MARKET MONITOR
from MacKay Shields' Municipal Team
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Municipals: Location, Location, Location

It turns out that location applies to more than just real estate. Location matters for municipal bond portfolios, too, according to David Dowden, Portfolio Manager at MacKay Municipal Managers™.

Location: By State

As a new administration moves forward on an economic agenda that includes federal tax cuts, Dowden and his colleagues believe bonds issued in states with relatively high income tax rates will outperform those of states with low or no taxes, especially when it comes to responsible issuers. One of the advantages of municipal bonds is that, in many states, they are exempt from state income taxes in the state they are issued. As federal tax rates are lowered, a greater awareness of the tax bite attributable to state taxes should ensue. California (13.3%) and New York (8.82%) rank among those states with relatively high income tax rates.

Location: Along the Yield Curve

The team believes the most attractive maturities along the municipal bond yield curve are currently below four years and beyond 10 years (see chart below). One metric municipal bond investors routinely monitor is the ratio of municipal bond yields to those of same-maturity Treasury bonds. (As shown, municipal bond yields were recently at or near parity with Treasury bond yields – despite municipal bonds being exempt from federal income taxes – along most parts of the yield curve.) The exception shown occurs in the five-year maturity range, where municipal bond yields were approximately 87% that of Treasury yields. Given the shape of the yield curve, the common practice of laddering individual bonds with staggered maturities could leave many investors overly exposed to those maturities along the yield curve that are relatively expensive at this time, when compared to longer-term bonds and the interest-rate risk of intermediate bonds.

Short- and Long-Dated Municipal Bonds are Attractively Valued

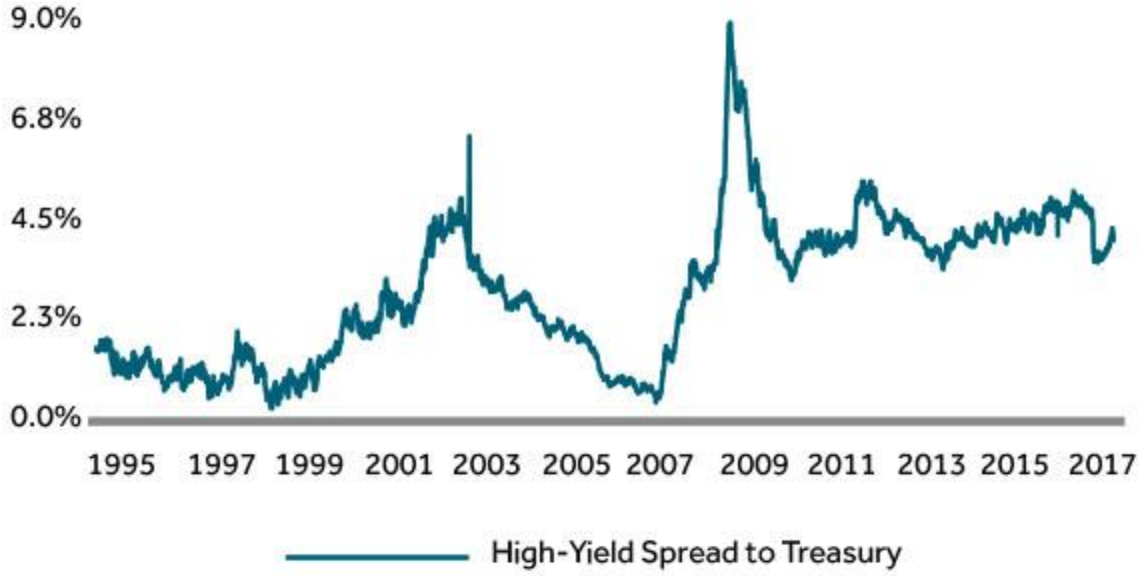
Years to Maturity	Municipal Yield	Treasury Yield	Municipal / Treasury Ratio	Valuation
2	1.09%	1.19%	92%	Attractive
5	1.66%	1.90%	87%	Average
10	2.38%	2.42%	99%	Attractive
30	3.18%	3.02%	105%	Attractive

Source: Bloomberg, as of 2/17/17. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index. Yield is the coupon amount of a bond divided by its price. It shows the return an investor receives on a bond. The municipal/Treasury ratio compares the yield of municipal bonds to U.S. Treasurys. Bond valuation is the act of evaluating certain aspects of a bond, like interest rate, yield, and maturity date, to determine the fair value of the bond. The Treasury yield is based on the Treasury yield curve. The municipal bond yield is calculated by the Municipal Market Monitor for various maturities along the calculated curve. The curve is a baseline curve for tax-exempt municipal bonds. It is populated with high-quality municipal bonds, with an average rating of AAA from Moody's and S&P.

Location: Along the Credit Spectrum

Dowden was quick to acknowledge that high-yield municipal bond spreads have contracted early this year (see chart). But, they've only partially reversed the spread widening that took place last year, leaving potentially more room for spreads to narrow further, as the economy grows, ratings are upgraded, and the Fed raises rates in 2017. Historically, lower-rated, revenue-backed bonds have outperformed general obligation and higher-quality bonds in rising-rate environments. The team recommends being overweight high-yield municipal bonds in their asset allocation framework.

BB-Rated Municipal Bonds Have Retraced Only Part of Last Year's Spread Widening



Source: Thomson Reuters DataStream, as of 2/21/17. Credit Ratings: S&P rates borrowers on a scale from AAA to D. AAA through BBB represent investment grade, while BB through D represent non-investment grade. Moody's rates borrowers on a scale from Aaa through C. Aaa through Baa3 represent investment grade, while Ba1 through C represent non-investment grade. Past performance is no guarantee of future results.

Duration Band

Although the team makes many active choices, the duration of their strategies stays the course. The team maintains a duration posture of staying within a band around its benchmark. Highly liquid hedges are used, as needed, to stay within the targeted duration band.

Thoughts on Liquidity and Fluctuating Prices

An easing of the regulatory and oversight burden currently imposed on the finance industry leaves Dowden and the team expecting liquidity in the marketplace to improve in 2017, but to do so unevenly. Preferences by banking institutions should favor issues rated by at least one agency, while unrated issues face liquidity challenges. In addition, the uncertainties caused by new legislation at the federal level could cause periodic price fluctuations across different sectors.

We believe that experienced investment teams with a disciplined understanding of their market are in a favorable position to identify value in volatile markets, manage risk, and generate attractive returns.

Parting Thoughts

For investors seeking after-tax income, the municipal bond market continues to offer a robust opportunity set. Like the case of real estate, location matters.

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.

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