# The Impact of Tax Reform on the Municipal Bond Market in 2018

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By: The Standish Municipal Bond Team

**On December 20, President Trump signed legislation passed by both houses of Congress, enacting the most sweeping changes in the U.S. tax code in 30 years.**

Individual tax rates were lowered marginally with the top rate remaining high at 37%. The state and local tax (SALT) deduction was curtailed with the income and property tax deduction limited to $10,000. Corporations were the biggest winners under the new law, with the corporate tax rate declining from 35% to 21%. The legislation eliminated the exemption for advance refunding bonds (which contributed up to 33% of 2017 total issuance), thereby removing a significant amount of future new bond issue supply.

We believe tax reform should be relatively constructive for our market based on continued demand from individual investors coupled with supply moderating to very manageable levels; however, a decline in corporate demand from banks and property and casualty insurance companies (P&Cs) will be something to closely watch.

**Tax Reform: Municipal Market Implications**

| KEY MUNI MARKET DRIVERS | CURRENT LAW | TAX CUTS AND JOB ACT 2017 | POTENTIAL MARKET IMPACT |
|---|---|---|---|
| **Individual Tax Rates** | 10%, 15%, 25%, 28%, 33%, 35% and 39.6% | 10%, 12%, 22%, 24%, 32%, 35% & 37%; Sunset after 2025 | A lower top tax rate (37%) should not curtail retail investor appetite for tax-exempt munis |
| **Corporate Tax Rate** | 35% | 21% rate starts in 2018 | Banks and P&Cs make up 23% of muni buyer base; lower tax rates will hurt demand but widespread selling not expected |
| **State and Local Tax (SALT) Deductions** | Unlimited deduction for income and property taxes | Income and property tax deduction capped at $10,000 | Impacts high-tax states the most; could boost muni bond demand (i.e., CA, NY) with higher value from "in-state" income exemption; marginal credit negative as it increases cost of living and may drive outmigration |
| **Individual Alternative Minimum Tax (AMT)** | Alternative income tax calculation for high-income taxpayers | Income exemption levels raised, which will reduce overall investors hit with AMT | Positive for AMT bond prices with broader buying base; yield differential vs. non-AMT bonds could decrease |
| **Advanced Refunding Bonds** | A frequently used refinancing technique for issuers to borrow at lower market rates and reduce borrowing costs; averaged 20% total supply | Eliminates tax-exempt advanced refunding issuance | Expect lower gross (estimated 15–20%) and net supply at least in near term; existing pre-re bond universe will run off and benefit from scarcity |
| **Tax Credit Bonds** | Most common with clean renewable energy bonds, qualified energy construction and school construction bonds | Eliminates tax credit bond issuance | A small segment of the overall market; existing bonds may benefit from scarcity value |
| **Private Activity Bonds (PABs)** | PABs are typically issued by airports, hospitals, universities and corporations to finance valuable infrastructure projects; PABs make up approximately 15% to 20% of muni bond market | Preserves tax-exempt status for PABs | PAB demand should be maintained and continued allowance is consistent with the administration's goal of supporting U.S. infrastructure |

Source: Standish, as of January 5, 2018.

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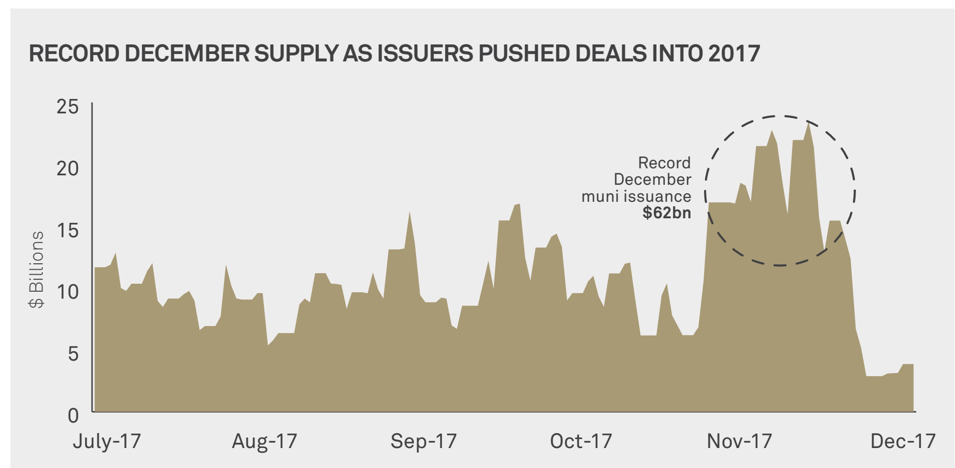
### Future Supply Backdrop Could Be Favorable for Municipal Bonds

During the fourth quarter of 2017, issuers reacted to the elimination of the tax exemption for advanced refunding bonds for 2018 by pushing deals forward into the quarter, resulting in a deluge of supply. Demand, however, stepped up to help absorb this issuance, mitigating the trend towards higher rates. We expect a slower near-term supply pace in January and February and a lower level of annual issuance for 2018. Broker-dealer estimates for 2018 supply range from $275 to $350 billion, and the expected net supply (issuance versus maturities and calls) range from approximately -$30 billion to -$60 billion for the year. Lower supply expectations for 2018 are due to 1) the elimination of tax-exempt advanced refunding bonds which made up around 20% of annual issuance in recent years, and 2) less issuance of private activity bonds for which many deals were underwritten during late November through December of 2017.

A potential upward surprise to new issue supply could be momentum towards infrastructure-related funding spurred on by any progress in Washington D.C. Also, taxable municipal bond issuance could increase above historical levels, as issuers seek alternative financing methods to replace lost access to tax-exempt advanced refunding bonds due to tax reform.



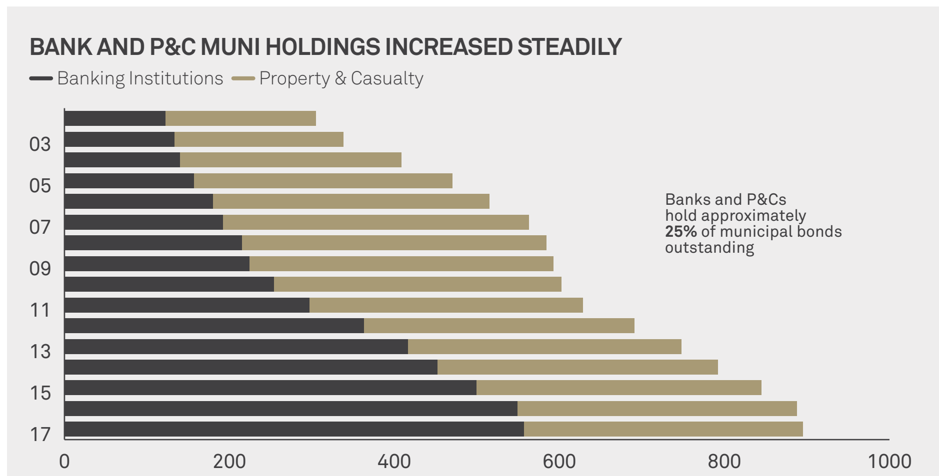

Source: Bloomberg, as of December 31, 2017.

### Individual Tax Rate Declines Are Not Enough to Deter Retail Investors From Buying Munis

Individual tax rates were lowered modestly. However, the top marginal rate remains high at 37%, helping maintain muni bonds as an attractive tax-advantaged vehicle. Demand for muni bonds should continue to benefit, as top marginal tax rates remain high amid a potential scarcity of supply as buyers compete for fewer available bonds.

### Lower Corporate Tax Rate Could Crimp Muni Demand From Banks and P&Cs

The much lower corporate tax rate of 21% could adversely affect bank and P&C demand. Banks and P&Cs could become the marginally less important buyers of municipal bonds as the lower corporate tax rate reduces the tax advantage and incentive to hold muni bonds. Widespread selling of municipal holdings is not expected as the advantages to hold municipal bonds include their high credit quality, historically low volatility and diversification aspects compared to other asset classes. Additional reasons for these corporate entities to maintain their holdings of municipal bonds include book yield and gain/loss considerations.



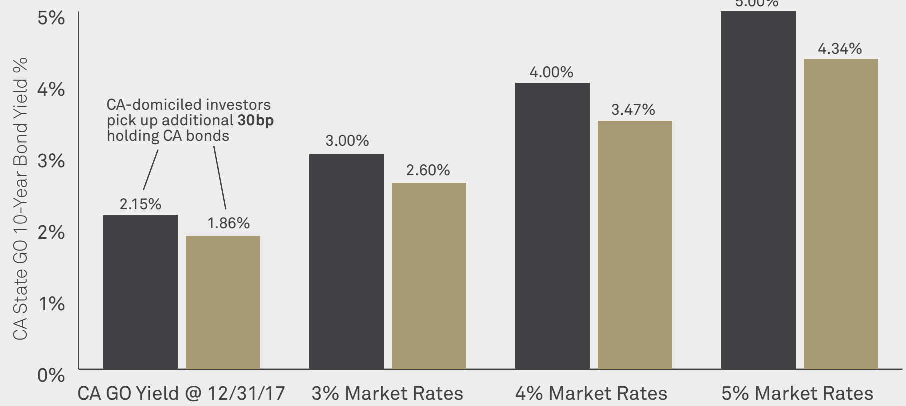

Sources: Federal Reserve Flow of Funds, Standish as of December 7, 2017.

### SALT Deduction Curtailment and Implications for High-Tax States

The SALT deduction was reduced to a $10,000 capped deduction. Our belief is that high-tax states will be the most affected by this change. While we do not expect this tax change to have major ramifications for these states, government officials at both the state and local level may find it politically difficult to raise new revenues via their own tax increases. There is also the possibility that residents may seek tax relief by migrating to other states with lower tax burdens.

We believe this outcome will take longer to play out as there are many variables that prevent people from moving, such as jobs, family and location preference.

We would expect increased demand for municipal bonds in those high-tax states, such as California, New York and New Jersey, where the curtailment of deducting state and local taxes on federal tax returns will have the most significant impact. Tax-exempt municipal bonds issued by and in those states would be a last remaining tax shelter satisfying a general aversion to paying taxes.




Sources: Standish, Bloomberg as of December 31, 2017; 10-year maturity bonds; assumes CA-domiciled investor subject to CA state tax rate of 13.3%.

### Other Credit Implications Resulting From Tax Reform

The $1 million cap on mortgage interest deductions for newly purchased homes could exert some downward pressure on property valuations, especially in high property cost areas of the country. This could have a negative impact on localities that are heavily dependent on property taxes and are unable or unwilling to raise these local taxes. Also, elimination of tax-exempt advanced refundings removes a potential cost-saving tool for most municipal issuers, both tax-backed and revenue-backed. We believe the impact will be minimal as most issuers could likely lower borrowing costs through current refunding transactions.

### Changes in the Individual Alternative Minimum Tax

The individual AMT liability was reduced as the income level exemptions were raised to $1 million for couples and $500,000 for individuals. With fewer individual investors impacted by AMT, spreads for bonds subject to AMT should tighten, as yield premium will decline. A collateral impact from these changes could be less investor demand for AMT-free funds.

### Overall, Tax Reform Supportive With Lower Supply and Stable Demand

The massive scope of the recently enacted changes to the tax code introduces a reasonable degree of uncertainty on its ultimate impact on the tax-exempt municipal bond market. It is our conviction, however, that the tax reform's preservation of relatively high individual tax rates combined with a shrinking pool of available municipal bonds resulting from the elimination of the tax exemption for advanced refunding bonds is supportive of our market. Investors subject to continued high individual tax rates will be competing for fewer additional bonds issued by municipalities. While the significant decline in the corporate tax rate could dampen bank and P&C demand, we do not anticipate material selling to develop from that base of investors. Credit implications from the limitation of the SALT deduction are confined to high local tax states and municipalities; however, we do not expect any major deterioration in their finances or population trends. We believe tax-exempt municipal bonds will continue to deliver relatively attractive after-tax income and returns and will continue to be a high-quality diversifier for an investor's portfolio.

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