MacKay Municipal Managers™

Investment Insights: Dislocations in the Taxable Municipal Market Today

March 2022

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 US 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 counter weight to inflation concerns, which is one of the main catalysts for the volatility 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 should 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. We believe this is a great opportunity to add exposure to taxable municipals, which for the reasons we pointed out, should outperform other investment grade fixed income markets for the eleventh consecutive year.

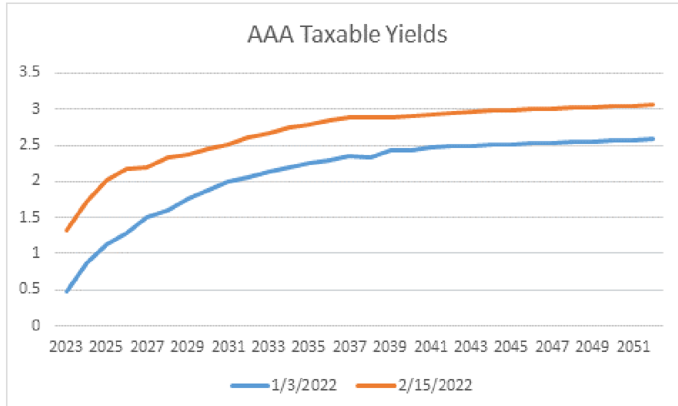
In January 2022, the Fed's more aggressive rhetoric drove treasury yields higher. Municipal yields largely followed suit. As spreads have widened, here are a few more reasons to take a closer look at this period as an opportune entry point for domestic and international investors to dollar-cost average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

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.

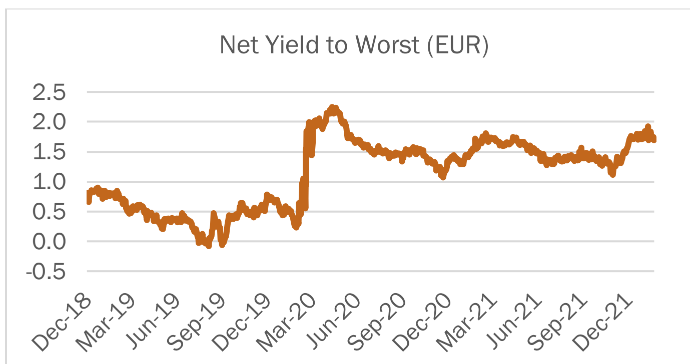
FIGURE 1:



Source: Bloomberg

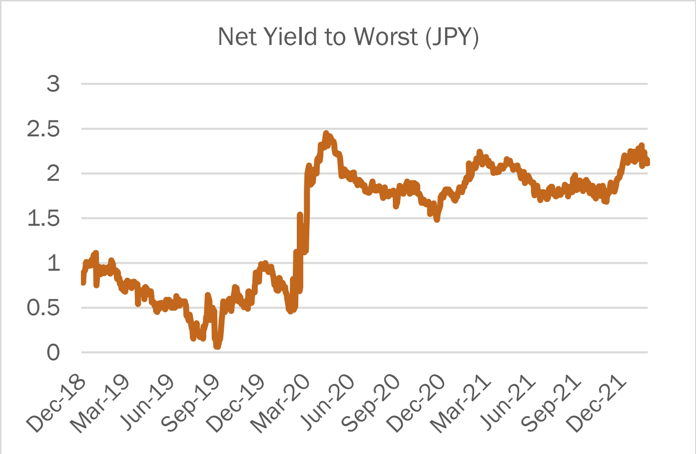
Even though the front end of the curve is rising with rising hedging costs, in our view net hedged yields are still attractive.

FIGURE 2:



Source: Bloomberg
Yield to Worst (%) for the ICE BofA US Taxable Municipal Index (Average credit rating: AA)

FIGURE 3:



Source: Bloomberg
Yield to Worst (%) for the ICE BofA US Taxable Municipal Index (Average credit rating: AA)

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 US, 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, stabilizes credit ratings and reduces 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 take advantage of these opportunities, and would welcome any additional capital allocations.

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DISCLOSURES

Comparisons to an Index

Comparisons to a financial index are provided for illustrative purposes only. Comparisons to an index are subject to limitations because portfolio holdings, volatility and other portfolio characteristics may differ materially from the index. Unlike an index, portfolios within the composite are actively managed and may also include derivatives. There is no guarantee that any of the securities in an index are contained in any managed portfolio. The performance of an index may assume reinvestment of dividends and income, or follow other index-specific methodologies and criteria, but does not reflect the impact of fees, applicable taxes or trading costs which, unlike an index, may reduce the returns of a managed portfolio. Investors cannot invest in an index. Because of these differences, the performance of an index should not be relied upon as an accurate measure of comparison.

The following indices may be referred to in this presentation:

ICE BofA U.S. Taxable Municipal Index

ICE BofA U.S. Taxable Municipal Securities 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.