

# Top Five Municipal Market Insights for 2015

## 2015: The Year of Transition to Active Management

1. Demand for municipals remains high – Institutions increase investments and proprietary trading desks resurface
2. Yield curve flattening – High grade bonds with short/intermediate maturities underperform
3. New bond issuance surprises on the upside – Net new supply negative for the fifth year in a row
4. Return of new issue monoline insurance – Greater than 10% penetration rate for the first time in six years
5. Tobacco sector outperforms – Investors seek to maintain yield as existing higher coupons are called or mature



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**MacKay Municipal Managers™** employs a relative-value investment approach across all of their municipal strategies, with a focus on total return. The team seeks to capitalize on opportunities created by their perceived mispricing of securities and will move along the credit curve based on where they find the best relative value. The team's active, research-driven process and keen emphasis on risk control may benefit investors seeking attractive tax-free income. There can be no guarantee that investment objectives will be met.

Every year, the team publishes their top five views and insights for the municipal market. Below are their insights for 2015, which they describe as "The Year of Transition to Active Management."

### 1. Demand for municipals remains high – Institutions increase investments and proprietary trading desks resurface

We foresee demand for municipals remaining high and liquidity improving as certain institutional clients, including insurance companies, continue to add municipals to their core portfolios. These institutions, with varying tax profiles, will likely view municipal bonds as a compelling investment solution that offers attractive, absolute income streams. On the heels of a dramatic decline in capital commitment to municipal bonds since 2008, our view is that favorable market conditions and regulatory developments will cause proprietary trading desks to resurface and, therefore, liquidity will improve on the margin.

### 2. Yield curve flattening – High grade bonds with short/intermediate maturities underperform

We expect a flattening of the yield curve to cause disruption in the market and spread widening among high grade bonds on the short/intermediate part of the yield curve and, as a result, we believe this segment of the market should be avoided in 2015. In light of their higher correlations to Treasury securities, AA and AAA-rated municipal bonds in the three- to seven-year maturity range have higher exposure to potential interest rate hikes by the Fed than most other segments of the municipal market. This is due in part to the expensive nature of the high grade, short/intermediate part of the municipal market. Getting defensive on rates without sacrificing income by focusing on cushion bonds (high coupon/premium bonds) is our preferred portfolio structure. We believe this will cause actively managed portfolios to outperform passive municipal bond ladders in terms of total return and current income.

### 3. New bond issuance surprises on the upside – Net new supply negative for the fifth year in a row

We project new bond issuance will surpass consensus and exceed \$375 billion. Although new issuance will rise as the U.S. starts to come to terms with its infrastructure needs, we believe net new supply will remain negative for the fifth year in a row, and the overall municipal market will continue to shrink. Refinancing will likely contribute to net negative supply as issuers capitalize on the opportunity to advance refund higher coupon bonds, while locking in more favorable long term borrowing costs. We believe new bond issuance and increased market trading will contribute to pricing transparency. As a result, portfolios taking an active, credit research-driven approach to municipal bond investing should further positively differentiate themselves as the true value of underlying credits materializes.

### 4. Return of new issue monoline insurance – Greater than 10% penetration rate for the first time in six years

We expect the penetration rate of monoline insurance on the new issue market to exceed 10% for the first time in six years as the market continues to rediscover the benefits of bond insurance. Challenges that monoline insurance companies experienced in years past have resulted in many clients having an underweight position to insured municipal bonds in their portfolio. We believe that attractive spreads and improving fundamentals, while also recognizing the relative position of select monoline insurers, including Ambac<sup>1</sup>, will yield opportunities in this segment of the market. While we do not expect to see Ambac re-entering the primary market in 2015, bonds backed by its insurance policies should continue to experience spread narrowing as various legal settlements proceed to a final resolution.

### 5. Tobacco sector outperforms – Investors seek to maintain yield as existing higher coupons are called or mature

With a projected increase in municipal refinancings taking out higher coupon bonds in 2015, we anticipate that municipal bond investors will look at tobacco settlement bonds to replace income in their portfolios. While the tobacco sector will likely experience periods of higher volatility throughout the year, we believe the overall return will place it as one of the top-performing sectors in 2015. MacKay Municipal Managers remains confident in certain areas of the tobacco sector as deep credit research identifies valuable bonds at an attractive price.

<sup>1</sup>Ambac: Ambac Financial Group, Inc., headquartered in New York City, is a holding company whose subsidiaries provide financial guarantees and other financial services to clients in both the public and private sectors globally.

**Flattening yield curve:** Occurs when yields on long-term Treasury bonds are falling faster than yields on short-term Treasury bonds. The area between the yields on short-term bonds and long-term bonds decreases, making the yield curve appear less steep. **Credit spread:** Difference in yield between two bonds of similar maturity, but different credit quality. Widening credit spreads indicate growing concern about the ability of a borrower to service their debt. **Bond ratings:** 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. **Yield curve:** A line that plots the interest rates of bonds with equal credit quality, but different maturity dates. The short/intermediate part of the yield curve typically includes three-month, two-year, and five-year debt. **Maturity:** The date on which a bond's principal is repaid to the investor and interest payments cease.

**Defensive investment strategy:** A conservative method of portfolio allocation management aimed at minimizing the risk of losing principal. **Monoline insurance:** A guarantee provided by an insurance company, often in the form of credit wraps, that enhances the credit of a municipal bond issuer.

Treasuries are backed by the full faith and security of the U.S. Government as to the timely payment of principal and interest when held to maturity. Fees for actively managed portfolios tend to be higher than for portfolios that are passively managed. Actively managed portfolios may have higher turnover, resulting in higher costs than a passively managed portfolio with low turnover.

#### Before you invest

**Mutual funds are subject to market risk and will fluctuate in value.**

A portion of a municipal 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. High-yield securities (commonly referred to as "junk bonds") are generally considered speculative because they present a greater risk of loss than higher-quality debt securities and may 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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# 2015 Municipal Bond Market Insights: Mid-Year Update

**MacKay Municipal Managers™** employs a relative-value investment approach across all of their municipal strategies, with a focus on total return. The team seeks to capitalize on opportunities created by the mispricing of securities and will move along the credit curve, based on where they find the best relative value. An emphasis is placed on risk management, and they currently do not employ leverage, which can increase volatility. The team’s active research-driven process and keen emphasis on risk control may benefit investors seeking attractive tax-free income.



## Top Five Municipal Market Insights for 2015: The Year of Transition to Active Management

Theme	Rationale	Portfolio in Action	Mid-Year Status
<b>1. Demand for municipal bonds remains high – institutions increase investments, and proprietary trading desks resurface.</b>	Institutions, such as insurance companies, continue to add municipals to their core portfolios, in search of attractive absolute income. Proprietary trading desks dramatically reduced their capital commitment to munis after 2008; however, we believe favorable market conditions and regulatory developments will result in their gradual return.	While we believe the capital commitment to munis increases on the margin, holding more liquid investment-grade and high-yield positions in a less liquid market is key. The team continues to take an active approach while seeking to uncover inefficiencies in a less liquid market.	<b>On Target:</b> In 2015, MacKay Municipal Managers has observed institutions, primarily insurance companies, increasing municipal bond exposure in the aggregate range of \$6 to \$7 billion.  Through 7/1/2015, municipal bond funds have experienced net inflows of \$8.6 billion. <sup>1</sup>
<b>2. Yield curve flattens – high-grade bonds with short/intermediate maturities underperform.</b>	We expect a flattening yield curve to put pressure on high-grade bonds of short to intermediate maturities, so we believe this part of the market should be avoided in 2015. This segment is relatively expensive, and we believe high-grade bonds’ higher correlations to Treasuries make them vulnerable to Fed interest-rate hikes.	We are underweight AA and AAA-rated municipal bonds in the three- to seven-year maturity range. Our portfolios are structured to be defensive on rates without sacrificing income. We believe this is accomplished by focusing on cushion bonds (high coupon/premium bonds).	<b>Mixed:</b> Lower-rated munis significantly outperformed AA and AAA credits. For example, the Barclays Municipal Bond Index returned 0.11% through June while the BBB-rated segment of the market returned 0.70%. Year-to-date, the yield curve has steepened, rather than flattened. We still believe the yield curve will flatten as the market “prices in” a rise in short-term rates. In the meantime, municipal bonds show value as 10-year and 30-year yield ratios, relative to Treasuries, are 98% and 106%, respectively, as of 6/30/2015. <sup>2</sup>
<b>3. New bond issuance surprises on the upside – net new supply negative for the fifth year in a row.</b>	We expect new issuance to beat consensus, exceeding \$375 billion as the U.S. starts to address infrastructure needs. But, we expect net new supply to remain negative for the fifth year in a row, causing the market to shrink. One likely driver of this is refinancing/advance refunding, as issuers lock in cheaper long-term borrowing costs.	We believe new bond issuance and increased trading will aid pricing transparency. We are taking an active, credit research-driven approach, which we believe will contribute to our excess returns as the true value of underlying credits materializes.	<b>On Target:</b> New issuance of \$220 billion through 6/2015 is on track to exceed \$375 billion by the end of 2015. Of the \$220 billion in new issuance, 66% represents the refinancing of existing debt. In 2013 and 2014, 52% and 57% of new supply stemmed from refinancing, respectively. <sup>3</sup>
<b>4. Return of new-issue monoline insurance – greater than 10% penetration rate for the first time in six years.</b>	We expect monoline-insured new issues to exceed 10% for the first time in six years. After the challenges faced by monolines since the credit crisis, many investors are still underweight to insured munis. We expect attractive spreads and improving fundamentals to create opportunities.	We continue to have an overweight position in bonds insured by select monolines and maintain our view that there are relative-value opportunities to uncover through active management. Given recent news coverage of the Puerto Rico debt crisis, we believe that the market continues to underestimate the trading value of select monoline insurers.	<b>On Target:</b> Year-to-date, 6/30/2015, the penetration rate of monoline insurance on the new issue market has risen to 7.5%. For example, in the first six months of 2015, Build America Mutual Assurance Company (BAM) has seen a 56% increase in municipal bond underwriting, based on par value. <sup>4</sup> We believe the monoline insurance penetration rate accelerates as retail investors demand extra protection from unknown pension costs.

**5. Tobacco sector outperforms – investors seek to maintain yield as existing higher coupons are called or mature.**

As municipal refinancings take out higher-coupon bonds, we expect investors to look at tobacco settlement bonds to replace income. While the sector will likely experience periods of volatility, we believe its overall return will make it one of the top-performing sectors in 2015.

We are overweight in certain areas of the tobacco sector and apply deep credit research when identifying valuable bonds at attractive prices. While we believe tobacco will be a top-performing sector in 2015, periodic spread widening in the tobacco sector may occur. Near-term stress in the high-yield municipal market may prompt some funds to reduce overweight positions in tobacco exposures, which could slow down price performance in the asset class.

**On Target:** Through 6/2015, the tobacco segment of the Barclays High Yield Municipal Bond Index has returned 1.63%. During the same period, the Barclays High Yield Municipal Bond Index returned -1.92%, and the Barclays Municipal Bond Index returned 0.11%.

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<sup>1</sup> Source: J.P. Morgan Municipal Research sourcing Lipper U.S. Fund Flows – year-to-date, as of 7/1/2015; Lipper, a Thomson Reuters company. Lipper data and information are for informational purposes only, and do not constitute investment advice or an offer to sell or the solicitation of an offer to buy any security of any entity in any jurisdiction. In addition, Lipper, a Thomson Reuters company, will not be liable for any loss or damage resulting from information obtained from Lipper or any of its affiliates.

<sup>2</sup> Source: MacKay Municipal Managers.

<sup>3</sup> Source: Barclays Municipal Strategy Monthly – June 2015.

<sup>4</sup> Source: Build America Mutual Assurance Company (BAM).

**Definitions**

Build America Mutual Assurance Company (BAM) - BAM has been created as a mutual bond insurance company and operates for the benefit of its mutual members - the cities, states, and other municipal entities.

Treasury securities, when held to maturity, are backed by the full faith and credit of the United States government as to timely payment of principal and interest. Interest income on these securities is exempt from state and local taxes.

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.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

The Barclays Municipal Bond Index is an unmanaged index that includes approximately 15,000 municipal bonds, rated Baa or better by Moody's, with a maturity of at least two years.

The Barclays High Yield Municipal Bond Index covers the high-yield portion of the USD-denominated, long-term, tax-exempt bond market.

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### **Past performance is no guarantee of future results. It is not possible to invest directly in an index.**

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