Asset Allocation Change: Increasing High Yield Municipal Exposure

November was the worst month for municipal bonds since September 2008, with the Bloomberg Barclays Municipal Bond Index down -3.73%. As lower-rated credits underperformed higher-rated ones within the market place, MacKay Municipal Managers™ was quick to use this opportunity to reposition their portfolios. We spoke with John Loffredo, Co-Head of MacKay Municipal Managers™, to get his thoughts on the market.

Increasing High-Yield Exposure to 40% from 25%

President-elect Donald Trump's victory on November 8 surprised investors. Yields were already rising on the heels of significant issuance in the month of October, but the election outcome triggered a reassessment of growth, inflation, and tax assumptions by investors that ultimately exposed liquidity fault lines in the municipal bond market. During this recent cycle, the yields on higher-yielding issues rose far more than those of higher quality names.

To put it into perspective, in the past four weeks, the spread between the AAA and BBB indices has widened considerably; a value proposition John and the team finds compelling. As a reminder, the default rate in BBB municipal bonds is actually lower than that of AAA corporate credits (see Figure 1). What's more, approximately half of the high yield municipal bond market is BBB-rated.

Figure 1 – BBB Municipal Bonds have had Lower Default Rates than AAA Corporates

Cumulative Historical Default Rates (%)

	Moody's[1]		S&P	
	Municipal	Corporate	Municipal[2]	Corporate[3]
Aaa/AAA	0.00	0.40	0.00	0.86
Aa/AA	0.02	0.81	0.03	1.09
A/A	0.07	2.31	0.11	1.95
Baa/BBB	0.38	4.03	0.45	4.64
Ba/BB	4.24	16.45	4.73	15.27
B/B	17.88	39.28	11.77	27.46
Caa-C/CCC-C	26.03	48.03	38.49	55.84
Investment Grade	0.09	2.45	0.15	2.72
Non-Investment Grade	8.18	29.42	8.96	24.17

1. Moody's Investors Service – U.S. Municipal Bond Defaults and Recoveries, 1970-2015.
2. S&P – U.S. Public Finance Cumulative Average Obligor Default Rates, 1986-2015 (10-year average cumulative default rates).
3. S&P – U.S. Corporate Average Cumulative Default Rates, 1981-2015 (10-year average cumulative default rates).

Credit Rating: 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.

The team used the opportunity to increase their recommended, base case allocation from 25% high yield to 40%; reducing the exposure to investment grade bonds from 75% to 60%. The change actually brings this recommended allocation back to a time when the spread between AAA- and BBB- rated bonds was at a similar level to today.

Well Positioned to Navigate and Capitalize

MacKay Municipal Managers was well positioned during the latest liquidity skirmish because (i) they don't use leverage or own entire issues, (ii) they limit their exposure in non-rated bonds, and (iii) they maintain cash on hand to quickly seize opportunities. Thus, they were able to provide liquidity when the price for it became dear.

They were also able to move swiftly because of their research capabilities. While evaluating investment-grade general obligation bonds takes time, as each state is different, there is somewhat of a standard procedure.

By contrast, evaluating revenue bonds - which are more prevalent in the high-yield market – has more variables and complexity involved, including a deep understanding of the cash flows and terms relating to each issue. A research team like MacKay Municipal Managers™ that is organized by sector across the investment-grade and high-yield market may be in a well-informed position to evaluate relative value across a sector's credit spectrum.

Favoring Longer-Dated Maturities

In recent weeks, the yield curve has not only moved higher, but also steepened because longer-maturity bond yields have risen more than shorter-maturity yields. As a result, John and the team now see more value in longer-dated issues. This view comes about from a value-based approach rather than a yield-seeking one. The nearby chart illustrates the ratio of municipal bond yields to Treasury yields at during maturities along the yield curve (see Figure 2).

Figure 2 – Municipal Bonds are Attractively Valued Relative to Treasury Securities

Years to Maturity	Municipal Yield	Treasury Yield	Municipal / Treasury Ratio	Valuation
5	1.77%	1.80%	98%	Attractive
10	2.29%	2.35%	97%	Attractive
30	3.07%	3.03%	101%	Attractive

Source: TM3 Data – Municipal Market Monitor, 12/7/2016. 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.

Duration

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.

Better Technicals Ahead

As we have pointed out previously, weak technical conditions in October often provide a favorable entry point for long-term investors. In 2016, the surprising election results appear to have shifted the seasonal timing by a month or so, according to John and company. Of note: in December approximately $40 billion of purchasing power should enter the municipal bond market via coupon payments ($14 billion), maturities ($13 billion), and refinancing ($14 billion). The team believes a similar amount of capital will look to reinvest in the municipal market in January as well.

What's more, historically, both investment-grade and high-yield municipal bonds have performed well following periods of stress (see below). Past performance is no guarantee of future results.

Figure 3 — 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 (11/08-10/10)	Meredith Whitney (MW) (11/10-01/11)	Post MW (02/11-01/13)	Fed/Detroit (05/13-08/13)	Post Fed/Detroit (09/13-12/15)	Market Selloff/Election (10/16-11/16)
Investment Grade Munis	-5.66%	22.43%	-4.61%	19.58%	-6.21%	15.45%	-4.74%
High Yield Munis	-13.95%	30.41%	-5.48%	31.96%	-10.7%	19.18%	-7.12%
Treasurys (5-7 yrs)	1.00%	18.46%	-3.35%	12.97%	-4.83%	7.11%	-3.73%
Excess Return (IG Muni)	*-6.66%*	*3.97%*	*-1.26%*	*6.61%*	*-1.39%*	*8.34%*	*-1.01%*
Excess Return (HY Muni)	*-14.95%*	*11.95%*	*-2.13%*	*18.99%*	*-5.88%*	*12.07%*	*-3.39%*

Source: Barclays 11/30/16. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index. 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.

Thoughts on Liquidity

We expect liquidity in the marketplace to remain front and center from a regulatory point of view. Experienced investment teams with a disciplined understanding of the issue may be in a favorable position to separate return from risk when the price (or "premia") for liquidity rises and falls from time to time.

Parting Thoughts

For investors seeking after-tax income, the municipal bond market continues to offer a robust opportunity set.

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.