OUTLOOK 2022

Top 5 Municipal Market Insights for 2022

From MacKay Municipal Managers

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From **MacKay Municipal Managers™**
The Minds Behind Munis

Embrace Change

"Change is the law of life. And those who look only to the past or present are certain to miss the future." **– John F. Kennedy**

The past two years' events are undoubtedly altering the future direction of our lives: where we live, how we work, learn and communicate and how to prudently invest in municipal bonds. In many respects, pre-existing trends are accelerating. In higher education for example, acceptance of virtual instruction has vaulted forward and is shifting our relative value assessments. Passive buy and hold municipal strategies such as ladder portfolios and most separately managed accounts (SMAs) may have worked historically but now lack the flexibility to generate excess return in the evolving municipal market. We note these dramatic structural shifts in the market: taxable issuance likely exceeds $100 billion for the third year in a row, 5% plus coupon structures have declined from 63.2% issuance in 2017 to 34.6% today,[1] and the Non-Rated percentage of the Bloomberg High Yield Municipal Index now exceeds 61% – up from 40.9% in 2017.[2] This year's five insights focus on the stark shifts occurring in the municipal bond market and provide our roadmap for embracing and capitalizing on the changes that lay ahead.

1. Transitory or not: View municipal investments as an inflation hedge

We believe credit-sensitive municipal bonds provide a larger cushion against inflation relative to other fixed income investments of similar quality because municipal bond credit tends to improve with inflation. Many taxes supporting municipal credits increase as asset prices rise. For example, general obligation issuers collect higher ad valorem taxes as real estate values grow. Dedicated tax bonds increase coverage ratios as the prices of taxed items rise. An array of municipal credits, including toll road financings and tobacco bonds, incorporate annual inflation adjustments in their covenants that increase revenues available to debt service. Adjusting fixed income exposures in favor of municipal bonds can help mitigate potential higher inflation.

1. Source: Bloomberg, 12/2021.
2. Source: FactSet.

2. Elevated tactical trading drives returns

Active management should differentiate performance outcomes in an expected lackluster 2022 municipal market. We believe one-to ten-year ladder strategies and/or SMAs will lag actively managed strategies, which may be counterintuitive to many municipal investors. We expect heightened levels of portfolio activity centered on tactical allocations among bond structures and credit qualities to produce meaningful alpha in portfolios. In addition, strategic cash allocations can balance portfolio duration and fund the purchases of securities in the event of volatility. In 2022, investors should be mindful of active strategy claims from managers whose trading is primarily tied to reinvestment. In our view, traditional passive municipal investors shifting to tactical active management in 2022 may improve outcomes.

3. Maintain overweight in high yield then begin to trade up in quality mid-year

We believe an overweight position in high yield municipals could drive outperformance through at least the first half of 2022. Any potential gains then may provide a buffer against an anticipated sluggish second half. Select – certainly not all – high yield municipal issuers emerged from lockdowns in strong financial condition as the ratio of ratings upgrades to downgrades in 2021 hit its highest level since at least 2013.[3] Therefore, investors can retain those high yield municipal credits with more confidence. In addition, those holdings stand to benefit from the market's positive technical outlook. We see Puerto Rico's emergence from bankruptcy producing a massive payout of cash that drives reinvestment demand in a market already short on supply. That demand tightens high yield spreads and contributes to strong relative returns compared to rate sensitive high grades in our view. Patient credit investors adjusting their strategy as the year progresses could be rewarded for their flexibility.

4. Shift focus to structure as fiscal policy [spending] gives way to monetary policy

While fundamental credit selection remains essential to generating favorable relative returns, we believe the main performance driver shifts from the federal spending support of municipal credit to the monetary policy impact on structure. For example, municipal investors must contend with the longer durations of lower coupon bonds. Since 2017, 2% and 3% coupons have risen from 16.1% to 29.8% of tax-exempt issuance as defensive coupon structures were refunded.[4] We see patient, active investors generating alpha by trading around periods of rising volatility exacerbated by wider ownership of lower coupons and potentially rising rates. In addition, municipal expertise is essential to understanding the nuanced aspects of municipal structure. For example, holders of 2% and 3% coupons should be prepared for the Market Discount Rule (i.e. "de minimis") impact on total return. In our view, investors modifying their strategy to incorporate structure decisions could discover new modes of potentially generating excess returns.

5. Taxable municipals outperform … again

In 2022, we believe taxable municipal bonds will extend ten years of inflation-adjusted outperformance versus most of the investment grade U.S. market.[5] We expect growing investor demand for high quality, monopoly-like municipals drives this outperformance. Issuers' ability to raise taxes and fees on their essential services maintains adequate debt service coverage, stabilizes credit ratings and reduces bond price sensitivity to rising rates and higher inflation. As a result, the price correlation between taxable municipal bonds and other taxable market segments can decline. The investment grade taxable market, as measured by the Bloomberg Aggregate Bond Index, is approximately 44% U.S. Treasury and Government related securities[6] and investors traditionally tracking this benchmark are facing significant exposure to both interest rate and inflation risk. In 2022, expected higher taxable municipal supply and trading volumes will likely attract new, non-traditional investors looking for low-correlation, high quality assets. As a result of these factors, we expect taxable municipals to reward investors who increase exposure to the asset class within their fixed income allocations.

3. Source: Moody's, Barclays Research, 12/2021.
4. Source: Bloomberg.
5. Source: Bloomberg, Morningstar.
6. Source: Bloomberg, 12/2021.

All investments are subject to market risk, including possible loss of principal.

Municipal bond risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities. Investing in below investment grade securities may carry a greater risk of nonpayment of interest or principal than higher-rated securities.

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value. Diversification does not assure a profit or protect against loss in a declining market. It is not possible to invest directly in an index.

Active management is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio. Active management strategies typically have higher fees than passive management.

Alpha measures a fund's risk adjusted performance and is expressed as an annualized percentage.

Bloomberg High Yield Municipal Index covers the high yield portion of the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, insured bonds, and pre-refunded bonds.

Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities.

The **de minimis rule states** that if a discount is less than 0.25% of the face value for each full year from the date of purchase to maturity, then it is too small (that is, de minimis) to be considered a market discount for tax purposes. Instead, the accretion should be treated as a capital gain.

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