MACKAY SHIELDS

INSIGHTS & PERSPECTIVES
from MacKay Municipal Managers™

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Market Insights for 2016 — LIQUIDITY WARS[1]

Liquidity in the municipal market has changed, and we believe a key to managing municipal portfolios in 2016 is to understand the factors that influence municipal liquidity and to position portfolios accordingly. In 2016, suppressed broker/dealer capital commitment, more aggressive cash flow demands on municipal mutual funds and the credit implications of issuer liquidity will, in our opinion, impact trading behavior. We believe that our approach to managing liquidity in 2016 will create investment opportunities.

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.

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.

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 revenue 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 under funded.

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.

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.

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