Municipal Insights

Special Report

Tax reform and the municipal fixed income market update

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The normally staid municipal bond market was turned on its ear beginning in early November, as the U.S. Congress began its journey to a revised tax code. The new tax code was passed by both chambers of Congress on December 20th, and has received President Trump's signature. Here are the key takeaways as it relates to the municipal fixed income market.

Elimination of tax-exempt advance refundings, effective January 1, 2018

- Tax-exempt advance refundings will be eliminated. Tax-exempt advance refundings is a tool currently used by issuers to reduce borrowing costs and represents nearly 15% of new issuances historically. This elimination will reduce the supply of municipal bonds. Without the elimination, we anticipated that advance refunding opportunities would have naturally declined because a large portion of debt has already recently been refunded at or near historically low interest rates. Please note, advance refunding bonds issued prior to January 1, 2018, will remain tax-exempt.
- Municipal issuers rushed to market during December 2017 in an attempt to get financing prior to the January 1, 2018 changes. December municipal issuance should come in at approximately $56 billion, the largest December issuance since 1990.
- After the elimination is effective, it is likely issuers will go to market with shorter maturities and/or shorter call features as they adapt to the new tax law. Outstanding long-dated bonds, which typically have 10-year call structures, are likely to outperform comparable bonds with a shorter call period during this adjustment phase.

Individual tax rates do not change substantially, with top marginal tax rate of 37%, and individual Alternative Minimum Tax (AMT) thresholds increased.

- Top marginal individual income tax rates will decline only slightly under the new legislation, decreasing from 39.6% to 37%. We predict retail investor demand should remain high as individuals seek tax-advantaged income in what is still a low interest rate environment
- The income threshold for Individual AMT will increase with the new legislation and is likely to affect fewer individual filers. For joint filers, the exemption increases to $109,400 and the phase-out threshold increases to $1 million.

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State and local taxes (SALT) and mortgage interest are still potentially deductible, but with limits.

- The legislation limits the SALT deduction, including state property taxes, to a maximum of $10,000. Mortgage interest will remain deductible for mortgages less than $750,000.
- Housing prices in high-tax states will potentially be impacted negatively, with some estimates ranging from a 1-3% decline.

Corporate tax rates move to 21%; corporate AMT eliminated.

- The traditional non-retail buyers of municipal securities, such as banks and property/casualty insurance companies, may be less inclined to invest because tax-equivalent yields will be less compelling. On the surface, the decline in investment by this group is potentially negative for the municipal bond market. Any lack of demand from this group is likely to be largely offset by lower overall supply in 2018.
- However, AMT bonds are likely to relatively increase in attractiveness to corporate investors.

Conclusion

Despite the initial volatility in the municipal markets as Congress worked toward its final proposed legislation, the new tax package was far less impactful on the municipal markets than initially feared. The new legislation will eliminate some potential supply, and individual tax rates will remain similar to current law. Investor demand for municipal bonds providing tax-advantaged income should remain high. We anticipate the continued high demand is likely to be a favorable environment for municipal securities' performance in 2018.

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