

## MacKay Municipal Managers' Insights for 2021

### Resilience

Definition: (noun) The ability to withstand or adjust to challenges (Merriam Webster)

It may seem bold to use only a single word to capture our outlook for the municipal market in 2021. However, our 2021 Insights explicitly point to the municipal market's ability to withstand and adjust to the unprecedented changes of 2020. Both the virus and the efforts to suppress its spread have taken an enormous toll on virtually every facet of life for people around the world. That toll includes stress on the municipal market, which is our responsibility to navigate for our clients. Our 2021 Insights reflect the core components of our research-driven investment process including a thorough understanding of municipal credit fundamentals, the influence of governmental policy and the structure of our market in terms of issuers and investors. We focus on credit strengths within the municipal market to survive adverse events and on rapid changes in the structure of the market that present new value opportunities. The U.S. municipal market is now on the world stage and, we believe, its presence grows as impact-oriented global investors better appreciate the ESG aspects of U.S. Public Finance. We expect the municipal market's path through 2021 will not be a straight one. As a result, successful investing requires well-developed credit skills, a relative value focus and the ability to actively adjust as market conditions shift. This year, each of our five insights may be summarized by a single word selected to convey the essence of why a specific insight relates to the municipal market. We hope that you find our 2021 Insights compelling and we look forward to implementing them in your portfolios.



### Policy: The Biden Administration makes an impact

The Biden Administration's policies are expected to positively impact the municipal market in multiple ways. Anticipated initiatives include infrastructure spending, increasing employment opportunities and addressing climate change. These objectives likely coalesce in a higher volume of infrastructure-related municipal issuance that will become more recognized by impact-oriented investors for its strong ESG aspects. We expect a broad array of municipal projects will be climate friendly, supportive of increased employment development and will carry the dual oversight of both federal and state governments. In addition, investor anticipation of the Biden Administration pushing taxes higher (more likely a 2022 event) increases the value of tax exemption and municipal demand.

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### Stamina: key sectors withstand the COVID shutdown

We expect to see excess return opportunities in the COVID-impacted healthcare, transportation and travel-related municipal sectors. COVID-induced wider credit spreads on select issuers should continue into 2021, and the risk for investors to avoid are those securities with perceived credit weakness. However, a subset of those issuers have access to a broad array of policy and financial tools that should aid them in surviving the current crisis. We believe strategies employing an active, relative value approach focused on understanding credit fundamentals, liquidity and the political landscape can better identify those bonds that represent value. However, because politics play a role and outcomes are likely uneven, investing agility is also essential.

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### Resurrection: Puerto Rico rises while high risk deal bond prices decline

We believe that the long-awaited final chapters in the restructuring of Puerto Rico debt will provide investors an attractive relative value opportunity in the Territory's credits. Ultimately, a combined \$11 billion of Puerto Rico related debt could restructure out of default in 2021 and resume paying interest. We anticipate demand for these bonds will be strong. The opportunity in Puerto Rico credits stands out relative to much riskier, primarily single site, project finance municipal credits that are prevalent in some high yield portfolios. We anticipate those highly leveraged and illiquid bond financings could face significant spread widening as project revenues fall short of original projections and investors, facing potential restructurings, attempt to sell their positions.

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### Oasis: taxable municipal bonds in a global fixed income world

We believe taxable bond investors, in recognition that corporate bond yields do not adequately compensate them for their relative risk, add to their taxable municipal holdings. When compared to corporate bonds, we believe taxable municipal bonds' stronger credit quality, higher yields, and risk benefits offer better value for investors with tax-free accounts. In 2020, corporate bonds yields fell to record lows while their interest rate risk, as measured by the duration of the ICE BofA US Corporate Index, had the largest single-year extension in over 30 years. In contrast, taxable municipal risk adjusted yields are the cheapest they have been in more than a decade when compared to investment grade corporate bonds.<sup>1</sup> Tax-exempt investors will likely benefit as strong demand for taxable municipal bonds spurs issuance and reduces tax-exempt supply.

<sup>1</sup> Source: ICE DATA, as of 12/2020 – Comparing yield to worst divided by modified duration to worst for the ICE BofA Broad US Taxable Municipal Securities Index and the ICE BofA US Corporate Index over the last 10 years.

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**Essentiality: municipal bonds outlast the headlines**

We believe that tax-exempt bonds from municipal issuers providing essential services will outperform other fixed income asset classes due to their favorable, intrinsic credit characteristics. While we understand municipal bond investor uncertainty is due to weak economic conditions, low yields and negative news coverage on the sector, investors should focus on what we believe is the inherent stability of municipal revenue streams sourced from municipal services that are essential to our everyday lives. They should find confidence in select local government bonds supported by property taxes that continue to be paid, income taxes collected and sales taxes withheld. Those revenue streams support many forms of state-level debt. Although we expect the economy to recover, thoughtful, research-driven credit selection is also essential to differentiate among issuers.

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