MONETA INVESTMENT MONTHLY

What Does Tax Reform Mean for Municipal Bonds?

Late last year, Congress passed and the president signed into law the Tax Cuts and Jobs Act of 2017. Here we examine the key facets of the new law affecting the municipal bond market, supply-and-demand dynamics, and what this means for our clients.

Advance refundings were eliminated

As of December 31, 2017, tax-exempt entities no longer have the ability to issue advance refunding bonds. Historically, advance refundings allowed issuers to refinance certain outstanding tax-free munis to a lower interest rate; the proceeds were used to purchase taxable securities that then made debt service payments on the refunded bonds. In anticipation of the change, many of the planned 2018 advance refundings were pulled into November and December of 2017, leading to a record amount of new issuance in December.

Going forward, we anticipate that the repeal of advance refundings will result in a lower supply of munis, which is likely to put pressure on rates. Refundings made up nearly 25% of all municipal bond issuance in 2017, amounting to nearly $100 billion. Total muni bond issuance in 2017 was around $420 billion, and issuance projections for 2018 are just under $300 billion. PNC has predicted that 2018 will see the lowest municipal bond issuance since 2011. Although these low issuance expectations are not entirely due to the loss of advance refundings, their loss has contributed significantly to those expectations. In addition, we could see new deals structured with earlier or more frequent call dates.

Private Activity Bonds (PABs) are safe

Although tax-exempt PABs were on the tax bill's chopping block, a group of legislators worked together to convince Congress of the benefits of PABs, and the bonds' tax-exempt status was spared. Some minor changes to PABs' structure outlined in the new law could reduce supply, but at this time we believe the effect will be minimal. PAB issuers include airports, utilities and hospitals, which use the bond proceeds to fund projects such as construction and infrastructure repairs.

Corporate tax rates were cut to 21% from 35%

As a result of the lower corporate tax rate, we expect to see less demand for munis from insurance companies and banks—organizations that typically look at the long end of the municipal yield curve. However, the expected lower supply could be offset by this reduction in demand, the net effect being that it could become more difficult to sell longer maturities.

Top individual rates were lowered from 39.5% to 37%

With the top tax bracket still relatively high at 37%—a married couple filing jointly would need to make at least $600,000 annually to be in the highest bracket ***(Display 1)***—municipal bonds remain attractive for high-tax-bracket individuals. The new rate should not have much of an effect on individual muni bond purchasers, however. The tax savings offered by muni bonds are still significant for investors in the 37% bracket, the tax bracket in which most tax-free muni bondholders are categorized.

Display 1

Tax Bracket Changes: Married Taxpayers Filing Jointly

2017		2018	
10%	$0-18,650	10%	$0-19,050
15%	$18,651-75,900	12%	$19,051-77,400
25%	$75,901-153,100	22%	$77,401-165,000
28%	$153,101-233,350	24%	$165,001-315,000
33%	$233,351-416,700	32%	$315,001-400,000
35%	$416,701-470,700	35%	$400,001-600,000
39.6%	$470,701+	37%	$600,000+
Standard deduction:	$12,700	Standard deduction:	$24,000
Personal exemption:	$8,100	Personal exemption:	Eliminated

State and local taxes are capped at $10,000

The law now stipulates that a maximum of $10,000 in state and local taxes may be deducted from federal taxes. The cap should make muni tax benefits even more valuable, especially for investors in high-tax states such as California, New York and New Jersey. Also, as the baby-boomer generation starts taking mandatory annual withdrawals, the tax savings offered by muni bonds could look very enticing. We expect demand for tax-exempt muni bonds in these states to increase.

The takeaway

Overall, we know the tax law change will have some effect on muni bonds' supply-and-demand dynamics ***(Display 2)***. However, it's still too early to tell if there will be enough change in either supply or demand to cause a major change in muni yields.

Display 2

Tax Law Implications for Municipal Bond Supply and Demand

	Demand Effect	Supply Effect
Advance refundings eliminated		↓
Private activity bonds retained		↓
Corporate tax rate reduced	↓	
Individual tax brackets adjusted	↔	
State and local taxes capped	↑	

THE GOOD NEWS IS:

- The municipal bond market's overall health and credit quality remain stable.
- With the top tax bracket still relatively high at 37%, municipal bonds remain attractive for high-tax-bracket individuals.
- Lower supply and reduced demand should make muni bonds more valuable versus U.S. Treasuries. The muni-to-Treasury yield ratio for the 10-year is currently around 85%; we expect that could drop into the 75-80% range.

We do not expect to see significant changes for Moneta clients—many of whom are in the top tax brackets—or a change in demand for munis. Our general rule of thumb is that munis should be considered for investors in the 28% tax bracket or higher.

Our municipal bond investment philosophy revolves around the careful construction of high-quality municipal bond ladders for our clients. To accomplish this, Moneta has established a strict set of parameters for identifying and monitoring municipal bond opportunities. As a result, we will continue to monitor for changes in the market as the new tax law's effects set in.

Rich McDonald, *Director of Fixed Income*