Top 5 Municipal Bond Market Insights for 2024

The Year of FUNDamental Municipal Investing

From MacKay Municipal Managers™

We are at the mid-point of 2024 and the landscape is beginning to shift. Inflation has resumed its downward trend, and the Federal Reserve is holding its policy rate steady. As inflation cools and the risk of rate hikes tends to dissipate, investors are looking beyond these issues pondering what will drive relative value in the municipal bond market next. This change in sentiment highlights the various complexities and nuances of the municipal market that were overshadowed by macroeconomic headlines over the past two years. Issues such as tax policy and emerging cracks in the riskier segments of the market underscore not only the importance of tax-free income streams but also the critical role of credit research in assembling a diversified, resilient portfolio. As always, we hope that investors find our insights and our self-assessments of these insights useful as they navigate the evolving municipal bond market.

Theme	Rationale	Portfolio in Action	Mid-Year Status
1 **Investing through a mutual fund captures the municipal market opportunity**	Since the end of 2021, prudent fund managers have increased dividend rates, restructured portfolios and harvested losses to manage future capital gains distributions. Simultaneously, many investors shed duration by retreating to exceptionally attractive yields on money market instruments. In response to a probable pivot by the Federal Reserve in 2024, we anticipate short term rates will decline while longer-term bonds outperform. Therefore, investors may consider securing longer duration and income durability in the near term. However, higher yields only matter if they are in your portfolio. We believe investors' have the opportunity to acquire high accrual rates, active portfolio positioning and the flexibility essential to capture the market's recovery is through mutual funds. Other professionally managed solutions are available, such as passive, index bound ETFs or buy-and-hold, laddered separately managed accounts. However, in our opinion, the rigidity of their constrained investing approaches limits their efficacy. In 2024, we believe municipal market prices will rise and mutual funds will provide a compelling vehicle to capture that performance potential.	We believe that active portfolio positioning and flexibility are providing an edge so far this year. For example, the municipal yield curve has been inverted all year. In our portfolios, we actively positioned outside the intermediate segment of the curve, the most richly valued and lowest-yielding segment. This posture enabled us to continue capturing relatively attractive, more durable income streams at favorable values for our portfolios. In contrast, rules-based passive strategies and bond ladders often face constraints that limit their potential performance. Specifically, strategies restricted by maturity may find themselves lagging better-diversified peers as the yield curve begins to normalize.	**On Target** • Portfolios concentrated in the lowest-yielding, most richly valued portion of the municipal curve underperformed the broader investment grade (IG) market by 120 basis points (bps). The Bloomberg Managed Money Intermediate (1-17 Yr) Index, an industry proxy for managed money accounts, returned -1.6%. The broad IG market benchmark, the Bloomberg Municipal Index, of which one third of its constituent holdings mature in more than 17 years, outperformed, returning -0.4%.[1] • Curve positioning should continue to play a key role. Moving from a 1-year AAA-rated municipal bond to a 5-year AAA-rated municipal bond results in a loss of 27 basis points (bps) of yield per year. Meanwhile, a 25-year bond yields 3.6%, translating to a pickup of 71 bps of yield per year over the 5-year bond.[2]

1. Source: Bloomberg as of June 30, 2024
2. Source: ICE Data as of June 30, 2024

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2 **The specter of rising taxes increases the value of tax exemption**	We believe anticipation of rising taxes will increase the value of tax exemption. In 2024, we expect Federal taxes due on elevated taxable money market earnings will renew investors' tax awareness. Investors should recall that the Tax Cuts and Jobs Act of 2017 income tax provisions expire at the end of 2025.[3] In addition, the Federal government will likely need other incremental revenues to finance its $33 trillion of debt.[4] The bite of impending, higher Federal taxes may also be accompanied by state tax increases. For example, some states may face budget pressures as State and Local Fiscal Recovery Funds (SLFRF) grants are exhausted.[5] We believe anticipation of higher taxes motivates investors to seek the attractive, legacy income streams of well managed mutual funds. While focusing on tax strategy now may seem early, we maintain it would be advantageous for investors to get ahead of potential tax increases.	Concerns about future tax increases and the potential sunsetting of the Tax Cuts and Jobs Act have placed tax-exempt municipal bond mutual funds back to the forefront. We observe this through largely consistent positive net fund flows so far in 2024.	**On Target** • Net flows YTD indicate $11.4 billion for all municipal bond mutual funds and ETFs. A nice reversal, so far, from the previous two years. We believe investors will increasingly focus on the value of tax-free income supporting steady demand in the future.[6]
3 **Deep analysis is necessary to find credits that will outlast headline risk**	We continue to have confidence in the general condition of municipal credit despite some rising concerns to the contrary. The strength of municipal credit has become the subject of casual observers opining on the impact of a potentially slowing economic cycle. Despite the dire warnings, we believe that many municipal issuers have ample financial flexibility to weather this environment. For example, focus has been placed on the slowing growth of state and local tax bases due to stagnating personal incomes and wavering office property values. However, a deeper analysis reveals that revenue streams remain diverse and that last year's collections reached all-time highs while budgetary reserves are nearly double that of pre-pandemic levels.[7] In addition, municipal issuers have the capacity to raise revenues and cut expenses when needed to stabilize credit strength. Based on historical patterns, we expect municipal default rates should remain significantly more stable than corporate bonds even if the economy weakens more than expected.	As anticipated, municipal credit fundamentals remained strong during the first half of 2024 and demonstrated resilience despite signs of a slowing economy. Municipal credit rating upgrades outpaced downgrades by a ratio of 2.1 to 1.[8] Moreover, the amount of Municipal defaults, which are historically rare, were down by 52% year-over-year through May 2024, according to BofA Global Research.	**On Target** Using Illinois as an example, a state that receives elevated industry news coverage and a proxy for many other states from the sole perspective of rising credit fundamentals: • Illinois was rated BBB- and on the verge of losing its investment-grade credit rating at the beginning of the decade. • Today, the state holds a credit rating of A3/A-/A- (Moody's/Fitch/S&P) with a stable outlook. Illinois has managed to outlast negative headlines by passing balanced budgets on time, paying off debts, building reserves and funding its pensions. • Recently, state lawmakers passed a balanced $53 billion budget on-time and the process transpired smoothly. Yield spreads on Illinois General Obligation debt subsequently dropped to their lowest levels of the year, reflecting reduced volatility and credit risk.

3. https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-personal-taxes
4. https://fiscaldata.treasury.gov/datasets/historical-debt-outstanding/historical-debt-outstanding
5. https://www.nlc.org/covid-19-pandemic-response/american-rescue-plan-act/arpa-local-relief-frequently-asked-questions/
6. Source: LSEG Lipper Global Fund Flows, J.P. Morgan as of June 27, 2024
7. https://www.pewtrusts.org/en/research-and-analysis/articles/2023/09/27/state-tax-revenue-declines-from-record-highs and https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Fiscal%20Survey/NASBO_Fall_2023_Fiscal_Survey_of_States_S.pdf
8. Source Moody's, S&P, and Fitch as of March 31, 2024

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4	**Capitalize on high yield market participants' overcorrections**	In our opinion, there has been an historical pattern in the high yield municipal market where certain investors have used a selection process based on chasing yield somewhat indiscriminately. This can lead to overweight positions in weaker, less liquid and typically non-rated credits. The somewhat anomalous combination of rising bond yields and, for some issuers, improving credit conditions over the past two years has brought focus on the shortfalls of chasing yield. It has also confirmed the efficacy of using a risk - managed, relative value approach to investing in high yield municipal bonds. In our opinion, those yield - chasing investors will over compensate for historically chasing yield by indiscriminately selling and/or avoiding credits. Consequently, we believe more disciplined managers will be presented with opportunities to acquire better quality high yield municipal bonds at attractive levels. We expect discerning high yield municipal investors employing a credit research-driven, relative value approach to security selection will be rewarded in 2024.	In 2024, high yield municipal mutual funds have seen solid inflows, a welcome change from the previous two years. This development has reduced the urgency for high yield investors to sell positions to meet redemptions. Nonetheless, we observe instances where market participants are selling misunderstood credits at prices that don't reflect their true fundamentals. These selling decisions often stem from positions with modest book yields acquired when interest rates were much lower, making them less attractive in the current higher-rate environment. Additionally, we believe some investors have been rebalancing their portfolios in favor of higher quality sectors and enhanced liquidity. Liquidity constraints during outflow cycles often lead to the sale of larger, more liquid names and sectors to meet redemption needs. High yield sectors like Charter Schools and Land-Backed deals, which are typically smaller and often lack published ratings, face liquidity challenges during market downturns. Despite this, these sectors continue to present opportunities to acquire securities backed by strong financial metrics at attractive valuations.	**On Target** • The Bloomberg High Yield Municipal Index returned 4.14% YTD, outperforming the Bloomberg Municipal Index, which returned -0.40%, by +454 bps.[9] • We shifted our municipal asset allocation mix for the average moderate investor to 70% investment grade/30% high yield in February 2024. As of July 2024, we have moved the allocation to 75% IG/25% HY. This still represents an overweight to high yield municipals relative to our neutral posture of 80%/20%.
5	**Individual investors embrace taxable municipal bonds in retirement plans**	We expect U.S. based individual investor demand for taxable municipals will continue to increase. In our opinion, individuals will view taxable municipal bonds as an attractive complement to their investment grade corporate bond exposure in their qualified accounts. Taxable municipal bonds can offer attractive absolute yields, credit spreads and additional return potential with the same strong fundamentals as traditional tax-exempt financings. Additionally, in our view, demand from both domestic and overseas institutional investors should be robust in 2024 as credit spreads remain attractive and hedging costs will most likely recede with the normalization of yield curves around the world. This one-two punch should increase demand and help propel returns in this often overlooked segment of the municipal marketplace in 2024.	We believe taxable municipal bonds have met investor expectations this year. They are either outperforming or performing in line with key high-grade U.S. fixed income sectors and are doing so with a higher quality mix. Index spreads have tightened due to demand from diverse participants, including U.S. mutual funds. The pace of new issue supply is picking up at the mid-year point. As a result, we expect to see more relative value opportunities that we can potentially capitalize on to drive total return across our portfolios.	**On Target** • Mutual funds that invest primarily in taxable municipal bonds took in $98 million in positive YTD net flows.[10] • Based on index returns, including taxable municipals within a diversified fixed-income portfolio has been beneficial so far this year. The ICE BofA Broad U.S. Taxable Municipal Securities Index generated excess returns over U.S. government bonds of +159 bps, outperforming the ICE BofA U.S. Corporate Index, which only generated +116 bps. This is notable despite the credit rating differential: 98% of the Taxable Municipal Index is rated A or above, compared to only 54% of the Investment-Grade Corporate Index.[11]

9. Source: Bloomberg as of June 30, 2024
10. Source: Morningstar as of June 30, 2024
11. Source: ICE Data as of June 30, 2024

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Bloomberg Municipal High Yield Index is an unmanaged index of municipal bonds with the following characteristics: fixed coupon rate, credit rating of Ba1 or lower or non-rated using the middle rating of Moody's, S&P, and Fitch, outstanding par value of at least $3 million, and issued as part of a transaction of at least $20 million. **Bloomberg Municipal Managed Money Intermediate 1-17 Year Bond Index** is an unmanaged, tax-exempt bond market index that measures the 1-17 year maturity component of the Bloomberg Barclays Municipal Managed Money Bond Index. **Bloomberg Municipal Bond Index:** a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two ratings agencies. 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 dated-date after December 31, 1990, and must be at least one year from their maturity date. **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. **ICE ICE BofA U.S. Corporate Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

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