# Bond Case Briefs

*Municipal Finance Law Since 1971*

---

## Tax Revenue Is Rising With Inflation. That's Good for Munis.

- **Credit for some munis could improve from bigger tax hauls**
- **Firm promotes active trading stance amid market slide**

Inflation might not be all that bad for municipal bonds.

State and local debt has already posted a 0.9% loss since the start of the year amid speculation the Federal Reserve could raise interest rates as soon as March to combat inflation.

However, munis can offer a hedge against rising prices because their credit quality could actually improve as a result of it, according to MacKay Municipal Managers.

In a report released Thursday, MacKay Shields' municipal-bond team noted that higher price pressures can mean municipalities are collecting more in taxes that support bond repayment. For example, toll road operators often adjust their debt service coverage levels to inflation as part of their bond covenants.

As a result, John Loffredo, co-head of MacKay Municipal Managers, said his team is looking to increase exposure to sectors that will see their revenues benefit from inflation, such as bonds backed by excise taxes.

To be sure, rising prices and interest rates still pose a risk to the overall municipal bond market. But the firm's stance is illustrative of the way asset management companies are looking to navigate a less rosy outlook for munis in 2022.

"We cannot sit still and wait for the market to perform," said Loffredo, who's expecting the market index to be flat or slightly down in 2022. "To make a positive return, you're going to have to be very active."

Among the the greater threats from rising interest rates will be the hit to low-coupon bonds, which the firm is avoiding. Over the past few years, low-coupon bonds have been embraced by investors because they can offer higher yields, but their longer duration can be a risk during rate hikes.

"Structure is going to be important" this year, said Bob DiMella, co-head of MacKay Municipal Managers, adding the biggest query his team gets from clients is about inflation.

Another possible bright spot through at least the first half of the year could be high-yield municipals, which the firm has an overweight position on.

The high-yield portion of the market will benefit from Puerto Rico's emergence from bankruptcy, given the territory is in the "ninth inning" of its restructuring, Loffredo said.

Once the territory begins repaying its bonds again, the asset class could see strong demand from investors, which will support performance.

“The way you create alpha and positive return is the active trading stance that we’re taking,” Loffredo said.

**Bloomberg Markets**

ByAmanda Albright

January 13, 2022, 5:30 AM PST