, tightened by 18 bp during the Q, decreasing from 148 bp to 130 bp.
- IG spreads, as measured by the 3-5 Yr BBB rated FactSet Index, tightened by 26 bp during the Q, decreasing from 195 bp to 169 bp.
- The Taxable Fixed Income Strategy outperformed the Bloomberg Intermediate Gov't Credit Index during the Q with a gross return of 0.1% versus the index's negative return of -0.8%. YTD, the strategy outperformed the index with a gross return of 2.4% versus the index's return of 1.5%.
- The strategy's overweight exposure to corporate bonds contributed to outperformance relative to the index. Corporate bonds contributed positively on a cash flow basis due to higher coupon cash flows relative to the index. YTD, the overweight position, however, did not positively or negatively impact performance on a price basis versus the index as corporate bond spreads finished the Q returning to near where they began 2023.
- Duration, at 3.5 Yrs, has remained near the low end of the strategy's stated range of 3-7 Yrs for the last several Qs in the midst of a historically low interest rate environment. With the Fed raising short-term interest rates 5% over the last 15 months, we have looked to extend duration on the back of long term yields climbing alongside the Fed move.
- Average portfolio quality remained steady Q / Q at A-.
- The strategy's Yield to Maturity (YTM) increased during the Q from 4.95% on March 31, 2023 to 5.44% at Q end.
- The strategy's top three economic sectors are Financials, Information Technology, and Communication Services.
- We continue to find value in corporate credits and remain overweight vs the index with an allocation of 79% to corporate bonds. Agency valuations are growing more attractive, boasting spreads above treasuries of greater than 100 basis points. We continue to monitor yield levels for an opportunity to increase exposure to the government agency sector.

- The strategy's 6% allocation – up from 5% last Q – to preferred securities provides an increase in the total yield and aims to capture incremental cash flows.
- We believe that despite inflation retreating from recent highs, there will be a long period of higher inflation (over the Fed's 2% target) ahead. This uncertainty could lead to swings in bond prices and yields allowing for active strategies to add value in a volatile environment.
- For the remainder of 2023, the strategy aims to capitalize upon the reinvestment of maturities and calls, swaps, and coupon cash flows, into an attractive interest rate environment.

Municipal Fixed Income Strategy:

- Representative AAA rated 5 Yr Municipal Bond yields increased by a meaningful 48 bp during the 2nd Q of 2023. The index's YTM began the Q at 2.22% and closed the Q at 2.70% which is a Taxable Equivalent Yield of 5.22%[1]. The 5 Yr UST yield rose by 52 bps during the same period.
- The 2Yr-to-10Yr municipal curve remained inverted. The curve inversion grew during the Q as the spread between 2 Yr and 10 Yr munis increased from -13 bp to -37 bp at Q end. The maximum inversion occurred on May 18th at -46 bp. We are not surprised the curve has remained inverted for this long as the Fed continues to bump up the Fed Funds Rate.
- The Municipal Fixed Income Strategy returns were negatively impacted by the rise in interest rates during the 2nd Q. On a positive note, municipal market fundamentals remained quite strong during the Q with elevated budget surpluses, positive rainy-day funds, and encouraging headline tailwinds. The strategy's gross return for the 2nd Q was -0.6% while the Bloomberg 5 Yr Muni Index returned -0.7%. YTD returns are positive with the strategy returning 1.4% compared to the benchmark return of 1.2%. We continue to see positive absolute and relative value in both the short-term and the extended intermediate-term parts of the yield curve.
- The strategy's duration-to-worst decreased slightly from 3.7 to 3.6 Yrs Q / Q which is in-line with the duration of Bloomberg 5 Yr Muni Index (3.7 Yrs).
- Average portfolio quality continues to be AA.
- The National Association of State Budget Officers released their most recent Spring 2023 Fiscal Survey of US States, which includes timely data on state fiscal conditions. Among its highlights, it estimates that total FY22 balances (rainy day funds + general funding balances) were 3.5 times FY20 levels, representing 37.3% of operational spending.
- Municipal mutual fund net inflow/outflows were mixed during the Q. April and May were net outflow months while June experienced strong inflows on the heels of higher yields. The fund flows for the 2nd Q totaled $500 million in net inflows. YTD 2023 net inflows totaled $5 billion. Separately managed accounts (SMAs) and municipal ETFs garnered inflows over the same time frame.
- 2nd Q 2023 new issuance was $98 billion which was ahead of the 1st Q's $77 billion. YTD issuance was $176 billion, down 19%, compared with $219 billion during 1st H22. New project borrowing accounted for 60% of new issuance during the 1st H23. Taxable Municipal Bond issuance has declined in recent Qs and now represents only 11% of municipal issuance (was 14% in 2022). Demand in the 1st Q continued to override the new issue supply. Demand has been driven by compelling yields, maturities, and calls against the "lighter than last year" new issue supply amounts.

Opportunity Fixed Income Strategy:

- During the 2nd Q of 2023, 5 Yr UST yields increased 52 bp to 4.13% while 6 Mo UST rates increased 57 bp to 5.46% as the Fed continued its inflation fight, albeit at a less aggressive pace. We believe the Fed is close to ending its pattern of increasing the Fed Funds Rate but will leave rates higher for longer – this is providing a unique opportunity for short-duration High Yield (HY) bond investors.
- HY rates (as measured by the iBoxx HY Index) increased from 8.26% on March 31st to 8.44% on June 30th, an increase of 18 bp.

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- HY spreads tightened during the Q, decreasing from 465 on March 31st to 431 on June 30th, a tightening move of 34 bp. We find this interesting as the "street" debates between a soft or hard landing – typically, economic contractions are associated with widening not tightening credit spreads.
- IG spreads, as measured by the 3-5 Yr BBB rated FactSet Index, tightened by 26 bp during the Q, decreasing from 195 bp to 169 bp.
- The strategy outperformed the Bloomberg Intermediate Gov't Credit Index during the 2nd Q, with a positive gross return of 1.0% versus the index's negative return of -0.8%. YTD, the strategy outperformed the index returning 2.9% versus the index's return of 1.5%.
- The Strategy's duration increased from 2.5 Yrs at the start of the Q to 2.7 Yrs at the end of the Q as we took advantage of higher rates and a conservative position entering the Q.
- Average portfolio quality held constant Q / Q at BB+; additionally, IG exposure at Q end was 42% versus 38% at the end of the 1st Q. While we expect the economy to slow, we do not anticipate a hard landing. We have increased our exposure to IG credit as HY spreads have tightened and we patiently await HY spread widening in the Qs ahead. We would again highlight that earnings remain firmly above pre-Covid levels, thus providing solid credit profiles for many HY bonds.
- We remain defensively positioned and have ample flexibility to add value as credit and interest rate opportunities arise – nearly 38% of our bonds mature in the coming 12 months.

Enhanced Cash Strategy:

- Ultra-short-term interest rates remained elevated, as the yield on the 6 Mo UST increased from 4.89% to 5.46% during the Q. Over the last twelve months, the 6 Mo UST has increased a notable 304 bp.
- IG spreads, as measured by the ICE BofA 0-1 Yr A-AAA US Corp Index, tightened meaningfully during the Q, decreasing from 80 bp to 53 bp. Tightening IG spreads were mostly driven by the recent federal debt ceiling crisis, which drove investors away from UST into corporate bonds, as well as renewed hope of the Fed avoiding a hard landing.
- Average portfolio quality remained at A+ for the Q, while duration shortened slightly from 0.35 Yrs to 0.27 Yrs.
- The Enhanced Cash Strategy performed well during the Q, returning 1.0%, with the ICE BofA 0-1 Yr UST Index up 1.0% over the same time frame. YTD, the strategy returned 2.2% compared to 2.2% for the index.
- While short-term interest rates were raised less aggressively by the Fed in the 2nd Q, ultra-short-term bonds still offer the highest yield across the inverted yield curve. We expect that these higher ultra-short rates will remain elevated for the next few Qs and continue to offer meaningful opportunities for the Enhanced Cash Strategy.

Separately Managed Account Strategies:

Taxable: Carret's Taxable Bond Strategy seeks to achieve above-average total returns with an emphasis on preservation of capital and consistent cash flow. We utilize investment grade fixed income securities and shift across bond sectors based on changing market conditions. Our intermediate duration approach (3 - 7 Yrs) seeks to identify the sweet spot on the yield curve and structure maturities accordingly. Active management of the strategy includes forecasting the long-term direction of interest rates and credit spreads. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk adjusted returns.

Municipal: Carret's Municipal Bond Strategy seeks to maximize tax efficiency through opportunistic portfolio management while preserving principal through practical portfolio structuring and fundamental credit analysis. We actively manage investment grade portfolios with a diversified blend of issuers, sectors, and maturities aimed at delivering consistent, risk adjusted returns with an emphasis on tax-efficient cash flows. Carret uses a value approach when buying and selling bonds. This method recognizes the inefficiencies of the municipal marketplace and enables clients to benefit from our expertise and market knowledge.

Our high-quality, intermediate-maturity bias is designed to balance preservation of principal, total return, and tax-exempt cash flows. We opportunistically add value through credit research, bond structuring, and yield curve positioning. Our municipal bond portfolios are actively managed as either state-specific or state-focused (general market in approach, otherwise). Essential service revenue bonds and high-quality general obligation bonds make up the framework of our municipal bond portfolio strategy. The strategy's primary focus is on high-quality, investment-grade municipal bonds with an intermediate duration of approach (3 - 7 Yrs), which enables us to utilize bonds in the 2 - 12 Yr maturity range.

Opportunity: Carret's Fixed-Income Opportunity Strategies seeks to generate a higher level of current income with a secondary focus on long term capital appreciation. We utilize various types of higher yielding fixed income securities and shift among types based on changing market conditions. We actively manage risk, respond quickly to market movements, and utilize interest rate hedges to limit duration risk. We focus on high quality high yield and low-quality investment grade bonds, and couple them with preferreds and broken convertibles to try to generate above average levels of cash flow.

Our intermediate duration approach (2 - 10 Yrs) seeks to identify the sweet spot on the yield curve and structure maturities, accordingly. Active management of the strategy includes forecasting the long-term direction of interest rates and credit spreads. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk adjusted returns.

Leveraged Opportunity: Carret's Fixed Income Leveraged Opportunity Strategy seeks to utilize low cost leverage and favorably negotiated release rates to potentially enhance our existing Opportunity Strategy returns. We actively manage leverage to augment opportunities within the high yield and investment-grade sectors of the fixed income market.

Enhanced Cash: Carret's Enhanced Cash Strategy seeks to provide excess returns above those offered by cash equivalents, while focusing on capital preservation and liquidity. The strategy invests in ultra-short-duration investment grade bonds – those with a maximum maturity of 12 months, and a typical duration of less than 6 months.

Our custom, tailored approach opportunistically utilizes a thoughtful mix of Investment Grade Corporate debt, US Treasury and Agency securities, as well as taxable and tax-exempt Municipal bonds to enhance overall after-tax returns.

Mutual Fund Strategy:

Kansas Tax-Exempt: The Carret Kansas Tax-Exempt Bond Fund seeks to preserve capital while producing current income that is exempt from both Federal and Kansas state taxes. The Fund seeks to generate monthly income and principally invests in investment-grade bonds of intermediate maturity.

For more complete information on the Carret Kansas Tax Exempt Bond Fund, you can obtain a prospectus containing complete information for the Funds by calling 888.266.8787 or by downloading it from Carret's web site. You should consider the Fund's investment objectives, risks, charges, and expenses carefully before you invest or send money. Information about these and other important subjects is in the Funds' prospectus. The prospectus and, if available, the summary prospectus, should be read carefully before investing. Shares of the Carret Kansas Tax Exempt Bond Fund are distributed by ALPS Distributors, Inc., which is not affiliated with Carret Asset Management, LLC.

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