Top 5 Municipal Insights for 2020

From MacKay Municipal Managers. The Minds Behind Munis.

INSIGHTS SERIES January 2020

In Uncharted Territory, Leverage Knowledge

Reflecting on 2019, there were few regrets for municipal bond investors as rates approached all-time lows, spreads tightened, and fundamentals generally improved. However, the resulting current conditions place the municipal bond market in uncharted territory and increase municipal investor uncertainty and anxiety. To overcome those concerns, MacKay Municipal Managers™ believes that prudent planning based on what we know in the present will likely provide our investors with strong relative returns in 2020. We are structuring portfolios by leveraging our knowledge and experience, not duration. While we do not believe that 2019's municipal performance (Bloomberg Barclays Municipal Bond Index: +7.54%; Bloomberg Barclays High Yield Municipal Bond Index +10.68%) will repeat, we do expect that active management has the potential to enhance performance in 2020. We believe the most prudent strategy for 2020 is security selection based on the key qualities of prospective investments. Whether evaluating investment grade or high yield municipal bonds, we look beyond a stated rating to further assess each bond's structure, liquidity profile, rate sensitivity, and credit fundamentals. Anticipating the potential for periods of higher volatility, we also place a premium on maintaining liquidity as an essential strategy for capitalizing on the resulting opportunities that may arise. These observations are the foundation for our 2020 five municipal insights.

1 Security selection and bond structure drive performance

As we begin 2020, municipal credit spreads are tight, the yield curve is relatively flat, and absolute yields are low. We believe the tax-exempt municipal market will maintain its strong technical and fundamental characteristics versus other fixed income asset classes. However, successful municipal investing in 2020 requires that investors plan, not hope: plan how to generate strong relative returns, not hope for another year of outsized absolute returns. To a large degree, the prospect for excess returns from additional rate declines and market-wide tightening of credit spreads will be limited, so the aggressive strategies of 2019 will leave investors exposed to unnecessary risk if volatility rises in 2020. As a result, we believe that a relative-value based security selection strategy that incorporates rebalancing credit, reducing exposure to the long end of the market and favoring 4% and higher coupon structures will likely lead to outperformance.

2 Tactically positioning portfolios when volatility rises can reward investors

We believe that an ongoing low rate environment, monetary policy on hold and a mixed economic outlook point to coupon-dominant performance in 2020. However, the 2020 U.S. Presidential Election, foreign trade and the potential for weaker equity returns may create periods of notable volatility. Given the backdrop of strong technical conditions in the tax-exempt municipal market, prudent professional managers will seek to reward their investors by 'buying the dips.' However, it is essential for professional managers to maintain adequate liquidity in preparation for seizing those opportunities and critical that they employ an active trading strategy to subsequently monetize those positions.

3 Strategic underweight exposures likely to drive outperformance in the high yield municipal market. Quality high yield investments will be key as cracks appear.

Signs of distress appearing in certain pockets of the high yield municipal market suggest that poor security selection can lead to underperformance. Therefore, we believe a focus on avoiding losers rather than stretching for winners will be the more successful strategy to investing in high yield municipal bonds. In 2020, prudent high yield municipal investors will likely focus on quality income and avoid leveraged or speculative income.

4 Taxable municipal refunding trend leaves the weak behind

Although interest rate dependent, we expect that the 2019 surge in taxable municipal issuance to re-finance higher coupon tax-exempt debt will continue in 2020. This anticipated growth in the taxable segment of the municipal market should give it the size and scope to warrant inclusion in investor portfolios. A continuation of this issuance pattern would result in smaller, less sophisticated issuers being denied access to this re-financing activity, as the taxable market favors larger issuers of generally higher credit quality. We expect that taxable refunding activity will support supply-related technical conditions in the tax-exempt market, which will contribute to the overall market's relative performance strength. The combination of reduced supply pressure, ongoing strong demand for tax-exempt income and a shift in those credit sensitive sectors dictates even more need for sophisticated, credit-research driven investment managers and prudent security selection.

5 Beware of fleeting income

In 2020, coupon will likely be king but only when the quality of the income source is high. We believe that assertion will hold true in both the investment grade and high yield segments of the municipal market. **To protect themselves, municipal investors should select professional guidance based on management style, not distribution rate.** Investors should verify that their portfolio income is not reliant on strategies employing hidden leverage, excessive duration, speculative project bets or short call bonds on the verge of retirement. While market conditions in the last number of years were very forgiving with respect to such tactics, a turnaround would bring to light the fragility of those investment approaches.

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 not indicative of future results. It is not possible to invest directly into an index.

Source: Bloomberg Barclays Municipal Bond Index is considered representative of the broad market for investment-grade tax-exempt bonds with a maturity of at least one year. Bonds subject to the alternative minimum tax or with floating or zero coupons are excluded. Bloomberg Barclays High Yield Municipal Index is an unmanaged index of municipal bonds with the following characteristics: fixed coupon rate, credit rating of Ba1 or lower or non-rated using the middle rating of Moody's, S&P, and Fitch, outstanding par value of at least $3 million, and issued as part of a transaction of at least $20 million. In addition, the bonds must have a dated-date after December 31, 1990 and must be at least one year from their maturity date Index results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into 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.

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2020 Municipal Market Insights: Mid-year update

"In Uncharted Territory, Leverage Knowledge"

INSIGHTS SERIES July 2020

MacKay Municipal Managers' Market Insights for 2020, published in January, noted that historically low yields and tight credit spreads positioned municipal bond investors in uncharted territory. The recommendation was to leverage market knowledge and position portfolios based upon the key attributes of each bond held including structure, liquidity profile, rate sensitivity, and credit fundamentals. It was also noted that investor uncertainty in 2020, a presidential election year, over economic sustainability and stock market performance could lead to volatility. However, based on our belief in improving municipal credit fundamentals and favorable market technicals, we were prepared to be buyers in periods of volatility. During the spring of 2020, the municipal market experienced one of the deepest, swiftest dislocations seen in decades. While we did not foresee the tragic human impact and massive economic slowdown caused by COVID-19, our portfolios were well positioned. Initially, the market was impacted by a liquidity squeeze that was amplified by credit spread widening, as the implications of the abrupt shutdown of the economy became apparent.

The thesis MacKay Municipal Managers™ ("MMM") employs remains intact and is further solidified by the four core pillars of our investment process:

1. **Disciplined Security Selection –** Strict credit review standards through all markets remains paramount, particularly during turbulent times.

2. **Focus on Liquidity –** Constructing portfolios that include short-term securities, rated bonds and bonds with a diverse buyer universe are at the core of every portfolio we manage.

3. **Commitment to Diversification –** Mitigating credit risk through diversification by geography, sector, issuer, credit rating, and yield curve positioning.

4. **Flexible and Active Approach –** Market volatility creates either risk or opportunity. The flexibility of our portfolios allow the credit research team, our traders, and our portfolio managers to seek out opportunities during market volatility and dislocations.

Top Five MacKay Municipal Managers' Market Insights for 2020: "In Uncharted Territory, Leverage Knowledge"

Theme		Rationale	Portfolio in Action	Mid-Year Status
1	**Security selection and bond structure drive performance**	As we begin 2020, municipal credit spreads are tight, the yield curve is relatively flat, and absolute yields are low. We believe the tax-exempt municipal market will maintain its strong technical and fundamental characteristics versus other fixed income asset classes. However, successful municipal investing in 2020 requires that investors plan, not hope: plan how to generate strong relative returns, not hope for another year of outsized absolute returns. To a large degree, the prospect for excess returns from additional rate declines and market-wide tightening of credit spreads will be limited, so the aggressive strategies of 2019 will leave investors exposed to unnecessary risk if volatility rises in 2020. As a result, we believe that a relative-value-based security selection strategy that incorporates rebalancing credit, reducing exposure to the long end of the market, and favoring 4% and higher coupon structures will likely lead to outperformance.	The strong municipal performance and spread tightening experienced last year continued over the first two months of 2020. MMM reduced exposure to weaker credits, sub 4% coupons and very long maturity bonds. As the entire market sold off, MMM selectively identified and acquired securities it believed would be best positioned for recovery based on credit, structure, and relative liquidity.For example, we bought insured bonds for those attributes. In addition, MMM executed tax swaps when prices declined to improve portfolio income and realize losses for better tax efficiency. We continued to actively trade portfolios as credit spreads began tightening in May and June.	**On Target** Through June 30, 2020, the higher credit quality part of the market outperformed lower credit. Bloomberg Barclays Municipal Index BBB returned -2.05% vs. AA Index 2.73%. Additionally, performance for sub 5% coupons varied throughout this volatile period, further emphasizing our belief that active management focusing on structure delivers. During the months of March and May, 5% and higher coupon bonds outperformed lower coupon bonds; the differentiation in performance amongst these structures varied greatly due to volatility in the market.
2	**Tactically positioning portfolios when volatility rises can reward investors**	We believe that an ongoing low rate environment, monetary policy on hold, and a mixed economic outlook point to coupon-dominant performance in 2020. However, the 2020 U.S. Presidential election, foreign trade, and the potential for weaker equity returns may create periods of notable volatility. Given the backdrop of strong technical conditions in the tax-exempt municipal market, prudent professional managers will seek to reward their investors by 'buying the dips.' However, it is essential for professional managers to maintain adequate liquidity in preparation for seizing those opportunities and critical that they employ an active trading strategy to subsequently monetize those positions.	MMM built significant liquidity into its portfolios prior to the end of 2019. As a result, those portfolios were well positioned to weather the market's reaction to COVID-19. In early March, that reaction could have been best described as a liquidity squeeze, and ill-prepared market participants were forced to sell bonds at significant discounts to intrinsic value to meet redemption obligations. MMM tactically employed its ample liquidity to 'buy the dips' and acquire bonds at attractive prices. As an asset management firm well positioned to 'provide' liquidity during the peak of the disruption, we further increased our market access, which benefits our client portfolios beyond this current time period.	**On Target** Comparing active trading volume in some of our strategies showcased that during the first six months of 2020, we were able to proactively participate in the market in a meaningful way. Turnover percent in these strategies was 2x higher compared to the prior year. Although, our process has always involved being active, the rise in volatility allowed for tactical positioning as well. Additionally, the ratio of buys and sells shows we were very engaged in the market finding opportunities to acquire bonds at attractive prices and taking the opportunity to implement tax loss swaps in the portfolio. During the deepest part of the dislocation — the last three weeks of March — the municipal bond industry experienced a historically steep selloff of approximately $27 billion in fund outflows.[1]

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3	**Strategic underweight exposures likely to drive outperformance in the high yield municipal market; Quality high yield investments will be key as cracks appear**	Signs of distress appearing in certain pockets of the high yield municipal market suggest that poor security selection can lead to underperformance. Therefore, we believe a focus on avoiding losers rather than stretching for winners will be the more successful strategy to investing in high yield municipal bonds. In 2020, prudent high yield municipal investors will likely focus on quality income and avoid leveraged or speculative income.	MMM believed credit spreads were too tight and investors were not being adequately compensated for exposure to credit risk. Throughout 2019, and right up to the COVID-19 disruption, MMM was increasing the credit quality of client portfolios while still remaining active and tactical. As credit spreads widened in mid-March, MMM selectively began to add credit risk at significantly lower prices. Based upon the re-inflation of credit spreads, MMM shifted its asset allocation model. On April 1, model allocation went to 70% investment grade and 30% high yield from the credit-neutral positioning of 80%/20%, respectively. MMM adjusted the allocation due to significantly wider spreads in high yield while also maintaining material exposure in Investment Grade due to the near-term total return opportunity.	**Pending** Up until this point in 2020, there were segments of the high yield market where prices have not been fully transparent. However, as we see two-way flow return to the market, we expect prices to reflect reality over time. At the same time, MMM has observed a bifurcation of strength and weakness within the high yield segment of the market, where segments are generating more reliable, quality income have outperformed. Year-to-date as of June 30, 2020, sectors that have performed well in the Bloomberg Barclays High Yield Municipal sector sub-indices are tobacco, electric, Puerto Rico, and water/sewer; returning 5.31%, 2.22%, 2.21%, and 0.28%, respectively. Conversely, there are pockets of the high yield municipal market that have shown weakness in 2020. For example, the worst performing sector in high yield municipal sector sub-indices were: the hospital index (encompassing Continuing Care Retirement Communities) with year-to-date performance as of June 30, 2020 of -6.96% and the transportation index, returning -5.13% vs. the Bloomberg Barclays High Yield Municipal Index at -2.64%.
4	**Taxable municipal refunding trend leaves the weak behind**	Although interest rate dependent, we expect the 2019 surge in taxable municipal issuance to re-finance higher coupon tax-exempt debt will continue in 2020. This anticipated growth in the taxable segment of the municipal market should give it the size and scope to warrant inclusion in investor portfolios. A continuation of this issuance pattern would result in smaller, less sophisticated issuers being denied access to this re-financing activity, as the taxable market favors larger issuers of generally higher credit quality. We expect that taxable refunding activity will support supply-related technical conditions in the tax-exempt market, which will contribute to the overall market's relative performance strength. The combination of reduced supply pressure, ongoing strong demand for tax-exempt income, and a shift in those credit sensitive sectors dictates even more need for sophisticated, credit-research driven investment managers and prudent security selection.	Based on the premise of continued taxable municipal issuance, MMM has dedicated strategies that we believe are well positioned to evaluate and capitalize on this segment of the market. MMM continues to believe that the taxable municipal market has taken supply away from the tax-exempt market, which will be beneficial for the tax-exempt market in the long term. Within taxable municipal portfolios, MMM continues to increase its exposure to more index eligible, larger, non-callable issuers. As hedging costs have decreased significantly, these index eligible issues have been sought after by a growing base of overseas buyers as well.	**On Target** Through May, gross primary market volume was $160 billion, 21% above the post-Tax Cuts and Jobs Act (2018-19) average of $133 billion. The split between taxable and tax-exempt is striking, with tax-exempt issuance at $108.6 billion or 7.7% below the prior two-year average, while taxable issuance at $51.7 billion was 3.4x the $15.4 billion average in 2018-19.[2] Looking at taxable municipal supply through June 30, 2020, MMM has seen shifts in issuance patterns across both deal sizes and average ratings. The historic issuance of BBB rated securities in the taxable municipal market has run between 5-6%, and year-to-date 2020, it is approximately 1%.[3] There has also been a shift in issuance patterns in the tax-exempt market, with growth in deal sizes of $25 million or less, and a corresponding increase in $1 billion plus deal sizes in the taxable municipal market. These factors have inhibited access to the taxable municipal market for smaller, lower rated, less sophisticated issuers.[4]

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5 **Beware of fleeting income**	In 2020, coupons will likely be king but only when the quality of the income source is high. We believe that assertion will hold true in both the investment grade and high yield segments of the municipal market. To protect themselves, municipal investors should select professional guidance based on management style, not distribution rate. Investors should verify that their portfolio income is not reliant on strategies employing hidden leverage, excessive duration, speculative project bets, or short call bonds on the verge of retirement. While market conditions in the last number of years were very forgiving with respect to such tactics, a turnaround would bring to light the fragility of those investment approaches.	Instead of employing a "maximum distribution yield strategy," MMM defines value as a compelling dollar price along with a competitive yield, together contributing to maximizing total return. MMM believes that leverage may not be appropriate in all strategies. The events of March confirmed this position. In addition, highly leveraged project finance deals came under scrutiny as the abrupt economic shutdown brought to light their fragile financial conditions. What MMM focused on instead is reliable income and sought to achieve higher yields in client portfolios by adding lower priced bonds with higher book yields while focusing on solid credits.	**On Target** The largest defaults the municipal market has seen thus far in 2020, have been in single site, single credit risk, and project finance issues. Approximately 90% of the default occurrences represent these types of credits[5] which did not have broad revenues or government support in order to sustain the slowdown in economy. MMM has stayed away from such securities from a credit perspective even prior to the dislocation.

1. Source: Morningstar Data
2. Source: JPM Municipal Markets Weekly
3. Source: Citigroup Municipal Research
4. Source: Citigroup Municipal Research
5. Bloomberg

Definitions

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Bloomberg Barclays Municipal Bond Index: A rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark. The index has four main sectors: general obligation bonds, revenue bonds, insured bonds (including all insured bonds with a Aaa/AAA rating), and pre-refunded bonds. Most of the index has historical data to January 1980. In addition, sub-indices have been create based on maturity, state, sector, quality, and revenue source, with inception dates later than January 1980.

Bloomberg Barclays Municipal High Yield Index: An unmanaged index of municipal bonds with the following characteristics: fixed coupon rate, credit rating of Ba1 or lower or non-rated using the middle rating of Moody's, S&P, and Fitch, outstanding par value of at least $3 million, and issued as part of a transaction of at least $20 million. In addition, the bonds must have a dated-date after December 31, 1990 and must be at least one year from their maturity date.

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