OUTLOOK 2023

Top 5 Municipal Market Insights for 2023

From MacKay Municipal Managers

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

Preparation Seizes Opportunity – Higher Accruals Set the Pace

MacKay Municipal Managers (MMM) is optimistic about the 2023 municipal market. As we enter 2023, we believe our portfolios are positioned to earn more income while taking less risk and retain the capacity to add value through active relative value trading. In 2022, MMM reset municipal portfolios' total return profiles starting with higher accruals. Income once again provides a meaningful base from which relative value decisions can enhance performance. In our view, relative value investors who repositioned their credit, sector, structure and curve exposures should be rewarded in 2023. Compared to the last few years, high quality municipal credits are in relatively strong financial condition and available at much higher yields. As a result, portfolios should be tilted toward higher quality. In 2022, mutual fund redemptions overwhelmed traditional drivers of value in the municipal market. We believe that investment discipline that goes beyond credit underwriting standards to include an appreciation for market structure and trading dynamics will differentiate performance results in 2023. In our opinion, MMM's core investment principles – prudently pricing risk, appreciating the municipal market's unique structural aspects and combining long-term experience with the willingness to think creatively – are essential to achieving investment objectives. In 2023, we expect this approach succeeds upon encountering the following factors that we believe will impact the municipal market:

1. Tax-Exempt Accrual Plays a Key Role in Total Return

Income has regained its prominence in municipal bond total return. Municipal investors can now realize much higher income accruals due to 2022's sharp rise in rates. Top income tax bracket investors, and especially those living in high income tax states, should find the higher tax-exempt income levels attractive on a taxable equivalent basis versus other asset classes. Raising accrual rates tend to reward investors who reinvest their dividends through the compounding effect of buying more shares at relatively lower average prices. We believe higher income levels can also better stabilize returns compared to the last several years, when low coupons and yields offered little cushion against price declines. Additionally, we believe investors who remained in passive strategies have missed this opportunity while hoping the market would recover. Raising accrual rates required actively replacing low book yield positions with much lower priced, higher yielding bonds trades typically known as tax swaps. We believe investors can benefit from current market accrual rates in 2023 and beyond.

2. Overweight General Obligation and Essential Service Bonds

We believe essential investment grade sectors, such as General Obligation bonds and Water & Sewer bonds, will regain favor with investors in 2023. We expect greater demand for traditional municipal bonds such as bonds backed by the taxing power of general obligation issuers or secured by the revenues of essential service providers like public water and sewer authorities. We anticipate continued investor uncertainty over the path of inflation, the Federal Reserve's policy decisions, and the potential for a recession will be the reason why investors find comfort in the core municipal sectors. In addition, investors should favor shifting to higher quality sectors that now pay higher accrual rates. We believe core sectors of the municipal market outperform in 2023.

3. In a Bifurcated High Yield Municipal Market Liquidity Drives Performance

We believe a disciplined pursuit of liquidity will be rewarded in the 2023 high yield municipal market. In 2022, the massive wave of high yield fund redemptions resulted in an equally sized selloff of bonds as funds sought liquidity. High yield municipal funds primarily sold their more widely held and better quality positions to meet those redemptions resulting in those more liquid bonds underperforming relative to holdings that did not trade throughout the year. In anticipation of a healthier market in 2023, we believe those underperforming bonds now provide the opportunity to outperform as investment discipline re-emerges. In our opinion, discipline in the high yield municipal market goes beyond credit research to include an understanding of liquidity, tradability, and the investor base. We expect inflows will return to the high yield municipal market and issuance will be light. As a result, we believe the more liquid part of the high yield municipal market outperforms in 2023.

4. Fund Flows Drive Recovery in Long Municipal Bond Prices

We believe exposure to longer-term bonds drives return in 2023. Municipal mutual funds and Exchange Traded Funds are the natural buyer of the long end of the municipal curve. We expect a return to positive mutual fund flows results in the outperformance of longer-term bonds. Additionally, mutual funds will likely seek to increase their distribution yields, causing them to extend the maturity and duration profile of purchases. As a result, bond structures with long durations and discount prices enhance return potential relative to shorter duration, premium structures. Finally, the municipal to Treasury yield ratio curve remains steep, indicating that the longer end of the municipal market offers better value opportunities. Long municipal bonds with ratios in the mid 90% range are cheap on a relative basis. We believe portfolios with exposure to longer maturities outperform.

5. Thinking Outside the Box – Using Short Taxable Municipals to Enhance After-Tax Performance

We believe shorter-term taxable municipal bonds provide better after-tax value than comparable maturity tax-exempt bonds. Investing in shorter term municipal bonds, a tactic used to add liquidity and/or manage duration in a portfolio, becomes more difficult when such bonds are overpriced. Shorter-term tax-exempt bonds have risen in price beyond fair value primarily due to passive investor demand. In 2023, we expect demand for shorter-term tax-exempt bonds to continue unabated and we do not expect that new issuance sufficiently offsets that demand. As a result, we believe shorter-term tax-free municipal to Treasury yield ratios remain rich through the year. Comparable maturity taxable municipal yields, however, offer better value on an after-tax basis. The taxable municipal market's continuing expansion, in both size and breadth, has brought a new dimension to relative value trading in the municipal market. We believe investors should favor shorter-term taxable municipal bonds because they provide competitive after-tax yields, attractive spreads to Treasuries and the same high credit quality of the tax-exempt municipal asset class.

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. 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.

Distribution yield is the ratio of all the distributions a fund paid in the past 12 months divided by the current share price of the fund.

Muni Treasury ratio is computed by dividing a given municipal bond's yield by the yield on a comparable maturity Treasury security. The yield ratio curve is an array of ratios for given maturities, typically 1 to 30 years.

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