Transcript

Better conversations. Better outcomes.

Episode 1.29 – Tax and policy implications for tax-exempt fixed income

President Trump - We're going to undertake one of the great tax reforms and simplifications in American history. It will provide major tax relief for middle income and for most other Americans. There will be a major tax reduction. And all of this does not end to our debt or our deficit --

Ben Jones - Welcome to Better conversations. Better outcomes. presented by BMO Global Asset Management. I'm Ben Jones.

Emily Larsen - And I'm Emily Larson. In each episode, we'll explore topics relevant to today's trusted financial advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide you with actionable ideas designed to improve outcomes for advisors and their clients.

Ben Jones - To access the resources we discuss in today's show or just to learn more about our guests, visit bmogam.com/betterconversations. Again, that's bmogam.com/betterconversations. Thanks for joining us.

Emily Larsen - Before we get started, one quick request - If you have enjoyed the show and found them of value, please take a moment to leave us a rating or a review on iTunes. And, don't forget, we're giving away three signed copies of Dina Renee Weiss' book Ready to Launch. As you may recall, Dina was a guest on our last podcast. To claim your copy, leave us a review on iTunes and we'll announcement winners at the start of our episode on May 31.

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Emily Larsen - Today's episode focuses on a current issue and centers on the US tax-exempt bond market, but you may also get something out of it if you're outside the US. Our topic is focused on how proposed US tax and spending policies may impact tax-free investors in drastic or not so drastic ways.

Ben Jones - Today, our guest is discussing three major areas that his team is investigating in terms of their potential impacts on tax-free fixed income investors.

Rob Wimmel - My name is Rob Wimmel, I am head of municipal fixed income for BMO Global Asset Management.

Ben Jones - Rob is going to take us through each of these major areas of impact. But to recap, they are first, the repeal and replace of the Affordable Care Act, otherwise known as Obamacare. Second, an infrastructure spending bill by the federal government. And third, the recently proposed overhaul of the federal tax code. First, let's do some level setting with context and talk a little bit about how tax-free bonds work.

Rob Wimmel - It's a bond issued by municipalities, cities, villages, school districts, all types of issuers across the United States. And actually, there's about over 30,000 active issuers in the United States. And these issuers and these bonds, this is what pays for your roads, your schools, your municipal facilities. So it's a very important part of the fixed income market in the United States. Now the big draw for municipal bonds is that the interest is exempt from US federal taxes, and in many cases, state taxes as well. So it's a big benefit to retirees and individual investors across the US.

Ben Jones - And one question which I was curious about is, are tax-free fixed income or tax-free bonds kind of US centric, or are there other sovereigns in the world that issue something similar?

Rob Wimmel - There are sovereigns across the world that issue municipal debt. However, the United States is unique as far as the exemption from income taxes at the federal and state level in many cases.

Ben Jones - In general, who are the buyers of municipal debt in the US? Who are the end beneficiaries or clients?

Rob Wimmel - In the US, a good chunk of the holders of municipal bonds are retail, mom and pop. They buy municipal bonds for income and that's what we deliver to them. They hold about 65% to 70% of the bonds in the US. And then after them, the next largest holders would be banks and insurance companies. They hold about 20% to 25% of the US municipal bonds. And there's a good -- it's a $3.8T market, so it's not a small market. And then we have other smaller investors. Even we're starting to see interest from across the world, Japan, with low interest rates there. We're seeing them hold more municipal bonds as well as European entities.

Ben Jones - It was interesting to me because when I think of municipal bonds, I think of wealthy people who want to legally evade or avoid taxes on income that they might receive from all this money they've got stashed away. But I thought I read stat while I was preparing for the interview, that the majority of muni bonds are actually held by people who aren't in the top tax bracket, is that true?

Rob Wimmel - That is true from the studies we've seen. The average holder of municipal bonds is in the 25% to 28% tax bracket. So, much lower than the highest tax bracket, which right now is 39.6%. There are a good chunk, probably 1/3 of the holders are in the upper tax brackets, but your average holder is in a much lower tax bracket.

Ben Jones - So, very much a Main Street instrument.

Rob Wimmel - Yes, yes, without a doubt.

Emily Larsen - Well, this is the first time we've tackled tax reform. It's not the first time we've tackled the topic of tax manage investing. In episode 13, we addressed the topic of tax loss harvesting, another strategy for managing the tax impacts of your client's investment portfolio. The current state of the municipal market has a lot of outside influences, but the fundamentals remain the same.

Ben Jones - Bond math gets kind of tricky and there's a lot of different factors that you use to calculate a yield on a bond. But in no places did I find any place where the tax rate is then calculated into the pricing of the bond. So talk to me a little bit about the impact that tax policies actually do have on municipal bonds.

Rob Wimmel - The main impact that a tax policy would have is when you are tax-exempt, you're going to have lower yields in our market versus taxable markets, like the Treasury market or the corporate markets. But the way to compare on an apples to apples basis, is to look at what we call taxable equivalent yields in the municipal market. And it's very simple calculation. You take the yield of a municipal bond, and you divide it by one minus your tax bracket. So if you're in the 39.6% tax bracket, you take a yield, let's say 2% in the municipal market, and divide it by one minus 0.396, and that'll give you a taxable equivalent yield, and compare that to a Treasury yield or a corporate yield. It's -- you know, we can put that out there in writing as well, but it's as simple as that. Once you do it once, you'll see how easy it is.

Ben Jones - So for everyone, the taxable equivalent yield is a little bit different just based on your situation --

Rob Wimmel - Exactly, exactly.

Ben Jones - With respect to just the general market, before we shift really deep into tax policy, the current taxable to muni ratio versus kind of historic levels, are we issuing debt right now, is it about the same proportionate level as in the past, is it higher and are the durations different? What's kind of the current state of the muni market?

Rob Wimmel - We're fairly neutrally valued right now versus Treasury Bonds and corporate bonds. So the ratios, particularly down the curve where a lot of retail buyers are 15 years and in, the yields are much lower than Treasury Bonds can offer and corporate bonds. But again, take a look at your tax bracket and do that calculation and the taxable equivalent yield, and you can see that municipal bonds will yield more than those instruments after taxes. But, we're not extremely cheap right now. We did get very cheap last fall. And when those opportunities arise, we try to point those out in some of our monthly writings. But right now, there's nothing too unusual about the technicals right now. We are lower in issuance of municipal bonds so far this year. Most of that's due to refunding issuances dropped off dramatically with the higher rates we saw from last year. But other than that, demand is okay. We've seen flows into the broad municipal market improve at the beginning of the year, and now they're kind of flat. But it's good supply is low. Demand isn't outstanding right now, so it's a good balance right now.

Ben Jones - Calculating the tax equivalent yield can help guide your client conversations. To aid you in this, we've built a client guide which you can access in our show notes, at www.bmogam.com/betterconversations. Let's dive into the three potential tax or policy changes that could have implications for tax-free investors. We'll talk about tax reform first, and work our way backward to the Affordable Care Act. We've heard a lot of stuff from citizen Trump, and continuing through President Trump and some of his administration discussing the possibility of kind of reducing or eliminating the tax-exempt status of municipal bonds. Would this significantly change the marketplace?

Rob Wimmel - It would significantly change the marketplace, but the latest we've been hearing on eliminating the tax exemption on municipal bonds, we don't think, and I was just at a conference with a lot of my peers from other big money managers, nobody thinks that they're going to eliminate the tax exemption of municipal bonds and make them fully taxable. It would be a hit to municipal issuers. And they have a strong contingency, governors and local mayors, etc., that they know how needed municipal bonds are for building infrastructure and facilities in the US, so that's not likely to happen. We also don't think lowering the tax exemption to say 28%, for example, which is what President Obama wanted to do at one point and Hillary Clinton also proposed that. We do not think that is going to happen, as well.

Ben Jones - I would imagine you would kind of get in a situation where like you're spiting the constituents. In other words, you make it harder for cities and states to be able to finance the projects that provide services to the people, and it just seems like that might be a really difficult thing to push through.

Rob Wimmel - Yeah, it would -- the mayors are all against it, obviously. The governors are all against it. And ultimately, all you're doing is passing on the increased cost to taxpayers because we'll have to pay the higher yields for issuing municipal bonds if they ever do reduce the tax exemption.

Ben Jones - I didn't ever really think of that angle, but that's absolutely correct.

Rob Wimmel - Mm.

Ben Jones - It ultimately hurts the taxpayer. I didn't actually think about that.

Rob Wimmel - It does, it does in many aspects.

Ben Jones - So, there has been some discussions -- kind of moving on from the elimination. If we don't go down that route, there's been a lot of discussions of lowering corporate tax rates. And I'm just curious what effect the corporate tax rates have on tax-exempt demand because it seems like those two things should be maybe separate in my mind.

Rob Wimmel - Yeah, you would think so and many people do think that. But lowering the corporate tax rate would have the same effect as lowering the individual tax rates. Individuals, like I said, own about 65% to 70% of municipal bonds, but corporations like the banks and insurance companies, again, they own about 20% to 25% of municipal bonds. And if you lower their income taxes, which is why they hold those to avoid interest -- income taxes on the interest of municipal bonds. If you lower that, you're making it less appealing to invest in municipal bonds. But again, I've seen surveys, particularly one from Citigroup that they took a survey of their corporate buyers of municipal bonds. And they said that, even if you go as low as 20% on the corporate tax rate, they are still going to be buyers of municipal bonds. And that's lowering it from 35% to 20%. Now, can they get that -- can the Trump Administration get the corporate tax rate as low as 20%? That would be, we're thinking, as low as they could get it. So for us, it still looks like we're going to have banks and insurance companies interested in buying municipal bonds.

Ben Jones - I want to kind of just talk a little bit about any of those tax policy ramifications are at the federal level. So there's federal tax policy, but are there potential changes at the state level that might also impact -- and I realize there's 50 states, you can't possibly know all of them.

Rob Wimmel - Yeah.

Ben Jones - But are there any big things that you see on the horizon at the state level that might impact some of the muni market?

Rob Wimmel - No, the only trends we've seen at the state level over the past several years is higher tax rates. For example, the City of Chicago, they are in a sticky position, and the State of Illinois, I should say, more broadly. They might be increasing income tax rates. And that would just make certain bonds in the State of Illinois more attractive that are exempt from state income taxes. Other than that, the states are pretty dependent on aid from the federal government. If you cut back any of that aid, it makes it more difficult for states. So, states are in a bit of a sticky position right now with less spending from the federal government. But other than that, no, we don't see a lot of trends in state tax policies.

Ben Jones - Great, so let's shift gears here and talk about all the other factors that you mentioned that you're watching. And this is the -- the two that you mentioned, infrastructure and the Affordable Care Act, really weren't ones that I thought of initially when we started thinking through this topic. But after reading a lot of your writing, I realize these have significant impacts on different market factors. So let's talk first about infrastructure. Trump has proposed this $1T of infrastructure spending. Infrastructure seems to be only the thing that Republicans and Democrats agree on.

Rob Wimmel - Yes, yes.

Ben Jones - So it's likely there will be something, I don't know what. But how would that spending over the next 10 years affect the muni market? And a lot of the talk has been around these public/private partnerships --

Rob Wimmel - Yes.

Ben Jones - Which seems to be kind of in competition with munis.

Rob Wimmel - Exactly.

Ben Jones - Help me walk through that.

Rob Wimmel - First, the biggest fear that investors in the municipal market had is that the market would be flooded with $1T of new tax-exempt bonds. And right now, I don't think there's anything further from the truth than that. First of all, the -- there is no plan for infrastructure spending. It doesn't exist. I've listened to experts talk about planning for infrastructure spending and increased spending, and it will take years to figure out where to spend the dollars. There's over half a dozen committees in Congress that are in charge of various forms of infrastructure spending. There's surface transportation spending, there's air transportation, there's telecommunications, there's energy, and then there's water as well. So, it's going to be a lot to try to get in line, figure out how you're going to pay for it. Nobody has figured that out so far. And that the very conservative Republicans are not going to do deficit spending. And as you mentioned, it doesn't necessary have to be in the form of tax-exempt bonds. There are other forms of bonds, taxable bonds. Maybe you're going to bring up the Build America program. We had that happen in the past. We also had the public/private partnerships, which is where you can have equity incentives for private companies to come in and build and manage say a toll road or a bridge. So it's all up in the air right now. And what we're thinking and what we've been reading is the earliest that they'd even start thinking about this is in 2018. Funding, wouldn’t come for another year after that - 2019. So right now, this is not even out there in our thought process for how we're positioning our funds.

Ben Jones - So not really an immediate impact on the market,

Rob Wimmel - No.

Ben Jones - But certainly something that when it's more closer to an actual plan,

Rob Wimmel – Yes

*Ben Jones - S*omeone would want to evaluate. And I know your team will watch this very closely.

Rob Wimmel - Exactly.

Ben Jones - Talk to me just really quickly. We did issue a lot of Build America Bonds kind of during the financial crisis. Is there still issuance and -- or demand?

Rob Wimmel - There is -- there's no more issuance of the Build America Bonds. That program did end. And the effect of that program was really to take away from tax-exempt bonds. Tax-exempt bonds became more attractive because there was a lot less of the tax-exempt bonds versus the Build America taxable bonds.

Ben Jones - So reduce supply in the marketplace.

Rob Wimmel - Reduce supply in the marketplace. The other thing to keep in mind in the municipal market, there's always taxable issuance. Not everything is tax-exempt. So when you hear us talk about $350B of municipal bonds were issued in a given year, some of that is taxable. But that's not -- it's not really that important to municipal buyers in our market.

Ben Jones - Okay, great. So let's shift gears to your number one item that you're watching, and that is the effects of the Affordable Care Act. Now I have to say, I was a little bit shocked to see this show up as something that really impacts the muni market. And after doing some reading, I realized -- I didn't -- I guess I didn't realize all the municipal hospitals that finance through municipal debt. So for our listeners, just explain how any changes to the Affordable Care Act might impact municipals.

Rob Wimmel - The big benefit to hospitals under the Affordable Care Act and Obamacare was the expansion of Medicaid. So a line item, a revenue line item for hospitals would be uncompensated care, where they take care of somebody that can't pay for it. They're in a poverty level or what have you, and the hospitals don't get reimbursed. Medicaid expansion increased their reimbursement for servicing those individuals. And that helped out hospitals across the country.

Ben Jones - They've increased their revenues.

Rob Wimmel - Definitely increased their revenues. Made their bottom line stronger. What you'll be doing if you repeal and replace Obamacare, is lowering that uncompensated care that they currently get from Medicaid. It'll make them weaker. We're not talking about defaults. We're talking about some downgrades, a notch downgrade, multi-notch downgrade in some cases, for some hospitals that are more dependent on Medicaid for their revenue stream. And it's -- really it's a small amount of hospitals across the US. And our analysts have done a good job keeping us out of those hospitals to begin with, but the few that we found, we got rid of. But right now, it's not even an issue with Obamacare still in place.

Ben Jones - Yeah, I saw recently that Paul Ryan said they're going to bring it back with another bill soon,

Rob Wimmel - Yes.

Ben Jones - But it seems like the issue that's just not going to go away any time in the near future.

Rob Wimmel - Exactly. What it takes to satisfy that block of very conservative Republicans, I don't know what it'll take.

Ben Jones - They're going to either have to reach across the aisle to the left, or really dig deep to the right.

Emily Larsen - Three big policy areas that could have potential implications. In episode seven we interviewed Scott Kimball of TCH on *Fixed income: the way forward*. Scott was just recently featured on the Wall Street Journal Money Beat Podcast. On that podcast Scott spoke about how not only is The Fed doing what they've said they'll do, but they're also starting to address the $4B balance sheet and how the ladder also factors into the handoff of the monetary and fiscal policy. We asked Rob to provide his thoughts from the perspective of the muni bond market.

Ben Jones - So I want to just talk a little bit about interest rates, because that's another external factor that's got to impact the muni market. We've seen interest rates increase already this year, and we expect more rate increases into the future. How does this impact the muni market?

Rob Wimmel - It's interesting, I was taking a look at that to see from 2015, in December of 2015, we had our first FOMC Fed interest rate hike of 25 basis points. We went from 25 basis points on the high end to 50 basis points. Now we've had two more since then. What that's done in the muni market is pushed up short rates. But the long end has actually fallen a bit in the municipal market - so municipal long interest rates are a bit lower than they were back in December of 2015. And that's because inflation, and inflation expectations is really what drives yields on the long end of the fixed income curves in general. And we're not seeing any scares on the inflation side, so you're seeing that flattening of the curve. And a good example of how far short rates have come in the municipal market is, last year about this time on a daily or weekly bond we could get about five basis points of yield. Now we're up to 100 basis points. So a good jump. And if you look at your money market funds right now in the tax-exempt world, they're much higher and much more attractive than they used to be.

Ben Jones - Wow that's a big jump.

Rob Wimmel - A big jump – yes.

*Ben Jones - A*nd that's not a small jump. In bond world that is --

Rob Wimmel - Significant.

Ben Jones - Yeah, a mammoth move.

Rob Wimmel - Especially from what we're used to.

Ben Jones - And so given that there's potentially more interest rate increases, and at the same time inflation seems to be heating up from at least most recent reports, do you see this curve flattening, and is it possible to actually invert?

Rob Wimmel - It happens very rarely. We've only seen the inversion of the municipal curve three or four times over the past 50 years. We're not anywhere close to that, and I don't expect that. Because this is not your typical -- it's not going to be your typical interest rate tightening scenario. In the past when the Fed decided to tighten interest rates, they would tighten 300 basis points over 12 months. Now we've gotten, what over the past year and a half we've gotten 75 basis points. It'll continue this way. It's going to be gradual. It'll be a gradual flattening. I don't expect – I still expect it to be steep for quite some time here. The other thing that I think a lot of people aren't talking about, not only do you have the Fed tightening, but you have the big balance sheet they're sitting on. They're sitting on a good $4T plus of treasury bonds and mortgage related fixed income bonds. And they're only starting now to talk about reducing the balance sheet. That's going to be something that we're going to be keeping a closer eye on. That could definitely have more of an impact than their Fed hikes on particularly the longer end of the market. So that's developing. We'll keep an eye on The Fed and their comments, but something that our investors should be aware of as well.

Emily Larsen - Now that we have a clear understanding of the areas of policy and spending that may have implications for tax-free investors, let's turn our attention to your advisor client relationship.

Ben Jones - Our audience is primarily made up of advisors, and I want to just talk for a minute about some of the challenges that you think advisors are presented with in this current environment for their investors that are looking for tax-exempt income.

Rob Wimmel - Yeah, I think the main challenge right now for advisors is what to do with their investors durations, or do we put them in a long fund, intermediate fund, short, ultra short and money markets. We're a bit cautious right now with all these uncertainties in the municipal market, so we would suggest advisors look for -- if you have a client in the intermediate fund, look for an ultra-short fund and put some of the allocation in an ultra-short fund or a money market fund if you're that concerned about interest rates going up.

Ben Jones - That's great advice. Now, how should advisors think about kind of the exposure itself in meeting the investor's needs? So you talk about shortening up positions or maybe considering blending an ultra-short or short, and an intermediate fund to hit those exposures. But the clients themselves I imagine have some sort of income target or some objective they're trying to hit with their portfolios. How should advisors balance the need for yield and the current market environment?

Rob Wimmel - With the uncertainty we're seeing right now, we're not stretching too far into the yieldier part of the market. When you have problems in the municipal markets, those are the sectors that get hit the hardest the quickest. And you'll see money flow out of municipal high yield funds, for example. And then the spreads on the lower quality BBBs and the nonrated bonds does get quite wide. So, right now we think it's prudent to stay in the higher quality funds. That's one thing we would steer advisors to -- I'm staying in the high quality for now.

Ben Jones - I'm sure there's advisors out there that are having these conversations with their clients, where the client sees something about tax policy on the news, or gets concerned about interest rates, etc. How can advisors have the conversation or even have a better conversation about tax policy and the potential impacts for their tax-free income?

Rob Wimmel - I think in our case, even the professionals, are still struggling with how this is going to play out. We don't think that there will be much impact from potential policy changes over the coming year, but you never know. So I think it's prudent for the advisors to talk to their customers and perhaps guide them to a bit more cautious stance in shortening their duration a bit. So take some of the money out of the long end of the long funds and go down intermediate and short. That's the best advice I think we can give to them right now. When you don't know the policy changes, and you have The Fed in a tightening mode, that perhaps doesn't bode well for the municipal market. But again, we'll see how it plays out.

Ben Jones - Rob pointed out that there's four areas you'll want to keep a close eye on in the year ahead. Now we mentioned three of them before. One, the Affordable Care Act. Two, infrastructure spending. And three is the proposed tax overhaul. But the fourth one is monetary policy. And as Rob points out, in particular, The Fed's balance sheet reduction. Now Rob and his team will keep a close eye on these things as well, and you can follow their thoughts in their monthly municipal insights piece. You can subscribe to that at bmogamviewpoints.com. Now for some parting thoughts from Rob.

Ben Jones - If you could kind of summarize our entire conversation today in one or two sentences, which I know is a heroic task, how would you do it?

Rob Wimmel - Right now I'd say, stay calm and carry on. It's still the only tax-free investment out there. That is not going away. And they will still benefit from the tax exemption on municipal bonds over the next year.

Ben Jones - And if you kind of think about writing your own warning label for this episode, what would it say?

Rob Wimmel - Right now, if -- and there's still a possibility of a global financial scare -- there's a flight to quality and treasury yields go down a lot lower because of the flight to quality, being short you would underperform. But I think there's a low probability of that occurring right now.

Ben Jones - My guest today has been Rob Wimmel from BMO Global Asset Management. Thanks for being part of the show.

Rob Wimmel - Thanks Ben, glad to be here.

Ben Jones - Thanks for listening to Better conversations. Better outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, visit us at bmogam.com/betterconversations.

Emily Larsen - We value listener feedback, and would love to hear what you have thought about today's episode. Or if you're willing to share your own experiences or insights related to today's topic, please e-mail us at betterconversations@bmo.com. And of course, the greatest compliment of all is if you tell your friends and coworkers to subscribe to the show. You can subscribe to our show on iTunes, Google Play, the Stitcher app or your favorite podcast platform. Until next time, I'm Emily Larson.

Ben Jones - And I'm Ben Jones. From all of at BMO Global Asset Management, hoping you have a productive and wonderful week.

Emily Larsen - This show and resources are supported by a talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gipson, Lindsey Blinstrub and Matt Perry. The show is edited and produced by the team at Freedom Podcasting, specifically Jonah Geil-Neufeld and Annie Fassler.