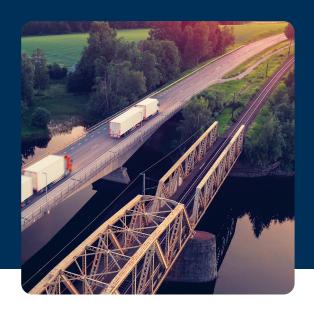
The old normal is back.

Prepare for it with meaningful municipal allocations.



MacKay Municipal Managers™

- Traditional tax-exemption persists, and we believe it's as attractive as ever
- 2 Capitalizing on the supply wave will require seizing initiative in multiple ways
- 3 Selection comes to the fore of the investment-grade market
- The high yield market is likely to outperform investment grades again, despite historically tight spreads
- The front end of the municipal yield curve should outperform cash-like instruments

At MacKay Municipal Managers, we believe 2025 will be a year of getting "back to normal" for the municipal market. We expect the market to provide, for the first time in several years, an orderly atmosphere leading to investor confidence while still offering compelling tax-equivalent yields. This return to normalcy arrives at a fortuitous moment. After the rapid expansion of other asset classes over recent years, much of the investor community finds itself underexposed to the municipal market; household investments in municipals declined by 2% compared to five years ago while their investments in Treasuries and equities are up 75% and 87% respectively. As a result, it is our view that the investor community is now in need of reallocation into municipals in order to take advantage of historically higher tax-exempt yields.



This team will pursue channels that are likely to be overlooked by a market fixated on the robust new issuance pipeline² by:

- Allocating core investments to borrowers who, in our view are emerging successfully from the era of pandemic aid;
- Using research-driven judiciousness to buy with conviction in the high yield market; and
- Reallocating cash into the shorter segment of the yield curve where we see opportunity for better performance

These are the best ways, in our view, to gainfully embrace this "new normal" market.

1

Traditional tax-exemption persists, and we believe it's as attractive as ever

As the federal government battles a budget deficit, some think the traditional tax exemption of municipal bond income could become a casualty. But at a 2024 cost of just \$33 billion,³ it is a small line item compared to the \$1.8 trillion deficit. Noise around this question will persist, but given the exemption's entrenched support in Washington and its purpose toward financing America's \$3.7 trillion deficiency in infrastructure investment,⁴ we believe that Congress will

determine the usefulness of the exemption far outweighs its cost. With the continuation of this benefit, our opinion is that the investor community has an opportunity to correct their underweight exposure to municipals. The current market offers attractive tax-equivalent yields, which can act as a ballast to portfolios against risk assets such as equities, while capitalizing on a buyers' market stemming from a projected surplus of issuance.⁵

2

Capitalizing on the supply wave will require seizing initiative in multiple ways

Many forecasters⁶ have insisted that record levels of new bond issuance in 2024 appear likely to continue in 2025, especially in the first half of the year as the future of tax-exempt interest generates noise in federal budget negotiations. We agree with these issuance forecasts and welcome such a scenario because we expect that an especially heavy calendar of new deals would garner investor attention and cashflow. This would potentially leave esoteric deals, private offerings, and secondary

market inefficiencies to fly under the radar. We believe, active and flexible investment managers have the opportunity to explore certain advantages in this environment by using those overlooked opportunities to allocate to favored credits and sectors, but doing so will require creativity and diligence. Managers who do not purposefully tread outside the well-beaten paths, even if they are equipped to do so, may not reap the same rewards.

3 Selection comes to the fore of the investment-grade market

We believe, state and local governments will return to a more normal budget environment as federal aid winds down. It is our view that this will create a bifurcation between municipal borrowers which spent that money prudently, and those which will face financial headwinds. We expect state and local political and fiscal tensions to resume in this environment, creating volatility and potential opportunity. As the pace of rating upgrades is likely to slow, identifying opportunities will require a depth of experience, thorough understanding of borrower financials, and relationships with issuer management teams in order to separate the wheat

from the chaff. We believe that research-driven active managers will achieve that understanding before the average investor and will be able to allocate capital accordingly. We see this as an opportunity for alpha. Additionally, we anticipate favorable performance arising from the prepaid gas and housing sectors. In 2024, both sectors saw spreads widen to between +100 bps to +140 bps over the AAA scale⁷ due primarily to technical factors. We expect those technical factors to continue in 2025, which would provide an attractive pair of areas for allocation.

4

The high yield market is likely to outperform investment grades again, despite historically tight spreads

While we expect certain issuers to face inflection points in their credit cycles, the overall quality of the high yield sector at large remains strong thanks to the health-giving effects of economic growth. At the same time, below-investment grade debt has received a meager share of the boom in new municipal bond supply. These two trends have combined to squeeze high yield spreads down to some of their lowest historical levels. While this spread compression leaves less room for outperformance, we expect the strong credit

fundamentals to continue and new issue supply to remain dominated by investment-grade issuers. We believe this should keep a lid on high yield spreads in 2025 and allow the sector to benefit from yield-driven outperformance. When allocating into this strength, it is our view that managers must use a research-driven approach to avoid the temptation of reaching for poorly secured deals with far greater risk, which has enticed some investors in the past but is counterproductive to long-term returns.

5

The front end of the municipal yield curve should outperform cash-like instruments

As the Federal Reserve considers normalizing its interest rate policy through cuts to the Federal Funds rate, the savings deposits and money market funds in which American households are currently holding \$14 trillion⁹ may not be able to offer the incomes they produced in 2023 and 2024. This applies to both taxable and tax-exempt products. Yet, we believe reallocating those assets from cash products into bonds does not necessarily require

adding undue risk. Returns from short-term municipal bond funds are generally much less sensitive to changes in interest rates than long-duration products while still offering the same tax-exemption and high credit quality. We believe short municipal funds will outperform cash products this year, and investors may wish to consider rotating into those funds early enough to outpace what could be a large wave of demand.

Explore in-depth insights, updates, and recommended allocations at muni360.com.

- 1, 9. According to Federal Reserve data, as of December 2024
- 2, 5, 6. According to Lerner, J. Threats to tax-exemption the X factor in 2025 issuance projections, Bond Buyer, as of December 2024
- 3. Estimated by the Joint Committee on Taxation, as of December 2023
- 4. According to the American Society of Civil Engineers' Report Card for America's Infrastructure, as of May 2024
- 7, 8. According to Municipal Market Data (MMD), as of December 2024

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