Since the spring dislocation stemming from the COVID-19 pandemic, the market has rebounded, while taking somewhat of a pause recently, and we believe focus will be on a number of economic and national events this year that could drive markets in either direction. At MacKay Municipal Managers, we believe the pace of the economic recovery in terms of reopening states, the potential of another stimulus package, and an orderly presidential election will go a long way towards healing the economic impact felt throughout certain municipal sectors and, more broadly, the US economy. Without this, the market could experience some volatility in the municipal asset class and more broadly.

Amidst this backdrop, one should also consider technical “seasonality” where in the fourth quarter, it is common to see municipal issuance rise and dealer inventory fall which can weigh on markets. Subsequently, a strong technical season in December and January typically follows as significant amounts of interest payments and maturities seek to reinvest in the market.

We continue to believe both pre-and post-virus that an active management style, coupled with relative value security selection, puts the team in a position to capitalize on mispricings during short term dislocations.

**Municipal credit—A wide range of strength and weakness**

The impact of the COVID-19 pandemic has created a massive credit shift in the municipal market. With the mandatory stay-at-home requirements and the closing of large segments of the economy, including travel, leisure and retail, the economic conditions of state and local governments and related entities has been significantly challenged. Fortunately, the credit picture of the municipal market ended 2019 at an all-time high as state governments had accumulated large reserves, and travel, traffic and retail, and subsequent tax revenues were at all-time highs (pre-Great recession). At this stage, revenues from sales and income tax are down in 2020 but in single digits which is not as daunting as expected.

From a credit perspective there is a wide range of sectors and we believe certain pockets of the market could experience added pressure, particularly in areas we’ve

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**About MacKay Municipal Managers**

Not all municipal managers are created equal. Our municipal bond strategies are managed by the experienced professionals at MacKay Municipal Managers, the minds behind munis. MacKay Municipal Managers is a recognized leader in active municipal bond investing and is entrusted with $53.7 billion in assets under management, as of 6/30/20. The team manages a suite of highly rated, award-winning municipal bond solutions, available in multiple structures, including mutual funds and exchange traded funds.
largely avoided that were weak prior to the virus, such as single site project finance, land-secured, and senior living. For example, it is one thing to own a utility credit or water & sewer authority with dedicated, reliable income streams versus owning more speculative credits where revenues may stem from occupancy of commercial tenants or retail traffic. Prior to the virus, we noted in our 2020 insights that we believe what you avoid and underweight is more important than stretching for yield or speculative credit. We maintain this view through the remainder of 2020.

Providing some support, the Federal Reserve Municipal Liquidity Facility (MLF) program was introduced this past spring to offer short-term borrowing to eligible states, cities, counties, and select revenue-backed issuers for up to 36 months for losses of revenues related to the COVID-19. To date, only two borrowers, the State of Illinois and NYC – Metropolitan Transportation Authority, have accessed the program although we believe the creation of this facility, in essence a “backstop” for certain borrowers, has contributed to market confidence.

At the foundation of deep credit and market analysis performed by MacKay Municipal Managers is a thorough understanding of public finance and the political landscape at the state and local level. With this in mind, the team will continue to monitor developments related to upcoming elections and ballot measures so we can factor this into our credit assessment and adjust portfolios accordingly.

Always key to municipal analysis, both pre- and post-virus, is credit specific security structures, which includes issuer access to additional liquidity and reserves to offset short term revenue losses, as well as management’s ability to manage through these times. As we expect the current shutdown/slowdown to impact the remainder of 2020 and beyond, we believe downgrades will increase and defaults will rise in select pockets of the market, further emphasizing the need for professional, active management.

Post-election tax policy
With the US deficit as it stands today, we believe there is a high probability of tax increases at the state and federal level regardless of who wins the Presidential election. We also believe corporate tax cuts implemented within the 2017 Tax Cuts and Jobs Act could reverse course and increase over time. Under these scenarios, the value of tax-free income would be more valuable in 2021 and beyond, solidifying demand for municipal bonds even further.

Infrastructure solutions move to the forefront in 2021
We believe the longstanding need to upgrade infrastructure in the United States, coupled with the added financial pressure of COVID-19 to states and local governments, will expand bi-partisan support for an infrastructure bill after the November election.

While still in early days with much negotiation ahead, some of the proposals circulating through Congress include programs similar to the “Build America Bonds (BABs)” program introduced after the 2008 financial crisis.

One recent bill that has been put forth is the “The American Infrastructure Bonds Act of 2020” (AIBs) by Senator Roger F. Wicker (R-MS) and Senator Michael Bennet (D-CO). Some aspects of the AIBs program resemble the BABs program with some added flexibility. For example, under the AIBs program, eligible issuers would be expanded, taxable bonds could be used for any public purpose expenditure eligible to be financed with tax-exempt bonds, and 28% of issuers’ interest costs would be covered by the Treasury Department. Unlike the BABs program, AIBs would be revenue-neutral, exempt from sequestration, and used not only for capital improvements but also refinancing debt.

If such a bill is implemented in the future, it comes at an interesting cross-road as taxable municipal bond issuance has increased from approximately 10% in annual municipal issuance in years’ past to more than 30% in municipal issuance thus far in 2020. This significant increase stems from changes to municipal bond advance refundings in the Tax Cuts and Jobs Act of 2017, going from tax-exempt financing to taxable, as well as select issuers seeking financing flexibility and alternate customer bases that accompany issuance of taxable municipal bonds. We believe a new infrastructure program resulting in an additional stream of taxable municipal bond issuance will further enhance the viability and liquidity profile of this market segment as the buyer base continues to expand. It also presents opportunities for professional municipal managers to capture value within unique structures and nuanced financings that may accompany a new infrastructure program.
Conclusion

Looking at the municipal market before and after COVID-19, while factoring in volatility we may experience during the fall season, we remind investors of our key five portfolio characteristics.

- **Municipals fund essential services** — The municipal market at the heart is funding basic infrastructure including water, sewer, roads, schools, utilities, healthcare, housing, trash removal, and transportation. Our portfolios reflect these basic essential services.

- **Disciplined security selection** — Strict underwriting standards through all markets remains paramount and assists the portfolios through turbulent times.

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

- **Commitment to diversification** — Each portfolio adheres to strict risk parameters in regard to exposure by issuer and sector. The diversification gives the investor a wide variety by geography, sector, credit rating, yield curve position, and by enhancement if applicable.

- **Being flexible and active** — 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.
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