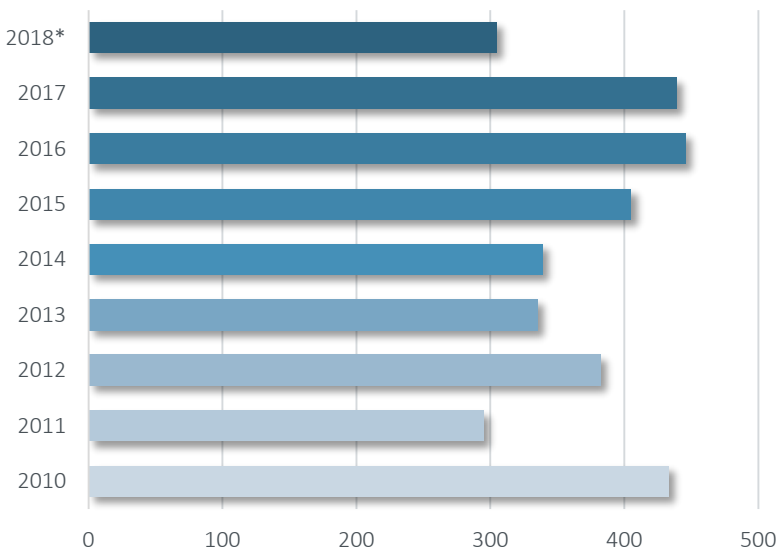


1 | Tax Reform on the 2018 Bond Business



Annual Municipal Issuance¹



The impact of recently passed tax reform on the municipal market will be pronounced - but not as extreme as it could have been. Under the House version, municipal supply could have decreased by as much as 35% in any particular year due to the elimination of both Private Activity Bonds (PABs) and Advance Refunding Bonds. The Senate bill, slightly less severe, pushed to eliminate Advance Refunding Bonds while preserving PABs.

The final version signed by President Trump late December looks more like the Senate’s version as it preserved PABs but eliminated Advance Refunding Bonds. This change is significant and is still likely to decrease supply by as much as 15% to 25% in any particular calendar year. Aside from a decrease in primary market supply, several other items within the bill will have an ongoing impact on the municipal market.

STATE AND LOCAL TAXES (SALT): Tax reform has capped SALT deductions at \$10,000, and as a result, demand for Munis from traditional retail investors in high tax states like California, New York, and New Jersey should increase as middle-to-high income earners will likely seek more tax-exempt income. However, from a credit perspective, we consider capping SALT deductions as negative since it will make future efforts to increase taxes at the state and local levels more burdensome politically.

CORPORATE TAX RATE REDUCTION: The Corporate tax rate will be reduced to 21% from 35%, which should moderately reduce demand for Munis at P&C insurers and banks. The reduction will lower the taxable equivalent yield of Munis for corporations, however this reduction should not prompt mass selling of Munis. Rather, these institutions will most likely let their Muni exposure roll off and should continue to hold some exposure for safety and diversification purposes.

REDUCED INDIVIDUAL TAX RATES: New income tax rates for the highest earners decreased to 37% from 39.6%, with similar reductions for middle-to-upper high income individuals. The marginal reduction should have a minimal impact, and demand for Munis should remain steady from high income earners.

ELIMINATION OF ALTERNATIVE MINIMUM TAX: Reform failed to eliminate the AMT but did increase the threshold for paying the AMT so it will affect fewer tax payers. Bonds subject to the AMT should continue to see yields decrease.

Looking past the actual provisions within the bill, investors must also pay attention to potential side effects. Now that issuers have lost the ability to advance refund bonds (a common cost savings practice in low interest rate environments), the market could begin to see a shift in coupon and redemption provisions. The municipal market has become accustomed to premium 5% coupon bonds with 10-year call options, however, since issuers are losing the ability to advance refund, there could be a push toward coupons at market levels (issuance closer to par) and shorter calls. These bonds can experience increased price volatility and could be more difficult to manage (due to reinvestment challenges). Furthermore, this scenario would likely produce a new slate of supply with much shorter duration characteristics.

For individual investors tax reform has unexpectedly made managing municipal bond accounts more arduous. For one, limited supply will make finding bonds at reasonable prices even more difficult, so access to the primary market through a robust dealer network is even more vital. By the time retail-size bonds hit a dealer’s retail inventory, they are likely to have been marked up to very expensive levels. As issuers attempt to make up for the loss of advance refunding, any shift to lower coupons and/or shorter calls will need to be monitored closely. Further, the difficulty in implementing future tax increases could add additional stress to issuers’ credit profiles over time, making it more difficult to fund pension contributions and other governmental needs. Ongoing credit surveillance and active management will be essential to monitoring and navigating this potentially challenging landscape.

1) Source: SIFMA 1/10/18
 * Expected 2018 Muni Supply
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