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MARKET MONITOR

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If Tax Rates Go Down, There's Still an Upside to Munis

While it's early days, President-Elect Donald Trump has indicated his intention to lower tax rates for top earners–his plan during the campaign called for lowering taxes with the rate for top earnings declining from 39.6% to 33%. So what might this mean for municipal bond investors? We caught up with John Loffredo, Co-Head of MacKay Municipal Managers™, to get his take. The fourteen member municipal investment team managed $20 billion in municipal bond assets as of October 31, 2016.

According to John, municipal bonds still offer a lot of value, and are not discounting the benefit of their full tax exemption. The team believes this provides some cushion in the event of lower income tax rates or higher Treasury yields. As you can see in Figure 1, at a 33% tax rate, investors would have to generate taxable yields upwards of 5% in order to get the tax equivalent yield of 3.5% on municipal bonds—not easy in today's low rate environment.

Figure 1: Even at Lower Tax Brackets, Municipal Bonds Generate Attractive After-Tax Yields

2015 Federal Income Tax Rate	Tax-Equivalent Yields			
	3.50%	**4.00%**	**4.50%**	**5.00%**
25.00%	4.67%	5.33%	6.00%	6.67%
28.00%	4.86%	5.56%	6.25%	6.94%
33.00%	5.22%	5.97%	6.72%	7.46%

Rates are hypothetical, not guaranteed, and not representative of any specific investment. Past Performance is not indicative of future results. The Federal Income tax rates are based on published rates in effect as of January 2015. Actual tax rates will vary depending on the investor's income, investments, and deductions. The tax information shown is current but subject to change. These calculations are for illustrative purposes only and are not intended to predict or depict any fund's performance.

John discussed municipal bond market volatility, both in October and following the presidential election, and noted that this may actually lead to opportunities for skilled active managers. John stated that some price moves that don't properly reflect the fundamentals may create opportunities. As you can see from Figure 2, investors who have taken advantage of volatility in the past have been rewarded in periods following cycles of market stress. Past performance is no guarantee of future results. Furthermore, liquid portfolios tend to be more greatly impacted by a sell off, but may have the potential to recover faster given that cash can be deployed quickly to take advantage of mispricings in the market.

Figure 2: Both Investment Grade and High Yield Municipal Bonds Have Historically Done Very Well Post Periods of Stress

Name	Financial Crisis (FC) (09/08-10/08)	Post FC (11/10-01/11)	Meredith Whitney (MW) (11/10-01/11)	Post MW (02/11-01/13)	Fed/Detroit (05/13-07/13)	Post Fed/Detroit (09/13-12/15)	Market Selloff/
Investment Grade Munis	-5.66	22.43	-4.61	19.58	-6.21	15.45	-3.68
High Yield Munis	-13.95	30.41	-5.48	31.96	-10.7	19.18	-5.65
Treasurys (5-7 yrs)	1	18.46	-3.35	12.97	-4.83	7.11	-3.57
Excess Return (IG Muni)	*-6.66*	*3.97*	*-1.26*	*6.61*	*-1.39*	*8.34*	*-0.12*
Excess Return (HY Muni)	*-14.95*	*11.95*	*-2.13*	*18.99*	*-5.88*	*12.07*	*-2.09*

Source: Barclays 11/22/16. Past performance is no guarantee of future results, which will vary. Post FC refers to Post Financial Crisis. Meredith Whitney is a financial analyst. The column "Meredith Whitney" refers to the period covering her 2010 interview on the CBS program 60 Minutes, in which she said that she expected that 50 to 100 counties, cities, and towns in the U.S. would have "significant" municipal bond defaults within the next 12 months. Post MW refers to the period after Whitney made her remarks. Fed/Detroit refers to the City of Detroit's bankruptcy filing. Post F/D refers to the period after the filing. Bloomberg Barclays Municipal Bond Index is an unmanaged index that includes approximately 15,000 municipal bonds, rated Baa or better by Moody's, with a maturity of at least two years. The Bloomberg Barclays High Yield Municipal Index is an unmanaged index that includes the universe of fixed rate, non-investment grade debt. Bloomberg Barclays U.S. Treasury 5-7 Year Index measures the performance of government bonds issued by the U.S. Treasury with maturities of 5-7 years. It is not possible to invest directly into an index.

Right now there are still a lot of unknowns in terms of the new administration. Once policies are more clearly vetted, the team believes technical factors should improve significantly. In the meantime, investors should focus on the long term and the attractive income that municipal bonds provide. Prices go up and down, but the MacKay Municipal Managers team has expertise navigating these markets and the potential to unlock additional value associated with these price movements.

About risk

All investments are subject to risk and will fluctuate in value. Funds that invest in bonds are subject to interest-rate risk and can close principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner.