MacKay Municipal Managers™

MMM Weekly Monitor

JANUARY 20, 2026

Co-Authors: Eric Kazatsky, Client Portfolio Manager & Jack Muller, CFA, Credit Analyst

Muni Risk Not Really California Dreamin'

- Munis outperform the competition to start the year
- Getting prescriptive on California credit
- Florida property tax questions

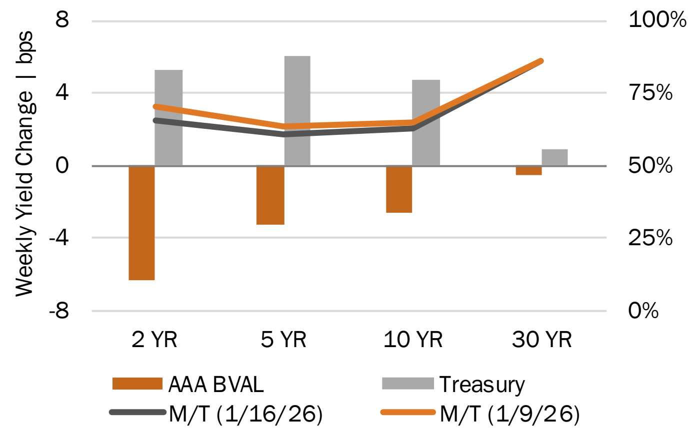
Relative Performance

Tax-exempt yields again outperformed Treasuries over the past week, with municipals rallying across the curve while Treasury yields moved decisively higher. AAA BVAL yields declined by 6 bps in 2s, 3 bps in 5s, and roughly 2–3 bps in 10s, while the long end lagged with 30-year yields down only 0.5 bp. In contrast, Treasury yields rose sharply, increasing more than 5 bps in 2s, 6 bps in 5s, and nearly 5 bps in 10s, with modest upward pressure persisting in 30s (See Figure 1).

The divergence drove further meaningful relative outperformance for municipals, particularly in the front and intermediate portions of the curve. Muni-to-Treasury ratios richened materially week-over-week, with the 2-year ratio falling nearly 2.8 points to 62.36%, while the 5-year ratio declined just under 2 points to 58.65%. The 10-year ratio also moved richer, down roughly 1.5 points to 61.23%. The long end saw more modest improvement, with the 30-year ratio edging lower by roughly half a point to 85.55%.

From a total return perspective, municipals continue to build on a strong start to the year relative to broader fixed income markets. Supported by declining tax-exempt yields, attractive absolute income levels, and steady reinvestment-driven demand, municipals have continued to outperform Treasuries and many taxable benchmarks year-to-date.[1] Taken together, the continued ratio richening and favorable relative performance reinforce municipals' defensive profile and underscore their relative value appeal versus domestic and global taxable fixed income alternatives as 2026 progresses.

FIGURE 1: MUNIS OUTPERFORM



Data as of January 16, 2026. Spot Muni, Spot AA rates
Source: Bloomberg

Technicals

Last week, Governor Newsom released his initial budget proposal for the 2026–27 fiscal year. As has been the case in recent years, California continues to contend with a structural imbalance in which projected expenditures over the multi-year budget window exceed expected revenues. Historically, this has required a mix of Rainy Day Fund draws, spending deferrals, and other one-time solutions.

This year's proposal, however, reflects a notable shift. Stronger-than-expected revenue performance in prior years has materially reduced the size of the problem the administration is attempting to solve. While the nonpartisan Legislative Analyst's Office (LAO) had been projecting a

1. Source: Bloomberg. Supported by declining tax-exempt yields, attractive absolute income levels, and steady reinvestment-driven demand, the Bloomberg Municipal Bond Index's year-to-date return of +0.93% has outperformed all of Bloomberg's major taxable US fixed income indices, including Treasuries (-0.15%), US Aggregate (+0.01%), and US Corporate (+0.09%).

shortfall of roughly $18 billion, the Governor now estimates the gap at just $2.9 billion.[2]

WHAT STANDS OUT POSITIVELY

The budget incorporates an approximately $42 billion upward revision to revenues relative to the Budget Act and assumes that recent strength in personal income tax collections persists through 2026–27. Importantly, the administration argues that these excess revenues have reduced the state's longer-term budget challenge and, notably, the proposal narrows the structural gap between ongoing revenues and expenditures compared with the 2025–26 budget.[3] From a credit perspective, this represents meaningful progress toward improving the durability of the state's financial position, particularly in the face of potential economic volatility or federal policy risk.

The proposal also includes a planned deposit into the Rainy Day Fund—the first in three years. We view this as a constructive signal of fiscal discipline and exactly the type of countercyclical policy California should pursue when revenue conditions are favorable.

WHAT RISKS REMAIN

Despite these improvements, California's multi-year budget challenges remain significant. The "LAO" continues to highlight downside risk tied to equity market valuations, which could translate into weaker capital gains realizations and materially lower personal income tax receipts. The Governor's budget explicitly acknowledges this risk and cites it as justification for a number of proposed discretionary savings measures. As a result, the state remains meaningfully exposed to broader economic conditions.

At MacKay Shields, as well as among the rating agencies, this risk is well understood and incorporated into our analysis. Our stable outlook reflects the state's continued capacity to respond to adverse scenarios through a combination of Rainy Day Fund resources and spending flexibility, including deferrals where necessary.

Federal policy represents another area of uncertainty, particularly with respect to Medicaid. Like other states, California's Medi-Cal program is facing reduced federal support. As these changes phase in over the next several years, the state will need to recalibrate the program to avoid further pressure on the general fund. The administration has already begun to move in this direction through measures such as freezing enrollment for undocumented immigrants, introducing premiums for certain adults, and implementing work requirements.[2]

THE WEALTH TAX AS A TAIL RISK

Separately, a healthcare workers union is advancing a potential ballot initiative that would impose a new tax on California residents with net worth exceeding $1 billion, assessed at an effective rate of 5% of assets. If enacted, the implications for state finances could be significant, given California's heavy reliance on high-income taxpayers and volatile capital gains within its progressive tax structure.[4]

That said, we currently view this proposal as a tail risk. It faces substantial legal hurdles and strong opposition from Governor Newsom and many Democratic lawmakers. We are monitoring developments closely and will continue to keep clients informed as the situation evolves.

BOTTOM LINE

Recent revenue outperformance has meaningfully improved California's near-term credit profile, reinforcing the state's standing as a borrower. This benefit has been complemented by several years of budgetary restraint. While expenditures—most of which are formula-driven—continue to rise, the combination of a renewed Rainy Day Fund deposit and a near-freeze on discretionary spending places the state on relatively solid footing for now.

Economic downturn risk remains a defining feature of California's fiscal landscape, but it is one we continue to explicitly incorporate into our credit assessments and outlook.

2. State of California Budget Office and State of California Legislative Analyst's Office.
3. California Department of Finance.
4. Service Employees International Union - United Healthcare Workers West.

Questions from the Field

Q Are there municipal credit concerns surrounding Governor Desantis's desire to eliminate property taxes in Florida?

A We have received questions regarding proposals in Florida to reduce or eliminate property taxes and the potential implications for the municipal market in the state. While proposals are still in a preliminary phase, we want to share our current perspective and how we are approaching this issue from a credit standpoint.

CURRENT PROPOSALS: Florida's legislature has put forward several proposals. Although the idea of property tax relief has broad support from the Republican-dominated statehouse, no single bill has garnered significant support more than others. The proposed measures vary widely in their substance. Some aim simply to limit property taxes, while others aim to nearly eliminate for certain residents. Some, but not all, carve out school district taxes. Finally, some include mechanisms to replace the revenue with increases to state taxes (such as sales or corporate taxes), while others abstain from doing so.[5]

STEPS FOR IMPLEMENTATION: Property taxes in Florida are authorized at the constitutional level for local governments. Any material elimination or restriction would therefore require a constitutional amendment, which entails a multi-step process requiring approval by 60% of both the Florida House and Senate to place a constitutional amendment on the ballot, and subsequent approval by at least 60% of statewide voters at a general election. These supermajority thresholds represent meaningful procedural hurdles and historically limit the likelihood of abrupt or unilateral change.

POTENTIAL IMPACT: Property taxes remain the primary revenue source for Florida local governments and the legal foundation of most local GO pledges. Importantly, the burden is not concentrated on primary residences. Data from the Florida Department of Revenue and analyses by the Florida Policy Institute indicate that approximately 60-65% of statewide property tax revenue is generated from non-homestead property, including second homes, rental and investment housing, and commercial property.[6] Independent policy analyses estimate that eliminating property taxes on homestead (primary residence) property could remove roughly $15–$18.5 billion annually from local government budgets statewide, with some jurisdictions facing proportionally larger holes due to having proportionally more homesteads.[7] For context, Florida Department of Revenue data shows that $61 billion in property taxes was levied in 2024.

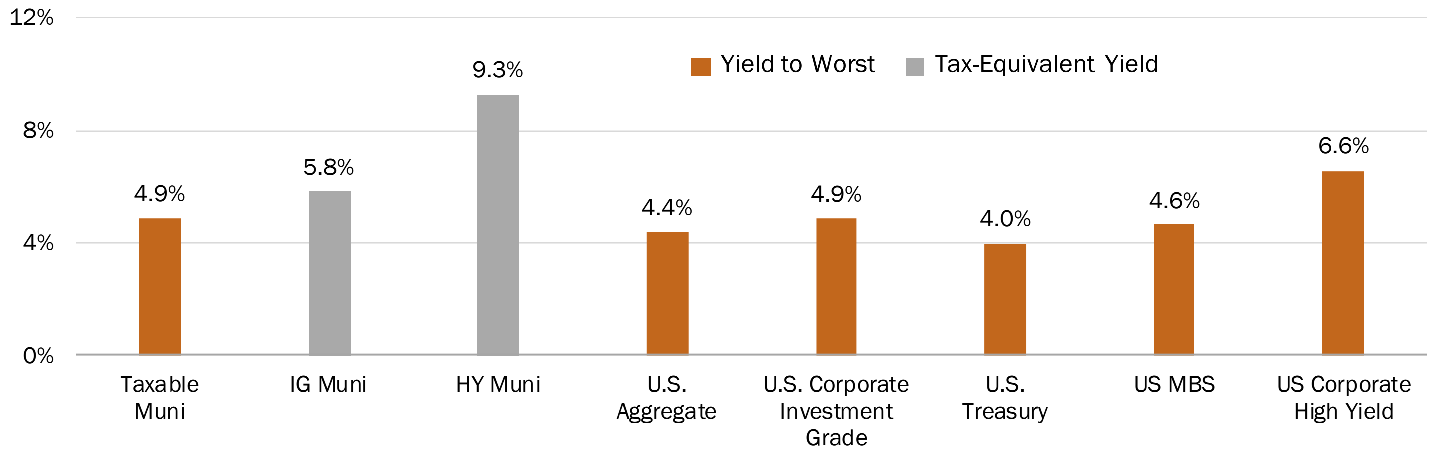
CREDIT IMPLICATIONS: The first point to be aware of is that Florida law requires counties, municipalities, and special districts to adopt a balanced budget each fiscal year and prohibits structural operating deficits. This statutory constraint, codified in Florida Statutes Chapter 129, has historically supported conservative budgeting, maintenance of reserves, and timely fiscal responses during stress. Should the state determine that revenue replacement is necessary to avoid undue stress on municipalities, as other states typically do when instituting property tax relief, we expect legislators to find a balanced approach, whereby it can provide some relief without spending beyond its own means. Its most recent enacted budget puts total state resources at $117 billion. Encouraging this view is the fact that, as one of the municipal market's AAA-rated borrowers, Florida has an excellent track record of fiscal responsibility.

CREDIT VIEW: Taken together, the likelihood of replacement revenues, the diversified and largely non-homestead tax base, and mandatory balanced budgets present mitigating factors against negative credit impacts from whatever policy choice the state ultimately makes. We will continue to monitor developments closely and will adjust portfolios if facts, rather than headlines, warrant action. Please reach out with any questions or to discuss specific credits.

5. https://flsenate.gov/.
6. Florida Department of Revenue and Florida Policy Institute.
7. Florida Policy Institute.

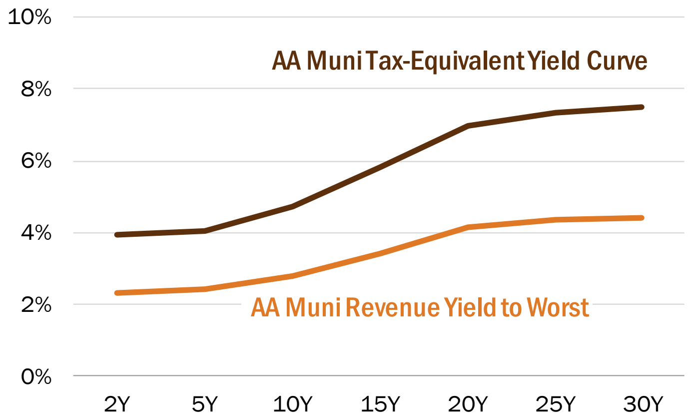
CO-AUTHORS: ERIC KAZATSKY, CLIENT PORTFOLIO MANAGER &
JACK MULLER, CFA, CREDIT ANALYST

INDEX YIELDS



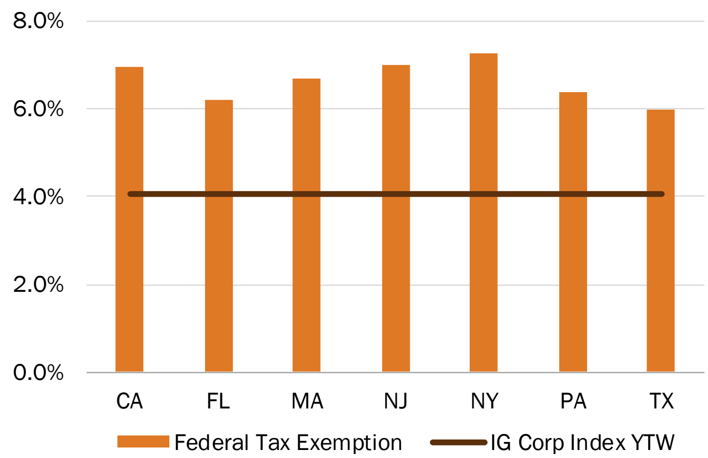
Data as of January 16, 2026.
1. Tax Equivalent Yield is using 40.8% federal tax rate, including 3.8% Net Investment Income Tax.
Source: Bloomberg

AA MUNI TAX-EQUIVALENT YIELD CURVE



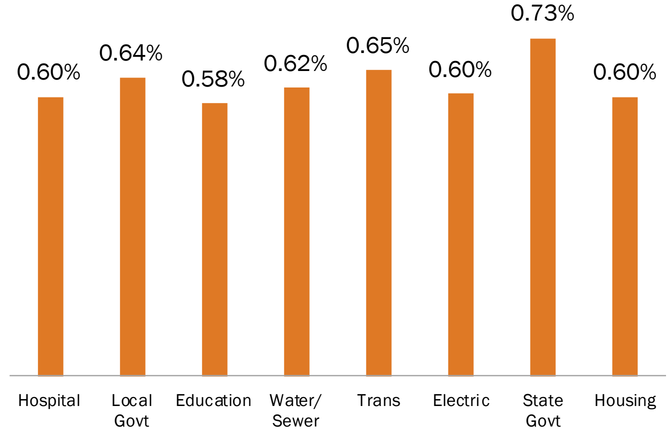
Data as of January 16, 2026.
Using 40.8% federal tax rate, including 3.8% Net Investment Income Tax.
Source: Bloomberg

IN-STATE MUNI TAX-EQUIVALENT YTW



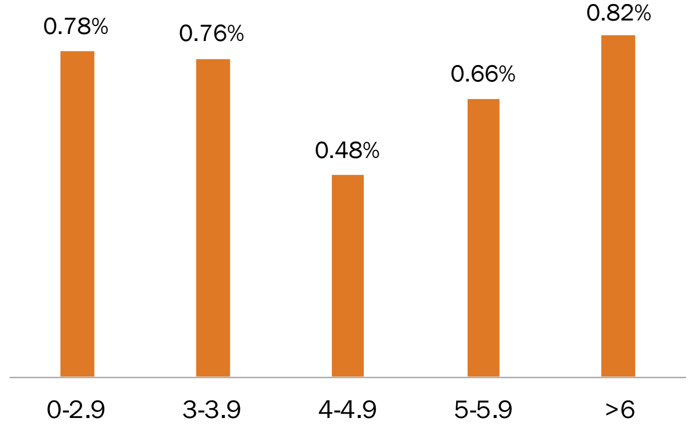
Data as of January 16, 2026.
Using 40.8% federal tax rate, including 3.8% Net Investment Income Tax.
Source: Bloomberg

YTD TOTAL RETURNS BY SECTOR



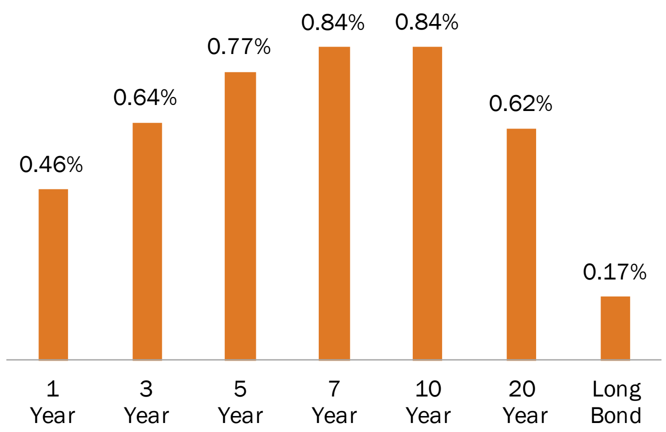
Data as of January 16, 2026.
Source: Bloomberg

YTD TOTAL RETURNS BY COUPON



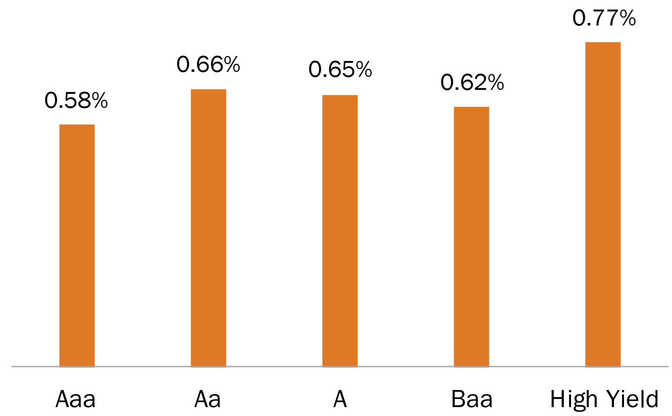
Data as of January 16, 2026.
Source: Bloomberg

YTD TOTAL RETURNS BY MATURITY



Data as of January 16, 2026.
Source: Bloomberg

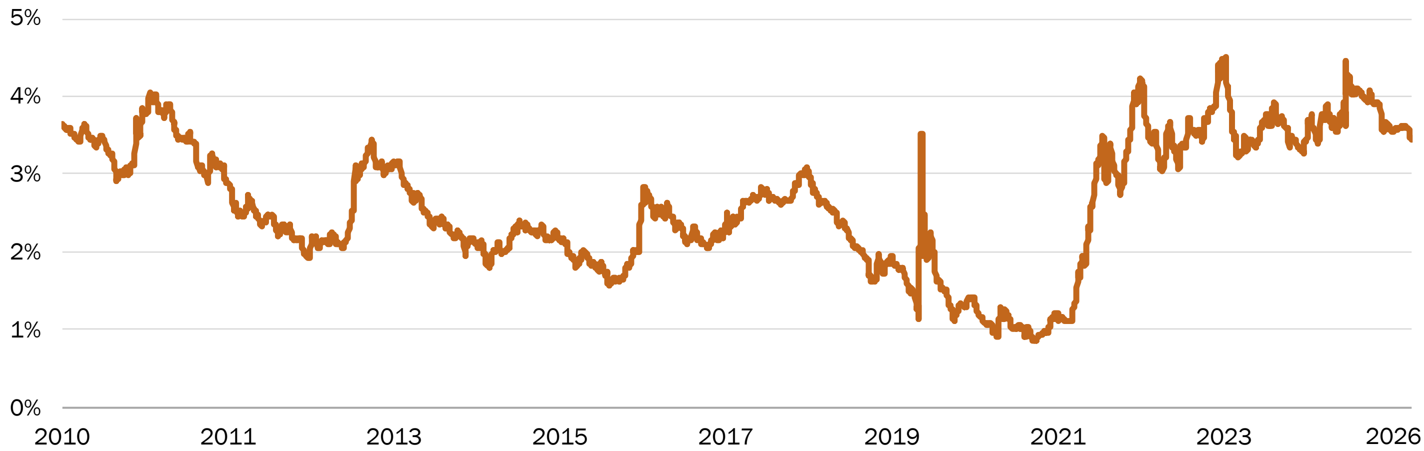
YTD TOTAL RETURNS BY RATING CATEGORY



Data as of January 16, 2026.
Source: Bloomberg

CO-AUTHORS: ERIC KAZATSKY, CLIENT PORTFOLIO MANAGER &
JACK MULLER, CFA, CREDIT ANALYST

BLOOMBERG MUNICIPAL YIELD-TO-WORST



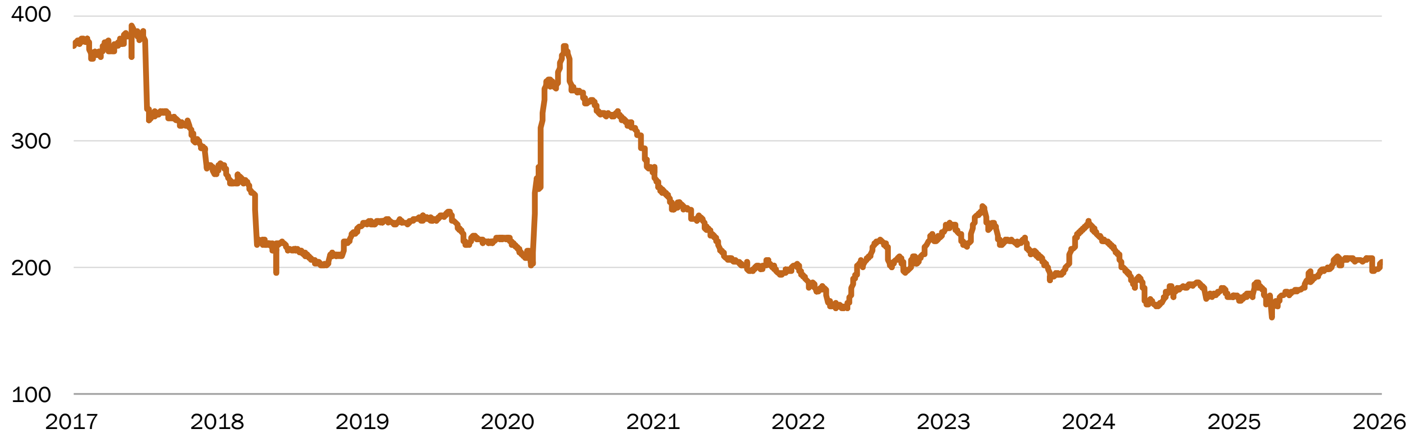
Data as of January 16, 2026.
"Post GFC Average" measures the period from 1/1/2010 – 1/16/2026
Source: Bloomberg

MUNI YIELDS

Tenor	1/16/2026	1/9/2026	Change (+/-)
BLOOMBERG AAA MUNI KEY RATE YIELDS			
2 YEAR	2.24%	2.30%	-0.06%
5 YEAR	2.24%	2.27%	-0.03%
10 YEAR	2.59%	2.61%	-0.03%
30 YEAR	4.14%	4.14%	0.00%
US TREASURY RATE YIELDS			
2 YEAR	3.59%	3.54%	0.05%
5 YEAR	3.82%	3.75%	0.07%
10 YEAR	4.24%	4.18%	0.06%
30 YEAR	4.83%	4.82%	0.01%
US TREASURY & AAA MUNI CURVE SLOPES[1]			
	2s10s	10s30s	2s30s
US TREASURY CURVE SLOPE	+ 65 bps	+ 59 bps	+ 124 bps
AAA MUNI CURVE SLOPE	+ 35 bps	+ 155 bps	+ 190 bps

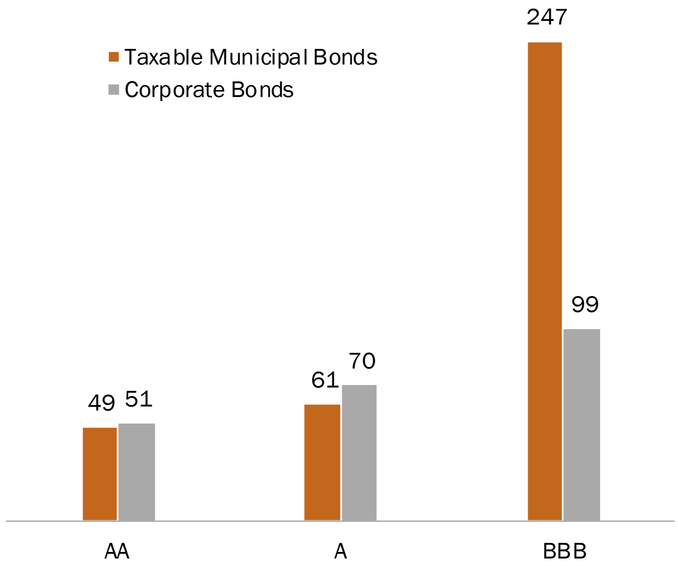
Data as of January 16, 2026.
1. 2s10s – is spread between 10yr and 2yr yield; 10s30s – refers to spread between 30yr and 10yr yield; 2s30s – refers to spread between 30yr and 2yr yield
Source: Bloomberg

BLOOMBERG MUNICIPAL HIGH YIELD | AAA YIELD DIFFERENTIAL



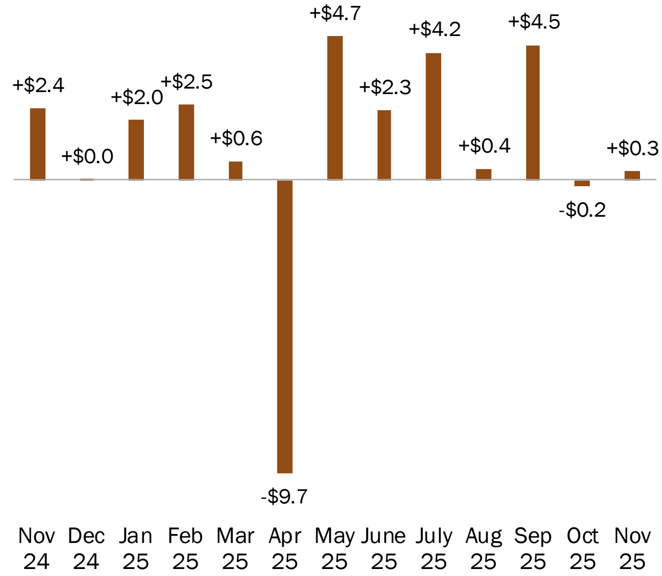
Data as of January 16, 2026.
Source: Bloomberg

TAXABLE MUNICIPAL AND CORPORATE CREDIT SPREADS



Data as of January 16, 2026.
The spread, better known as the option-adjusted spread (OAS) is the measurement of the yield of a fixed income security over that of a risk-free rate of return, which is adjusted to take into account an embedded option.
Source: Bloomberg

LONG TERM FUND FLOWS | USD $BN



Data as of January 16, 2026.
Source: Bloomberg

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COMPARISONS TO AN INDEX

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SOURCE INFORMATION

DEFINITION OF TERMS

OPTION-ADJUSTED SPREAD

The option-adjusted spread (OAS) measures the spread between a bond's rate and the risk-free rate, while adjusting for any embedded options like callables or mortgage-backed securities.

STANDARD DEVIATION

Standard deviation is a statistical measurement that looks at how far discrete points in a dataset are dispersed from the mean of that set. It is calculated as the square root of the variance.

TAX EQUIVALENT YIELD

The tax-equivalent yield is the return a taxable bond needs to equal the yield on a comparable tax-exempt municipal bond. Investors use this calculation to compare the returns between a tax-free investment and a taxable alternative.

TAX EQUIVALENT YIELD TO WORST

Tax Equivalent YTW is calculated by dividing the tax-exempt yield by one minus the marginal income tax. this is used to compare YTW on a tax-exempt investment to a taxable investment.

VOLATILITY

Volatility is a measurement of how varied the returns of a given security or market index are over time. It is often measured from either the standard deviation or variance between those returns. In most cases, the higher the volatility, the riskier the security.

YIELD TO WORST

Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures. YTW helps investors manage risks and ensure that specific income requirements will still be met even in the worst scenarios.

INDEX DESCRIPTIONS

BLOOMBERG U.S. TAXABLE MUNICIPAL BOND INDEX

The Bloomberg U.S. Taxable Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies if all three rate the bond: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate and must be at least one year from their maturity date. Remarketed issues (unless converted to fixed rate), bonds with floating rates, and derivatives, are excluded from the benchmark.

BLOOMBERG MUNICIPAL AMT INDEX

The Bloomberg Municipal AMT index refers to a specific Bloomberg municipal bond index that includes bonds subject to the Alternative Minimum Tax (AMT). Unlike most municipal bond indices, which exclude AMT-subject securities, these indices contain bonds that typically offer higher yields to individuals who are subject to the AMT

MUNI IG AMT EX TERRITORIES INDEX

The Muni IG ex. AMT and ex Territories Index is the Bloomberg Municipal Bond Index excluding AMT and US. Territory exposure.

Bloomberg Municipal Bond Index

A rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a date-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark. The index has four main sectors: general obligation bonds, revenue bonds, insured bonds (including all insured bonds with a Aaa/AAA rating), and pre-refunded bonds. Most of the index has historical data to January 1980. In addition, sub-indices have been created based on maturity, state, sector, quality, and revenue source, with inception dates later than January 1980.

Bloomberg 5-Year Muni Index

The Bloomberg 5 Year Municipal Bond Index is a capitalization weighted bond index created by Bloomberg intended to be representative of major municipal bonds of all quality ratings with an average maturity of approximately five years.

BLOOMBERG MUNICIPAL 1-10 YEAR BLEND 1-12 YEAR INDEX

The Bloomberg Municipal 1-10 Year Blend 1-12 Year Index measures the performance of short and intermediate components of the Municipal Bond Index — an unmanaged, market value-weighted index which covers the U.S. investment grade, tax-exempt bond market.

BLOOMBERG MUNICIPAL LONG BOND 22+ INDEX

The Bloomberg Municipal Long Bond 22+ Index (often referred to as the Bloomberg Long-Term Municipal Bond Index) tracks the performance of long-term, tax-exempt U.S. municipal bonds with maturities of 22 years or longer. This index serves as a benchmark for high-quality municipal debt and covers various sectors, including general obligation, revenue, insured, and pre-refunded bonds.

BLOOMBERG MUNICIPAL BOND HIGH YIELD INDEX

The Bloomberg Municipal Bond: High Yield Index is a flagship measure of the US municipal tax-exempt non-investment grade bond market. Included in the index are securities from all 50 US States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands). The index includes state and local general obligation bonds and revenue bonds.

BLOOMBERG U.S. AGGREGATE BOND INDEX

The Bloomberg U.S. Aggregate Bond Index measures the performance of investment grade, U.S. dollar-denominated, fixed rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. It rolls up into other flagship indices, such as the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt.

BLOOMBERG U.S. CORPORATE BOND INDEX

The Bloomberg US Corporate Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers. The index is a component of the US Credit and US Aggregate Indices, and provided the necessary inclusion rules are met, US Corporate Index securities also contribute to the multi-currency Global Aggregate Index. The index includes securities with remaining maturity of at least one year.

BLOOMBERG U.S. TREASURY INDEX

The Bloomberg U.S. Treasury Index measures the performance of public obligations of the U.S. Treasury, including securities that roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices.

BLOOMBERG U.S. MORTGAGE-BACKED SECURITY INDEX

The US MBS Index is formed by grouping the universe of individual TBA-deliverable MBS pools into pool cohorts and then applying the index inclusion rules at the cohort level. Each cohort is a representation of its mapped individual pools and contributes their total amount outstanding to the US MBS Index.

BLOOMBERG U.S. CORPORATE HIGH YIELD INDEX

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

BLOOMBERG GLOBAL AGGREGATE BOND INDEX

The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-seven local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

BLOOMBERG SECURITIZED BOND INDEX

The Bloomberg U.S. Securitized: MBS, ABS, and CMBS Index tracks all USD-denominated, investment grade, securitized issues within the “Parent Index”. MBS must have a weighted average maturity of at least one year. CMBS and ABS must have a remaining average life of at least one year.

BLOOMBERG US MUNICIPAL BOND INDEX TOTAL RETURN INDEX VALUE UNHEDGED

The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds

BLOOMBERG US AGGREGATE TOTAL RETURN VALUE UNHEDGED

The Bloomberg US Aggregate Total Return Value Unhedged Index (LBUSTRUU:IND) is a benchmark that measures the performance of the U.S. investment-grade, fixed-rate, taxable bond market, excluding any currency hedging. It tracks a broad universe of U.S. dollar-denominated securities, including U.S. Treasuries, government-related debt, corporate bonds, mortgage-backed securities (MBS), and asset-backed securities (ABS).

BLOOMBERG US TREASURY TOTAL RETURN UNHEDGED

The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.