INSIGHTS & PERSPECTIVES
from MacKay Municipal Managers™

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Market Insights for 2017 — Rebuilding America[1]

New federal legislation expected to be proposed in 2017 that, if implemented, could impact the municipal market include: tax reform, repatriation of corporate taxes, student loan financing, deregulation of corporate actions, and healthcare reform. Uncertainty regarding these changes and the resulting impact on state and local governments could delay the budget processes, capital projects and debt issuance of many municipalities. State and local governments with strong budget controls, long term capital planning processes and accumulated reserves will remain strong during this time. We believe that value will rise to the top in this uncertain market. With these uncertainties in mind, our five annual insights are as follows.

1. **Innovative Financing Accelerates**
   We believe Public-Private Partnerships (P3) projects, a popular infrastructure financing structure outside of the U.S., will gain increasing momentum. The faster development pace of P3 projects combined with tax credit incentives will align well with the new administration's infrastructure development agenda. While P3 financing may displace some traditional tax-exempt issuance, we believe that the acceptance of P3 projects will be a net positive for additional two-way flow in the municipal market. P3 projects should introduce a multitude of new entrants including private equity, developers and non-traditional buyers to the municipal market. We expect that these entities will be enticed by municipal financing attributes including attractive yields (for both borrower and lender), exposure to long duration, low correlation, cash flow stability and low default rates.

2. **Liquidity Improves in the Municipal Market**
   We believe federal regulations and oversight of U.S. banking institutions will ease. As a result, we expect these entities will increase the amount of capital committed to trading activities including the municipal bond market. However, we anticipate that a greater awareness of liquidity and capital costs will motivate those institutions to show greater preference for bonds rated by at least one rating agency. Therefore, we believe that the liquidity of non-rated municipal bonds will continue to decline.

3. **High Tax States Outperform**
   We believe states with high income tax rates will outperform states with marginal to zero income tax. As federal tax rates are reduced, we expect municipal investors to become more keenly aware of the benefit of double exemption. We believe that demand for bonds in high income tax states will be even greater for those fiscally responsible state and local issuers that have maintained their credit strength. Outperformance of states benefiting from population growth momentum and underlying economic stability should protect investors against possible volatility from both legislative and market uncertainty.

4. **Municipals Outperform Treasuries and Lower Rated Credit Outperforms Investment Grade**
   We believe municipal to treasury yield ratios will decline during 2017 as tax policy uncertainty subsides. The relative value of municipal bonds, when compared to the taxable market, will move back to more normal historical levels. We expect that this outperformance will provide municipal bond investors with an offset against any negative impact of federal income tax rate reductions. Additionally, spread widening in the fourth quarter of 2016 in the BBB and lower rated categories offers investors tremendous yield and potential total return opportunities in an uncertain market where rates will likely be more volatile. Historically, lower rated revenue backed bonds have outperformed general obligation and higher quality bonds in rising rate environments as underlying fundamentals improve, spreads tighten and ratings are upgraded.

5. **Alpha Generation from Active Trading and Timely Execution**
   We believe the uncertainties of new legislation at the federal level will cause swings in perceived value across many sectors, especially healthcare and education. As such, we believe that security selection and buy/sell execution will be key to outperforming. In these types of markets, a nimble active management style should be better positioned to generate strong relative performance. Investors employing a buy & hold strategy or investments in funds that have become too large to maneuver effectively will not be able to adequately adjust to the market changes and may underperform in our view.

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