In Uncharted Territory, Leverage Knowledge

Reflecting on 2019, there were few regrets for municipal bond investors as rates approached all-time lows, spreads tightened, and fundamentals generally improved. However, the resulting current conditions place the municipal bond market in uncharted territory and increase municipal investor uncertainty and anxiety. To overcome those concerns, MacKay Municipal Managers believes that prudent planning based on what we know in the present will likely provide our investors with strong relative returns in 2020. We are structuring portfolios by leveraging our knowledge and experience, not duration. While we do not believe that 2019’s municipal performance (Bloomberg Barclays Municipal Bond Index: +7.54%; Bloomberg Barclays High Yield Municipal Bond Index +10.68%) will repeat, we do expect that active management has the potential to enhance performance in 2020. We believe the most prudent strategy for 2020 is security selection based on the key qualities of prospective investments. Whether evaluating investment grade or high yield municipal bonds, we look beyond a stated rating to further assess each bond’s structure, liquidity profile, rate sensitivity, and credit fundamentals. Anticipating the potential for periods of higher volatility, we also place a premium on maintaining liquidity as an essential strategy for capitalizing on the resulting opportunities that may arise. These observations are the foundation for our 2020 five municipal insights.

1. Security selection and bond structure drive performance

As we begin 2020, municipal credit spreads are tight, the yield curve is relatively flat, and absolute yields are low. We believe the tax-exempt municipal market will maintain its strong technical and fundamental characteristics versus other fixed income asset classes. However, successful municipal investing in 2020 requires that investors plan, not hope: plan how to generate strong relative returns, not hope for another year of outsized absolute returns. To a large degree, the prospect for excess returns from additional rate declines and market-wide tightening of credit spreads will be limited, so the aggressive strategies of 2019 will leave investors exposed to unnecessary risk if volatility rises in 2020. As a result, we believe that a relative-value based security selection strategy that incorporates rebalancing credit, reducing exposure to the long end of the market and favoring 4% and higher coupon structures will likely lead to outperformance.

2. Tactically positioning portfolios when volatility rises can reward investors

We believe that an ongoing low rate environment, monetary policy on hold and a mixed economic outlook point to coupon-dominant performance in 2020. However, the 2020 U.S. Presidential Election, foreign trade and the potential for weaker equity returns may create periods of notable volatility. Given the backdrop of strong technical conditions in the tax-exempt municipal market, prudent professional managers will seek to reward their investors by ‘buying the dips.’ However, it is essential for professional managers to maintain adequate liquidity in preparation for seizing those opportunities and critical that they employ an active trading strategy to subsequently monetize those positions.

3. Strategic underweight exposures likely to drive outperformance in the high yield municipal market. Quality high yield investments will be key as cracks appear.

Signs of distress appearing in certain pockets of the high yield municipal market suggest that poor security selection can lead to underperformance. Therefore, we believe a focus on avoiding losers rather than stretching for winners will be the more successful strategy to investing in high yield municipal bonds. In 2020, prudent high yield municipal investors will likely focus on quality income and avoid leveraged or speculative income.
Taxable municipal refunding trend leaves the weak behind

Although interest rate dependent, we expect that the 2019 surge in taxable municipal issuance to re-finance higher coupon tax-exempt debt will continue in 2020. This anticipated growth in the taxable segment of the municipal market should give it the size and scope to warrant inclusion in investor portfolios. A continuation of this issuance pattern would result in smaller, less sophisticated issuers being denied access to this re-financing activity, as the taxable market favors larger issuers of generally higher credit quality. We expect that taxable refunding activity will support supply-related technical conditions in the tax-exempt market, which will contribute to the overall market’s relative performance strength. The combination of reduced supply pressure, ongoing strong demand for tax-exempt income and a shift in those credit sensitive sectors dictates even more need for sophisticated, credit research driven investment managers and prudent security selection.

Beware of fleeting income

In 2020, coupon will likely be king but only when the quality of the income source is high. We believe that assertion will hold true in both the investment grade and high yield segments of the municipal market. To protect themselves, municipal investors should select professional guidance based on management style, not distribution rate. Investors should verify that their portfolio income is not reliant on strategies employing hidden leverage, excessive duration, speculative project bets or short call bonds on the verge of retirement. While market conditions in the last number of years were very forgiving with respect to such tactics, a turnaround would bring to light the fragility of those investment approaches.

All investments are subject to market risk, including possible loss of principal.
Municipal bond risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities. Investing in below investment grade securities may carry a greater risk of nonpayment of interest or principal than higher-rated securities.

Past performance is not indicative of future results. It is not possible to invest directly into an index.

Source: Bloomberg Barclays Municipal Bond Index is considered representative of the broad market for investment-grade tax-exempt bonds with a maturity of at least one year. Bonds subject to the alternative minimum tax or with floating or zero coupons are excluded. Bloomberg Barclays High Yield Municipal Index is an 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 Index results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

Active management is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund’s portfolio. Active management strategies typically have higher fees than passive management.

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