INSIGHTS & PERSPECTIVES

from MacKay Municipal Managers™

JULY 2016

2016 Municipal Bond Market Insights — Mid-Year Update

MacKay Municipal Managers™ employs a relative value investment approach across all of their municipal strategies, with a focus on total return. The team seeks to capitalize on opportunities created by the mispricing of securities and will move along the credit curve based on where they find the best relative value. In doing so, an emphasis is placed on risk management. The team's active research-driven process and keen emphasis on risk control may benefit investors seeking attractive tax-free income.

Top Five Municipal Market Insights for 2016 — "Liquidity Wars"

Theme	Rationale	Portfolio in Action	Mid-Year Status
1. Market disruptions likely — both the probability and severity will be elevated	Active management of municipal assets will be essential, as we expect market volatility to rise. We believe uncertainty tied to the timing and degree of the Federal Reserve Board's policy adjustments will cause disruptions along the yield curve. Global economic conditions will likely blur the outlook in the United States and further contribute to market dislocations. In our view, selected credit events in the municipal market, while anticipated, will generate incremental volatility.	With market disruptions likely to continue, an active approach is employed to navigate and capitalize on opportunities that volatility may bring. While not immune to volatility, MacKay Municipal Managers believes maintaining liquidity at the portfolio level where possible (no leverage, liquid names, some mutual fund cash) mitigates the risk of forced selling and, by contrast, creates an opportunity to actively capitalize on market mispricings	**On Target:** The year began with heightened market volatility in January and February of 2016. Consensus views of future rate moves have been fluid and inconsistent this year, due to mixed economic data. The Brexit referendum lifted economic uncertainty further, perpetuating volatility in global markets.
2. Market technicals to drive returns — technical conditions to play a greater role	We believe supply, demand, and bond structure will impact returns to a much greater degree than in the recent past. We expect the municipal market to feel the effects of technical conditions in other markets, as investors react to changing conditions across their entire portfolios.	To position the portfolios for these favorable market technicals, the team has maintained a constructive view and overweight position in the lower investment grade and high-yield segment of the market. At the same time, having a longer bias to capitalize on a steep yield curve has been an integral part of the portfolios we manage. With the strong performance seen on the long end and in credit, the team has taken a slightly defensive posture by increasing credit quality on the margin and moving down the yield curve slightly, with added focus 10 to 20- year maturities.	**On Target:** We believe technical factors have played a heightened role in driving returns in 2016 Demand in the municipal market has been significant with year-to-date mutual fund inflows of $33 billion through June.(1) So far this year, there has been $ 221 billion in new issuance through June, 2016, 60% of that new issuance represents refinancings and advanced refundings in our market. (2)

1. J.P. Morgan Municipal Research sourcing Lipper U.S. Fund Flows – Year to Date, as of 6/30/2016; Lipper, A Thomson Reuters Company. Lipper data and information are for informational purposes only, and do not constitute investment advice or an offer to sell or the solicitation of an offer to buy any security of any entity in any jurisdiction. In addition, Lipper, a Thomson Reuters company, will not be liable for any loss or damage resulting from information obtained from Lipper or any of its affiliates
2. Barclays Municipal Strategy Monthly – June, 2016

Top Five Municipal Market Insights for 2016 — "Liquidity Wars", Continued

Theme	Rationale	Portfolio in Action	Mid-Year Status
3. Revenue bonds outperform — defined revenue streams preferred over pension uncertainty	We believe investor preference will gravitate to the well-defined cash flow streams securing bonds and away from general obligation debt. Pension issues will likely continue to cause uncertainty over the fiscal health of general obligation issuers. New Governmental Accounting Standards Board reporting standards may reveal that state and local governments, even those that have previously addressed their pension issues, still face risks or remain underfunded.	We have an increased allocation to revenue bonds as the team believes the market would favor bonds with well-defined cashflow streams. At the same time, deep credit research and market analysis selectively drives exposures within the general obligation segment of the municipal market.	**On Target:** Through June, the revenue bond segment of the Barclays Municipal Bond Index returned 4.82%, outperforming the general obligation segment by 86 basis points, which returned 3.96% during the same period. Through June, the Barclays Municipal Bond Index returned 4.33%.
4. Transportation sector outperforms — spending and usage to increase	The 2015 Federal Transportation Bill provides five years of funding for much needed infrastructure programs. Election year positioning should motivate Congressional support for legislation that promotes job-heavy projects. In addition, we believe continued economic growth and low energy prices will lead to higher usage of toll roads, airports, and other port facilities.	Consistent with our theme related to revenue bonds, we have an increased allocation to the transportation sector, as the team believes lower energy prices pave the way for higher usage fees related to toll roads, airports, and other port facilities.	**On Target:** Through June, the transportation segment (a sector within the Barclays Municipal Bond Index) returned 4.95%, outperforming the Barclays Municipal Bond Index by 62 basis points, which returned 4.33%.
5. High-yield municipals to SPRING ahead, but then investors should FALL back to investment grade	We believe high-yield municipal bonds should outperform during the first half of the year, as investor demand for yield continues. However, in the latter part of the year, we believe investment grade should outperform, as the flattening yield curve causes refundings to accelerate. Active management will be essential to capturing the performance in the relative-value shift.	For some time MacKay Municipal Managers recommended a 70% allocation to investment grade and 30% to high-yield municipals, as a starting point for the average moderate investor. This represented a constructive view on high-yield municipals since an 80% investment-grade/20% high-yield allocation indicates the team's neutral position. In light of strong performance within the high-yield segment of the market, the base case allocation has been revised to 75% investment grade/25% high yield, an increase in credit quality while maintaining a constructive view on high yield.	**On Target:** Through June the Barclay's High Yield Municipal Bond Index has returned 7.98%, outperforming the Barclays Municipal Bond Index by 365 basis points, which as returned 4.33%.

Barclays Municipal Bond Index

Rules-based, market-value-weighted index engineered for the long-term tax-exempt 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: 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, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark. The index has four main sectors: general obligation bonds, revenue bonds, insured bonds (including all insured bonds with a Aaa/AAA rating), and prerefunded bonds. Most of the index has historical data to January 1980. In addition, subindices have been create based on maturity, state, sector, quality, and revenue source, with inception dates later than January 1980.

Barclays High Yield Municipal Bond Index

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.