Municipal Market Insights for 2012 – "Still Offering Value"

January 2012

What's Driving the Municipal Market? Five Insights on the Municipal Market by MacKay Municipal Managers™

As U.S. states and localities managed through 2011 with few defaults, the municipal market gained strength after a weak first quarter and ended the year up over 10%. Many investors are asking, "Is it too late to enter the market?" ***Our response: Municipals still offer value.***

We believe 2012 will be a year of watching state legislatures and county commissions to distinguish which issuers will continue to offer relative safety to bond investors. In addition, we think the technical demand and supply outlook will be a driver of the overall market. Finally, it is our opinion that investors need to be cautious in evaluating bonds that are tied to real estate, such as continuing care retirement facilities, assessment districts (geared towards real estate land secured deals), and tax increment bonds[1], as we believe these issues will be the main areas of defaults.

With this is mind, we offer our five insights into the market for 2012:

1. Municipals outperform taxable alternatives.

There is still significant value in municipal bonds. While returns for 2011 were strong, we feel spreads[2] will continue to tighten in 2012. Spreads, which initially widened during the financial crisis starting in 2008, and came under additional technical pressure in the fourth quarter of 2010, are still elevated. We also believe the combination of greater demand and manageable supply will cause spread tightening and enable the municipal market to perform well on both an absolute and relative basis.

2. "BBB" municipals will lead the broad municipal index.

Municipal bonds posted declines from November 2010 through April 2011, as mutual funds raised money to meet redemptions. The largest declines were recorded in the BBB segment of the market, as many high-yield municipal funds, seeking liquidity, sold liquid BBB bonds. While the spread on BBB to AAA municipal credits did tighten somewhat during the second half of 2011, the spread is still well over twice the historical average. We believe that the demand for yield, coupled with a credit rebalancing from high-yield muni funds that were forced sellers in 2010/11, will continue to compress the BBB to AAA spread.

3. Security selection will drive performance as defaults and particularly downgrades increase across many segments of the municipal market.

In 2012, we believe that individual security selection will outperform sector-specific strategies. We anticipate that continued economic weakness and financial stress on state and local issuers will result in an increase in isolated defaults and credit rating downgrades across sectors. As a result, investors should not rely on sector trends but, rather, focus on individual security selection to identify bonds that will outperform.

4. Pragmatic state and local governance will separate winners from losers.

States and local municipalities that have been successful in balancing their budgets by expenditure reductions and structural reform, including employee compensation and pension costs, should see their ratings improve with the onset of revenue collection improvements. States and municipalities that have adhered to stringent budget cuts should see a return to surplus collections, as has begun in such states as Massachusetts and Florida. On the other hand, those governments that have not dealt with budget reform and stuck to poor fiscal management with one-time budget solutions or by tax increases should continue to experience budget deficits as federal mandates and pension liabilities increase the likelihood of ratings downgrades.

5. Taxes on earned and unearned income will increase in the future causing higher demand for municipal bonds.

We expect that dysfunctional governance in Washington will keep gridlock the norm, causing tax rates to increase on higher income earners. Increases will affect both marginal income tax rates and surtaxes. The net effect could increase the attractiveness of municipal bonds. In addition, we believe corporate tax rates have a high chance of declining.

1. Tax increment bonds are bonds primarily issued in California. These are done by redevelopment agencies and the incremental tax increases (as developments get built out and property values increase) serve as additional security for the bonds.
2. Credit spread refers to the difference between the value of two securities with similar interest rates and maturities when one is sold at a higher price than the other is purchased.

Bond Ratings are evaluations of a bond issuer's financial strength, or its ability to pay a bond's principal and interest as agreed upon. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'C' ("junk"), which is the lowest grade.

Past performance is no guarantee of future results.

Before You Invest

All mutual funds are subject to market risk and will fluctuate in value.

A portion of a municipal's fund's income may be subject to state and local taxes or the alternative minimum tax. Funds that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. 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. High-yield securities (sometimes called "junk bonds") are sometimes considered speculative because they present a greater risk of loss than higher-quality debt securities, may be less liquid, and can also be subject to greater price volatility. High-yield municipal bonds may be subject to increased liquidity risk as compared to other high-yield debt securities.

Municipal securities 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. Such uncertainties could cause increased volatility in the municipal securities market and could negatively impact the Fund's net asset value and/or the distributions paid by the Fund. Securities purchased by the Fund that are liquid at the time of purchase may subsequently become illiquid due to events relating to the issuer of the securities, market events, economic conditions or investor perceptions

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Municipal Market Insights for 2012 – Mid-Year Update

July 2012

What's Driving the Municipal Market?

MacKay Municipal Managers™ Update Their 2012 Municipal Market Insights

1. Municipals outperform taxable alternatives.

Halfway through the year, we've seen our first insight come to fruition, with a level of outperformance for munis that exceeded our expectations. The Municipal Bond Index has outperformed the Barclays U.S. Aggregate Index by about 130 basis points, and it's outperformed the U.S. Government Index by around 100 basis points. Municipals got off to a very strong start this year, and while there are pockets in the municipal marketplace that do seem a little rich from our perspective, we still see a lot of value. The primary reason being that the market was just so dislocated in both 2008 and 2010.

2. "BBB" municipals will lead the broad municipal index.

In January, we stated that we believed the demand for yield, coupled with a credit rebalancing from high-yield muni funds that were forced sellers in 2010-11, would continue to compress the BBB to AAA spread, leading to ouperformance of BBB rated municipal bonds. As of July 2012, the Municipal Bond BBB Index has outperformed the general municipal index by more than 300 basis points. In fact, we believe there is still value here because spreads continue to be wider than historical measures.[1]

3. Security selection will drive performance as defaults – and particularly downgrades – increase across many segments of the municipal market.

In the beginning of 2012, it was our opinion that individual security selection would outperform sector-specific strategies due to continued economic weakness, and financial stress on state and local issuers would result in an increase in isolated defaults and credit rating downgrades across sectors. Thus far in 2012, security selection has been the key driver of our outperformance relative to peers and benchmarks. Certain states have been downgraded. Illinois, for example, was downgraded, but the key driver for us among every segment of our market has been the securities we have selected, and how they've performed over the first six months.

4. Pragmatic state and local governance will separate winners from losers.

The states and municipalities that have adhered to stringent budgets have done well. New York is a perfect example of a state that really has its fiscal act together. New York continues to get its budgets done on time and investors have rewarded New York State with lower yields. Therefore, New York's bonds have generally experienced price increases. Other issuers have not been as pragmatic. That includes states like Illinois and Puerto Rico, and that's why we have moved away from those two states in our portfolios.

5. Taxes on earned and unearned income will increase in the future causing higher demand for municipal bonds.

Regardless of the outcome of the presidential election, we still firmly believe that rates on both earned income and unearned income have to go higher in the future. The reason for this is the structural problems that either the federal government or the local governments have can't be balanced without a balanced approach. So, we do still believe rates are going higher in the future, which may increase demand in the municipal marketplace and add a lot of support for municipal bond prices.

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