INVESTMENT INSIGHTS

# Dislocations in the taxable municipal market today

## From MacKay Municipal Managers

MARCH 2022

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

Given the backdrop of both geopolitical tensions and changing monetary policies at a global level, we have seen elevated volatility in both the fixed income and equity markets since the beginning of the year. In response, we wanted to share our thoughts on the investment opportunity at hand in the U.S. taxable municipal market. As discussed in our Top Five Municipal Insights, MacKay Municipal Managers expected heightened market volatility in anticipation of the Federal Reserve's policy actions in 2022.  And, as active relative value managers, we see these bouts of volatility as attractive investment opportunities.

With this in mind, where appropriate, we intentionally manage our client portfolios to be prepared to pivot and capitalize in these types of market environments. Exposure to taxable municipals already comes with the added benefit of serving as a potential counterweight to inflation concerns, which is one of the main catalysts for the volatility that markets are experiencing. Municipal enterprises can more easily raise prices or fees on consumers to combat rising inflation costs. Inflation concerns have not spared taxable municipal markets, but at their core, taxable municipals have the potential to be somewhat insulated from these concerns, and the current market environment is providing an opportunity to add exposure at levels that seem to disregard this strength.

The taxable municipal market is often underutilized in investment portfolios. These securities can be an appropriate solution for qualified accounts, such as IRAs, 401Ks and pension funds. We believe this is a great opportunity to add exposure to taxable municipals, which we believe have the potential to outperform other investment grade fixed income markets for the eleventh consecutive year.

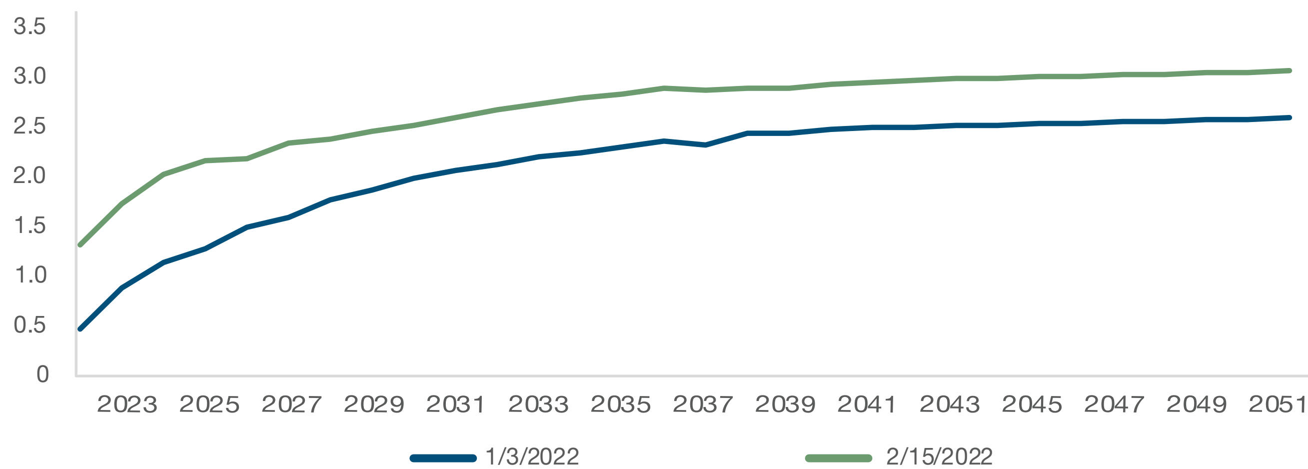
In January 2022, the Fed's more aggressive rhetoric drove treasury yields higher. Municipal yields largely followed suit. As spreads have widened, here are a few more reasons to take a closer look at this period as an opportune entry point for domestic and international investors to dollar-cost average any additional capital allocations:

## 1. Higher book yields

Bonds are trading at attractive book yields across the curve. **Figure 1** shows yield differential between what we were seeing in the market at the beginning of January vs. February 15.

As the curve has continued to flatten, we are seeing more opportunity down the curve specifically inside the 10 year where we are able to pick up additional yield. In some cases, yields are close to 3.25% - 3.50%. Additionally, positioning portfolios with lower duration, and diversified curve exposure can assist as rates move higher and can allow us to participate if the yield curve begins to steepen.

**Figure 1: AAA Taxable Yields**




Source: Bloomberg, as of 1/3/22 and 2/15/22. AAA Taxable is represented by ICE BofA U.S. Taxable Municipal Index. An investment cannot be made directly into an index. **Past performance is not indicative of future results.**

## 2. Volatility can create opportunity

Although we expect more volatility in the market over the next coming months as the Federal Reserve moves forward with its first rate hike in the U.S., we believe the majority of the rate hikes expected in 2022 have been priced into the market already. The unknowns in this cycle remain inflation, the unwinding of Quantitative Easing and the reduction of the Federal Reserve's balance sheet. These factors may potentially determine the shape of the yield curve for the remainder of the year and will present the market with continued volatility, and opportunities.

## 3. Credit fundamentals intact

Our view is the fundamentals of taxable municipal credits remain sound and we expect growing investor demand for high quality, monopoly-like municipals where issuers have the ability to raise taxes and user fees on their essential services. This allows issuers to maintain adequate debt service coverage, helps stabilize credit ratings and helps reduce bond price sensitivity to rising rates and higher inflation. Furthermore, we believe active management with tactical trading in these volatile periods should create alpha opportunities for the remainder of 2022. In this current environment, we will continue to maintain some cash and liquidity in portfolios to seek to take advantage of these opportunities.

### FOR MORE INFORMATION

**Visit [Muni360.com](Muni360.com) or call 888-474-7725 for more information about taxable municipal bonds and the experienced professionals at MacKay Municipal Managers. MacKay Municipal Managers is a recognized leader in active municipal bond investing and is entrusted with $80 billion in assets under management, as of 12/31/21.**

## About risk

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. Securities 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.

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. A portion of the municipal bond's income may be subject to state and local taxes or the alternative minimum tax.

**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.

**Credit Ratings:** 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.

**Duration** is a measure of the sensitivity of the price of a bond to a change in interest rates.

**Quantitative easing (QE)** is a form of unconventional monetary policy in which a central bank purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment.

**Reduction of the Federal Reserve's balance sheet:** The Federal Reserve can reduce its balance sheet of bonds in two main ways: selling securities or ceasing to reinvest in maturing securities.

**Yield to Worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting and is calculated by making worst-case scenario assumptions on the issue by calculating the return that would be received if the issuer uses provisions, including prepayments, calls or sinking funds.

Index results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

**ICE BofA U.S. Taxable Municipal Index** tracks the performance of U.S. dollar denominated investment grade taxable municipal securities publicly issued in the U.S. domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch). In addition, qualifying securities must have at least one year remaining term to final maturity, at least 18 months to maturity at point of issuance, a fixed coupon schedule and a minimum amount outstanding of $250 million. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Original issue zero coupon bonds and “”global”” securities (debt issued simultaneously in the eurobond and U.S. domestic markets) qualify for inclusion in the Index. Tax-exempt U.S. municipal, 144a and securities in legal default are excluded from the Index. Index constituents are market capitalization weighted. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index.

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