MacKay Municipal Managers™

Mid-Year Insights for 2023

July 2023

Preparation Seizes Opportunity – Higher Accruals Set the Pace

What a difference a year makes. Following a challenging 2022, the municipal bond market is stabilizing, yet it continues to offer attractive investment opportunities. Industry fund flows have been mixed, but the pace of outflows has slowed considerably since last year. Today we observe a firmer trading tone characterized by improvements in liquidity and the two-way flow of capital. The result is that the market is once again rewarding investors for selecting fundamentally-sound securities based on relative value. Notwithstanding these positive developments, MacKay Municipal Managers remains constructive on the market. In a welcome reprieve for income investors, high grade municipal bond yield levels are at or near their highest levels in a decade. Moreover, municipal income streams are improved from a credit risk-adjusted standpoint. With a market largely comprised of tax-backed state and local debt issuers and essential service providers, we believe municipals are an attractive late-cycle asset class. Many municipal issuers prudently restored their emergency reserves and reduced liabilities following a few years of strong revenue collection. We believe positive credit trends and, for those managers who have taken advantage of the opportunity, the attractiveness of current income streams will continue to anchor the municipal market during the second half of 2023.

Top Five MacKay Municipal Managers' Market Insights for 2023: "Preparation Seizes Opportunity – Higher Accruals Set the Pace"

Theme	Rationale	Portfolio in Action	Mid-Year Status
1 TAX-EXEMPT ACCRUAL PLAYS A KEY ROLE IN TOTAL RETURN	Income has regained its prominence in municipal bond total return. Municipal investors can now realize much higher income accruals due to 2022's sharp rise in rates. Top income tax bracket investors, especially those living in high income tax states, should find the higher tax-exempt income levels attractive on a taxable equivalent basis versus other asset classes. For investors in pooled vehicles, raising accrual rates tends to reward investors who reinvest their dividends through the compounding effect of buying more shares at	At times during the last year and a half, issuers were periodically forced to issue unusually high coupon bonds (i.e., above 5%) due to market conditions. These structures have rarely been available in the primary market in recent years. At key inflection points, when others were not as well-positioned to buy, we worked to secure material allotments of these attractively-structured bonds. Higher-coupon securities have helped to increase portfolio accrual	**On Target:** - Dividend distribution rates are up, year-over-year. The average actively-managed pooled investment vehicle's distribution is up by 26% on an asset-weighted basis. We think that investors should give more consideration to those that took the opportunity last year to reposition portfolios and improve income streams. (Source: Morningstar as of 6/30/2023) - Do not overlook the power of compound returns for those that opt to reinvest. The potential near-term performance benefit of investing in a pooled vehicle with a higher accrual rate may be enhanced over the long run by the compounding effect of buying more shares via dividend reinvestment. - High grade and high yield municipal bond taxable-equivalent yields of 5.95% and 9.65% compare favorably to the before-tax yields of U.S. Treasuries (4.37%), U.S. high grade corporates (5.48%), and U.S. high yield corporates (8.58%). (Source: Bloomberg as of 6/30/2023)* * Shown for illustrative purposes only. Assumes a U.S. taxable investor who pays U.S. Federal income tax rates at the highest current marginal rate of 37.0% and the 3.8%

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	relatively lower average prices. We believe higher income levels can also better stabilize returns compared to the last several years, when low coupons and yields offered little cushion against price declines. Additionally, we believe investors who remained in passive strategies have missed this opportunity while hoping the market would recover. Raising accrual rates required actively replacing low book yield positions with much lower priced, higher yielding bonds, trades typically known as tax swaps. We believe investors can benefit from current market accrual rates in 2023 and beyond.	rates while decreasing overall interest rate sensitivity. Higher coupon debt may become harder to source in the primary market, especially at lower prices, as municipal bond industry fund flows come back into equilibrium.	Medicare surcharge tax on income. There are limitations to presenting tax-equivalent yields including, but not limited to (i) they do not show the effect of state and local taxes, which will vary; and (ii) each individual taxpayer may possess unique circumstance that could alter the computation of tax-equivalent yields. Thus "tax-equivalent yields" are only intended to represent mathematical illustrations and not actual returns to any investor. Prospective investors cannot rely on this illustration as it is not possible to invest directly in an index, and not every investor would have the same return experience in investable products or strategies. See disclosures at the end of this document for information related to comparisons to an index and index descriptions. This illustration and nothing herein constitute tax advice. The information contained herein should not be used as a substitute for advice from your tax advisor. Neither MacKay Municipal Managers™ nor MacKay Shields LLC advise clients on tax matters. Consult your tax advisor for further information. **It is not possible to invest directly in an index. Past performance is not indicative of future results. Please see disclosures for index descriptions.**
2 OVERWEIGHT GENERAL OBLIGATION AND ESSENTIAL SERVICE BONDS	We believe essential investment grade sectors, such as General Obligation bonds and Water & Sewer bonds, will regain favor with investors in 2023. We expect greater demand for traditional municipal bonds such as bonds backed by the taxing power of general obligation issuers or secured by the revenues of essential service providers like public water and sewer authorities. We anticipate continued investor uncertainty over the path of inflation, the Federal Reserve's policy decisions and the potential for a recession will be the reason why investors find comfort in the core municipal sectors. In addition, investors should favor shifting to higher quality sectors that now pay higher accrual rates. We believe core sectors of the municipal market outperform in 2023.	We continue to favor State and Local General Obligation bonds and essential service revenue bonds for their generally strong, resilient credit profiles. Issuers in these sectors are monopolistic in nature and their debt is often backed by dedicated or secured revenue streams.	**Pending:** - Year to date, Fitch upgraded 86 total general obligation and essential service revenue issuers, while downgrading just 13. (Source: Fitch through 6/30/23)** - State balance sheets have improved. Aggregate rainy day fund balances more than doubled between fiscal year 2020 and fiscal year 2023 to a projected $155 billion, or 12% of median general fund expenditures. (Source: NASBO Fiscal Survey of States, Spring 2023) - Reflecting the possibility of an economic slowdown, S&P expects reserves across states to decline by an average 1.5% in 2024, compared to the 21% decline we saw during the Great Recession. (Source: S&P, April 2023)

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3 IN A BIFURCATED HIGH YIELD MUNICIPAL MARKET LIQUIDITY DRIVES PERFORMANCE	We believe a disciplined pursuit of liquidity will be rewarded in the 2023 high yield municipal market. In 2022, the massive wave of high yield fund redemptions resulted in an equally sized sell-off of bonds as funds sought liquidity. High yield municipal funds primarily sold their more widely held and better quality positions to meet those redemptions resulting in those more liquid bonds underperforming relative to holdings that did not trade throughout the year. In anticipation of a healthier market in 2023, we believe those underperforming bonds now provide the opportunity to outperform as investment discipline re-emerges. In our opinion, discipline in the high yield municipal market goes beyond credit research to include an understanding of liquidity, tradability and the investor base. We expect inflows will return to the high yield municipal market and issuance will be light. As a result, we believe the more liquid part of the high yield municipal market outperforms in 2023.	High yield municipal industry-wide fund flows have yet to return to positive territory and are essentially flat. That said, we still favor the liquid, rated names that came under selling pressure during 2022's liquidity squeeze. Not only can these securities benefit from eventual positive fund flows as investors buy them back, but their prices also better reflect current economic conditions. The latter point means that this subset could offer less downside risk than less-liquid, lower rated names if generic high yield market spread levels were to widen.	**On Target:** - The BBB-rated municipal bond index, considered to be a highly liquid segment, slightly outperformed and returned 4.45% YTD 2023, while the Bloomberg High Yield Municipal Index returned 4.43%. (Source: Bloomberg as of 6/30/2023)*** - Within the Bloomberg High Yield Municipal Index, larger, more liquid names were the top drivers of performance.
4 FUND FLOWS DRIVE RECOVERY IN LONG MUNICIPAL BOND PRICES	We believe exposure to longer-term bonds drives return in 2023. Municipal mutual funds and Exchange Traded Funds are the natural buyer of the long end of the municipal curve. We expect a return to positive mutual fund flows results in the outperformance of longer-term bonds. Additionally, mutual funds will likely seek to increase their distribution yields, causing them to extend the maturity and duration profile of purchases. As a result, bond structures with long durations and discount prices enhance return potential relative to shorter duration, premium structures. Finally, the Municipal to Treasury yield	Yield curve positioning has mattered this year. The AAA-rated municipal yield curve is inverted between two and ten years to maturity due to what we see as price-insensitive demand from SMA accounts. This area has offered little in the way of buying opportunities. Meanwhile, the curve has been persistently steep between ten and thirty years, still indicating that better value can be found in longer-term bonds. Opportunistic curve positioning will likely continue to drive alpha during the second half of the year.	**Pending:** - Longer-term municipal bonds outperformed shorter-term municipals through the first half of 2023. The Bloomberg Municipal Long 22+ Year Index returned 4.96%, outpacing the broader Bloomberg Municipal Index, the 1-Year Index, the 3-Year Index, and the 5-Year Index by +2.29%, +1.14%, +0.90%, and +3.77% respectively. (Source: Bloomberg as of 6/30/2023 ****

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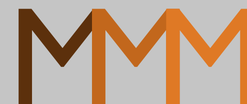
	ratio curve remains steep, indicating that the longer end of the municipal market offers better value opportunities. Long municipal bonds with Municipal to Treasury yield ratios in the mid 90% range are cheap on a relative basis. We believe portfolios with exposure to longer maturities outperform.		
5 THINKING OUTSIDE THE BOX – USING SHORT TAXABLE MUNICIPALS TO ENHANCE AFTER-TAX PERFORMANCE	We believe shorter-term taxable municipal bonds provide better after-tax value than comparable maturity tax-exempt bonds. Investing in shorter term municipal bonds, a tactic used to add liquidity and/or manage duration in a portfolio, becomes more difficult when these bonds are overpriced. In our view, shorter-term tax-exempt bonds have risen in price beyond fair value primarily due to passive investor demand. In 2023, we expect demand for shorter-term tax-exempt bonds to continue unabated and we do not expect that new issuance sufficiently offsets that demand. As a result, we believe shorter-term tax-free Municipal to Treasury yield ratios remain rich through the year. Comparable maturity taxable municipal yields, however, offer better value on an after-tax basis in our view. The taxable municipal market's continuing expansion, in both size and breadth, has brought a new dimension to relative value trading in the municipal market. We believe investors should favor shorter-term taxable municipal bonds because they provide competitive after-tax yields, attractive spreads to Treasuries and the same high credit quality of the tax-exempt municipal asset class.	Short-term taxable municipal bonds continue to provide benefits. The income advantage remains clear; these high-grade securities offer yields above comparable maturity U.S. Treasury bonds. On the other hand, AAA-rated short-term tax-exempt municipals are trading rich, only offering less than two-thirds of the yield of Treasury bonds. Also benefitting our positions is the present supply/demand imbalance. Taxable municipal new issue supply has been limited this year, while demand has remained strong.	**On Target:** – Short-term taxable municipals, maturing in 1-3 years, returned 1.34% YTD and have so far outperformed comparable maturity tax-exempt municipal bonds, which returned 0.90%. (Source: ICE Data as of 6/30/2023)*****



* Indices: Bloomberg Municipal Bond Index, Bloomberg Municipal High Yield Index, Bloomberg U.S. Corporate Bond Index, Bloomberg U.S. Corporate High Yield Index

**Includes States, Local Governments, Public Power, and Water & Sewer sectors.

*** Indices: Bloomberg Municipal BBB Index (BBB-rated municipal bond index) and Bloomberg High Yield Municipal Index. It is not possible to invest directly in an index. Please see disclosures for index descriptions.

**** Indices: Bloomberg Municipal Long 22+ Year Index, Bloomberg Municipal 1-Year Index, Bloomberg Municipal Long 3-Year Index, Bloomberg Municipal 5-Year Index. It is not possible to invest directly in an index. Please see disclosures for index descriptions.

***** Indices: ICE BofA Broad U.S. Taxable Municipal Securities Index, ICE BofA U.S. Municipal Securities index. It is not possible to invest directly in an index. Please see disclosures for index descriptions.

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INDEX DESCRIPTIONS

Bloomberg Municipal High Yield Index: 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. In addition, the bonds must have a dated-date after December 31, 1990 and must be at least one year from their maturity date.

Bloomberg U.S. Taxable Municipal 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 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.

Bloomberg AAA-, AA-, A-, and BBB-Rated Municipal Bond Indexes are sub-indexes of the Bloomberg Municipal Bond 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.

ICE BofA Broad U.S. Taxable Municipal Securities Index: tracks the performance of U.S. dollar denominated debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. Qualifying securities must be subject to U.S. federal taxes and must have at least 18 months to maturity at point of issuance, at least one year remaining term to final maturity to enter the index and one month remaining term to final maturity to remain in the index, a fixed coupon schedule (including zero coupon bonds) and an investment grade rating (based on an average of Moody's, S&P and Fitch). The call date on which a pre-refunded bond will be redeemed is used for purposes of determining qualification with respect to final maturity requirements. Minimum size requirements vary based on the initial term to final maturity at time of issuance. Securities with an initial term to final maturity greater than or equal to one year and less than five years must have a current amount outstanding of at least $10 million. Securities with an initial term to final maturity greater than or equal to five years and less than ten years must have a current amount outstanding of at least $15 million. Securities with an initial term to final maturity of ten years or more must have a current amount outstanding of at least $25 million. "Direct pay" Build America Bonds (i.e., a direct federal subsidy is paid to the issuer) qualify for inclusion in the index, but "tax-credit" Build America Bonds (i.e., where the investor receives a tax credit on the interest payments) do not. Local bonds issued by U.S. territories within their jurisdictions that are tax exempt within the U.S. territory but not elsewhere are excluded from the Index. All 144a securities, both with and without registration rights, 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

Bloomberg U.S. Corporate Bond 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 US Corporate 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.

Bloomberg U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included. Must have at least one year to final maturity regardless of call features. Must have at least $150 million par amount outstanding. Must be rated high-yield (Ba1/BB+ or lower) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule. Must be dollar-denominated and non-convertible. Must be publicly issued.

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