

Top 5 Municipal Bond Market Insights for 2022: Mid-year Update

“Embrace Change”

JULY 2022

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

Change characterized the first half of 2022. First, the Fed dramatically shifted its policy in response to rising inflation, pulling forward planned tightening measures and sparking a large upward move in U.S. government bond yields. Next, geopolitical issues took center stage as the largest armed conflict in over 25 years unfolded in Europe. In light of these shifting dynamics, today we believe the municipal bond market offers relatively attractive prices and yields, and credit health remains solid.

Top Five Municipal Market Insights for 2022: Mid-year Update – “Embrace Change”

Theme	Rationale	Portfolio in Action	Mid-Year Status
1 Transitory or not: view municipal investments as an inflation hedge	<p>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.</p>	<p>Inflation rose to a four-decade high. Meanwhile, municipal credit health continues to improve. This is due in part to concurrent increases in revenue streams (see our Mid-Year Status in this section.)</p> <p>We maintain our preference for issuers capable of growing their revenue streams by passing rising costs onto users without cutting into demand for services. This is represented in our portfolios via exposure to sectors such as transportation and electric utilities.</p>	<p>Pending</p> <ul style="list-style-type: none"> Through 1Q22, state total tax collections are 16% above 2021 collections, led by a 19.6% increase in personal income tax receipts and 17% increase sales tax receipts. (Source: National Association of State Budget Officers (NASBO), as of June 2022) 49 states reported that fiscal year 2022 general fund revenue collections are exceeding budget forecasts compared to just nine states in fiscal year 2020. (Source: NASBO, as of June 2022) In fiscal year 2021, state rainy day fund balances reached a record high of \$124.5 billion. Fiscal year 2022 rainy day fund balances are projected to close the year at a new high of \$132.2 billion. (Source: NASBO, as of June 2022) Issuers exhibited positive rating momentum, with upgrades of 60 vs downgrades of 18. 89.4% of the Fitch Public Finance sector has a stable outlook. (Source: Fitch, as of June 2022) Despite positive developments, sizeable municipal fund outflows temporarily overwhelmed fundamentals. The municipal bond market generated negative performance, in-line with the broader U.S. fixed income market. YTD through June 30th, the Bloomberg Municipal Bond Index returned -8.98% and outperformed the Bloomberg U.S. Aggregate Bond Index, which returned -10.35%, by +1.37%. Municipals also outperformed U.S. investment grade corporate bonds, which were down -14.39% over the same time period, as measured by the Bloomberg U.S. Corporate Bond Index. (Source: Bloomberg, as of 6/30/2022)



INVESTMENTS

Not FDIC/NCUA Insured	Not a Deposit	May Lose Value
No Bank Guarantee	Not Insured by Any Government Agency	

Top Five Municipal Market Insights for 2022: Mid-year Update – “Embrace Change”

Theme	Rationale	Portfolio in Action	Mid-Year Status
<p>2 Elevated tactical trading drives returns</p>	<p>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.</p>	<p>The sharp market dislocation drove municipal yields significantly higher than where they began at the beginning of the year.</p> <p>Valuations turned from historically rich to very cheap as indicated by the 10-year AAA municipal-to-treasury yield ratio, which surpassed 100% by mid-May.</p> <p>However, this opportunity was fleeting, and over the course of a handful of trading sessions, that ratio fell to the low 80% range.</p> <p>While many were forced to sell or not well-positioned to buy, we traded with greater frequency while also opportunistically deploying capital as prices became attractive.</p> <p>Focused on tax-efficiency, MMM also harvested losses across portfolios. This helped to increase potential income as we reset book yields.</p>	<p>On Target</p> <ul style="list-style-type: none"> Active management mattered during the first half of 2022. The average actively managed intermediate-term municipal bond fund returned -8.49% and outperformed its passive counterpart, which returned -8.75%, by +0.26% YTD through June 30th. (Source: Morningstar as of 6/30/2022) Across MMM’s actively managed portfolios, total dollar trading volume increased by +266% when comparing the first half of 2022 vs. the first half of 2021. (Source: MMM as of June 23, 2022)
<p>3 Maintain overweight in high yield then begin to trade up in quality mid-year</p>	<p>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. 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.</p>	<p>In March, the Puerto Rico GO and Public Building Authority (PBA) debt restructuring was completed. As anticipated, the transaction generated a large cash payout.</p> <p>The cash acted as a shock absorber, helping some investors maintain liquidity and curb some forced selling during the midst of a sizeable mutual fund outflow cycle.</p> <p>During the draw down, some of the highest rated, and thus most liquid names, were the most exposed to selling pressure. To capitalize on the temporary dislocation, we have shifted our asset allocation models toward higher quality.</p> <p>For example, we shifted our asset allocation model from a moderate risk exposure of 70% investment grade and 30% high yield to 80% investment grade and 20% high yield as of July 2022.</p> <p>This allocation represents our historic neutral weight to high yield municipals.</p>	<p>Pending</p> <ul style="list-style-type: none"> Investment grade municipal yields and prices are relatively compelling in light of the ongoing dislocation. We believe investors will be compensated while simultaneously boosting credit quality by increasing exposure to investment grade. Balancing this view, we maintain a constructive overweight to high yield municipals, some of which is driven by the restructuring of select Puerto Rico bonds. The yield spread between high yield and investment grade municipal bonds only slightly widened in the first half of 2022, starting at 202 bps and ending at 209 as of June 30, 2022. Contrast this spread with High Yield Corporate Bond spread levels, which rose significantly from 278 bps to 569 bps. (Source: Bloomberg, as of 6/30/2022)

Top Five Municipal Market Insights for 2022: Mid-year Update – “Embrace Change”

Theme	Rationale	Portfolio in Action	Mid-Year Status
<p>4 Shift focus to structure as fiscal policy [spending] gives way to monetary policy</p>	<p>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. 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.</p>	<p>We favored more defensive structures early in the year.</p> <p>Following the market dislocation, our focus shifted to lower coupon bonds, which often traded at temporarily discounted prices.</p> <p>Being selective about structure, including coupon and call, will likely continue to drive alpha during the second half of the year.</p>	<p>On Target</p> <ul style="list-style-type: none"> • Structure mattered. Lower coupon bonds accordingly underperformed the broad national investment grade benchmark index, YTD. 2% and 3% coupon bonds returned -17.84% and -16.44%, respectively, compared to -9.28% for the total index. Meanwhile, 5% coupon bonds outperformed, returning -6.96%. (Source: ICE Data as of 6/30/2022) • 2% and 3% coupon bonds are typically issued with longer terms to maturity, usually 15 years and out. During 2021, only 1% of these bonds traded below their de minimis threshold, on average. In contrast, that average gradually increased from 1% at the start of 2022 to 10% in May, and finally 12% as of June. (Source: MSRB as of June 2022)
<p>5 Taxable municipals outperform ... again</p>	<p>In 2022, we believe taxable municipal bonds will extend ten years of inflation-adjusted outperformance versus most of the investment grade U.S. market. 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 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.</p>	<p>Taxable municipal credit health was bolstered by the same general trends that aided their tax-exempt counterparts, such as increases in revenue collections and record-level rainy day fund balances.</p> <p>Taxable municipal yields increased during the first half of 2022, but we also observed that the yield differential between longer-term and shorter-term taxable municipal bonds narrowed.</p> <p>As a result, we were able to invest in shorter-term securities at compelling yield levels that were previously unobtainable without extending to longer maturities.</p>	<p>Pending</p> <ul style="list-style-type: none"> • The Bloomberg Taxable Municipal Index returned -14.0% YTD through June 30th, slightly outperforming the Bloomberg U.S. Corporate Bond Index, which returned -14.4%. Performance could further diverge in favor of taxable municipals as the U.S. economy slows. U.S corporate bonds are more sensitive to the economic cycle, driven in part by the fact that 50% of the U.S. Corporate Bond Index is rated BBB. In contrast, 73% of the Taxable Municipal Index is rated AA and higher. (Source: Bloomberg as of 6/30/2022)

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.

Bloomberg U.S. Corporate Investment Grade Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Bloomberg Taxable Municipal Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market.

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.

S&P rates borrowers on a scale from AAA to D. AAA through BBB represent investment grade, while BB through D represent non-investment grade. Moody's rates borrowers on a scale from Aaa through C. Aaa through Baa3 represent investment grade, while Ba1 through C represent non-investment grade.

This material contains the opinions of the MacKay Municipal Managers™ team of MacKay Shields LLC but not necessarily those of MacKay Shields LLC. The opinions expressed herein are subject to change without notice. This material is distributed for informational purposes only. Forecasts, estimates, and opinions contained herein should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Any forward-looking statements speak only as of the date they are made and MacKay Shields assumes no duty and does not undertake to update forward-looking statements. No part of this document may be reproduced in any form, or referred to in any other publication, without express written permission of MacKay Shields LLC. ©2022, MacKay Shields LLC. All rights reserved.



For more information

800-624-6782

newyorklifeinvestments.com

MacKay Municipal Managers is a trademark of MacKay Shields LLC.

MacKay Shields LLC is a wholly owned subsidiary of New York Life Investment Management Holdings LLC, which is wholly owned by New York Life Insurance Company.

"New York Life Investments" is both a service mark, and the common trade name, of certain investment advisors affiliated with New York Life Insurance Company. Securities are distributed by NYLIFE Distributors LLC, 30 Hudson Street, Jersey City, NJ 07302, a wholly owned subsidiary of New York Life Insurance Company. NYLIFE Distributors LLC is a Member FINRA/SIPC.