Market Insights for 2015: The Year of Transition to Active Management

MacKay Municipal Managers Views and Insights on the Municipal Market for 2015

1. Demand for Municipals Remains High—Institutions Increase Investments and Proprietary Trading Desks Resurface.
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1 Demand for Municipals Remains High—Institutions Increase Investments and Proprietary Trading Desks Resurface.

Rationale: Institutions, such as insurance companies, continue to add municipals to their core portfolios, in search of attractive absolute income. Proprietary trading desks dramatically reduced their capital commitment to munis after 2008; however, we believe favorable market conditions and regulatory developments will result in their gradual return.

Portfolio in Action: While we believe the capital commitment to munis increases on the margin, holding more liquid investment grade and high-yield positions in a less liquid market is key. The team continues to take an active approach while seeking to uncover inefficiencies in a less liquid market

Mid-Year Status: ON TARGET—In 2015, MacKay Municipal Managers has observed institutions, primarily insurance companies, increasing municipal bond exposure in the aggregate range of $6 to $7 billion. Through 7/1/2015, municipal bond funds have experienced net inflows of $8.6 billion.[1]

2 Yield Curve Flattening—High Grade Bonds with Short/Intermediate Maturities Underperform.

Rationale: We expect a flattening yield curve to put pressure on high grade bonds of short to intermediate maturities, so we believe this part of the market should be avoided in 2015. This segment is relatively expensive, and we believe highgrade bonds' higher correlations to Treasurys make them vulnerable to Fed interest-rate hikes.

[1] Source: J.P. Morgan Municipal Research sourcing Lipper U.S. Fund Flows – year-to-date, as of 7/1/2015; 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.

Portfolio in Action: We are underweight AA and AAA-rated municipal bonds in the three-to seven-year maturity range. Our portfolios are structured to be defensive on rates without sacrificing income.We believe this is accomplished by focusing on cushion bonds (high coupon/premium bonds).

Mid-Year Status: MIXED—Lower-rated munis significantly outperformed AA and AAA credits. For example, the Barclays Municipal Bond Index returned 0.11% through June while the BBB-rated segment of the market returned 0.70%. Year-to-date, the yield curve has steepened,rather than flattened. We still believe the yield curve will flatten as the market “prices in” a rise in short-term rates. In the meantime, municipal bonds show value as 10-year and 30-year yield ratios, relative to Treasurys, are 98% and 106%, respectively,as of 6/30/2015.[1]

3 New Bond Issuance Surprises on the Upside—Net New Supply Negative for the Fifth Year in a Row.

Rationale: We expect new issuance to beat consensus, exceeding $375 billion as the U.S. starts to address infrastructure needs. But, we expect net new supply to remain negative for the fifth year in a row, causing the market to shrink. One likely driver of this is refinancing/advance refunding, as issuers lock in cheaper long-term borrowing costs

Portfolio in Action: We believe new bond issuance and increased trading will aid pricing transparency. We are taking an active, credit research-driven approach, which we believe will contribute to our excess returns as the true value of underlying credits materializes.

Mid-Year Status: ON TARGET—New issuance of $220 billion through 6/2015 is on track to exceed $375 billion by the end of 2015. Of the $220 billion in new issuance, 66% represents the refinancing of existing debt. In 2013 and 2014, 52% and 57% of new supply stemmed from refinancing, respectively[2]

4 Return of New Issue Monoline Insurance—Greater Than 10% Penetration Rate for the First Time in Six Years.

Rationale: We expect monoline-insured new issues to exceed 10% for the first time in six years. After the challenges faced by monolines since the credit crisis, many investors are still underweight to insured munis. We expect attractive spreads and improving fundamentals to create opportunities.

Portfolio in Action: We continue to have an overweight position in bonds insured by select monolines and maintain our view that there are relative-value opportunities to uncover through active management. Given recent news coverage of the Puerto Rico debt crisis, we believe that the market continues to underestimate the trading value of select monoline insurers.

Mid-Year Status: ON TARGET— Year-to-date, 6/30/2015, the penetration rate of monoline insurance on the new issue market has risen to 7.5%. For example, in the first six months of 2015, Build America Mutual Assurance Company (BAM) has seen a 56% increase in municipal bond underwriting, based on par value.[3] We believe the monoline insurance penetration rate accelerates as retail investors demand extra protection from unknown pension costs.

5 Tobacco Sector Outperforms—Investors Seek to Maintain Yield as Existing Higher Coupons are Called or Mature.

Rationale: As municipal refinancings take out higher-coupon bonds, we expect investors to look at tobacco settlement bonds to replace income. While the sector will likely experience periods of volatility, we believe its overall return will make it one of the top-performing sectors in 2015.

[1] Source: MacKay Municipal Managers.
[2] Source: Barclays Municipal Strategy Monthly – June 2015.
[3] Source: Build America Mutual Assurance Company (BAM).

Portfolio in Action: We are overweight in certain areas of the tobacco sector and apply deep credit research when identifying valuable bonds at attractive prices. While we believe tobacco will be a top-performing sector in 2015, periodic spread widening in the tobacco sector may occur. Near-term stress in the high-yield municipal market may prompt some funds to reduce overweight positions in tobacco exposures, which could slow down price performance in the asset class.

Mid-Year Status: Through 6/2015, the tobacco segment of the Barclays High Yield Municipal Bond Index has returned 1.63%. During the same period, the Barclays High Yield Municipal Bond Index returned -1.92%,and the Barclays Municipal Bond Index returned 0.11%.