MacKay Municipal Managers™

Insights for 2024

JANUARY 2024

The Year of FUNDamental Municipal Investing

After two tumultuous years, we expect a municipal market recovery in 2024 and we believe municipal bond mutual funds will outperform other investment vehicles. While there are many ways to invest in municipal bonds, successful investment principles are relatively few: be highly diversified, maintain liquidity, employ strong fundamental credit analysis offensively, identify relative value opportunities, be active, build in an attractive income stream, manage tax liabilities and be flexible. A prudently, actively managed mutual fund incorporates all of these principles. In our opinion, other methods of accessing municipal investments necessitate concessions that violate the core principles of prudent investing in the municipal bond market: concentrated holdings, limited liquidity, minimal activity, rigidity and limited, defensively oriented credit research.

Markets can move quickly, so being early is often preferable to waiting and missing the opportunity. In our opinion, the opportunity includes capitalizing on attractive municipal yields and being well positioned to realize total returns. In 2024, we believe successful municipal bond managers will prioritize the fundamental facts over the headlines, recognize the strength of municipal credit and look to capture the opportunities in the high yield municipal market. We also hold the view that by diversifying their retirement portfolios to include taxable municipal bonds, investors may stand to benefit. The municipal market of the last two years provided active managers the opportunity to enhance returns in their funds via the principles mentioned earlier; investors might now consider exploring these funds as potential investment options.

Top Five MacKay Municipal Managers' Market Insights for 2024:

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.

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.[1] In addition, the Federal government will likely need other incremental revenues to finance its $33 trillion of debt.[2] 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.[3] 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.
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[4]. 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.
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.
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.

1. https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-personal-taxes
2. https://fiscaldata.treasury.gov/datasets/historical-debt-outstanding/historical-debt-outstanding
3. https://www.nlc.org/covid-19-pandemic-response/american-rescue-plan-act/arpa-local-relief-frequently-asked-questions/
4. 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

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MUNICIPAL MUTUAL FUND INVESTMENT RISK DISCLOSURE

Municipal bond risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities. Investing in below investment grade securities may carry a greater risk of nonpayment of interest or principal than higher-rated securities.

Diversification cannot assure a profit or protect against loss in a declining market.

Investing in municipal mutual funds involves risks, and there is no assurance that the investment objectives of any municipal mutual fund will be attained. Potential investors should consider the risks, fees and consult with a financial advisor before investing. The federal and state tax-free status of municipal bond income can be changed by legislative or regulatory action, potentially impacting the attractiveness and value of these securities. Investors should understand that the value of their investment can fluctuate and that they might lose money. Past performance is not indicative of future results. For detailed information about these risks, potential investors should read the fund's prospectus and consult with a financial advisor.

ACTIVE MANAGEMENT is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund’s portfolio. Active management strategies typically have higher fees than passive management.

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