Municipal Update 12/1/17

Tax Reform and the Muni Tempest

As you may have noticed, municipal bond yields have spiked and prices have fallen over the last couple of weeks. November performance was the worst in a year.

Why is this happening?

Earlier this month the muni market was caught off guard when tax reform proposals introduced in Congress included provisions that prohibit the issuance of certain types of tax-free financing after January 1st, 2018. These include private activity bonds (PAB) and advance refunding bonds. Healthcare bonds and college/university revenue bonds for private (albeit nonprofit) institutions are examples of PAB's. A refunding is essentially a refinancing mechanism that enables a municipality to issue new bonds at a lower rate, offsetting an older outstanding issue and saving on interest cost.

The House bill prohibits both PAB's and refunding issues after January 1st. In the Senate version, only refunding transactions are terminated. In either case, municipalities and other issuers that would be affected by these potential changes are not waiting around for the vote. They are currently rushing to the market with deals to beat the year-end cutoff. New issues that were planned for 2018 are being pulled forward into the present. Visible supply for the next 30 days is the highest it's been in nearly 13 years.

Digesting this unexpected additional volume has been challenging for the market with year-end approaching. As a result, yields have spiked considerably across the curve. On the short end, munis have dramatically underperformed UST's. Daily and weekly variable rate bond yields haven't been this high since December 2008. Muni yields in two years have risen 40-50 basis points since early November. In ten years, AAA rates are up approximately 25 basis points since the introduction of the House tax reform bill early this month.

What's not changing, and what are the positives?

- Municipal bond income will remain tax-free for investors
- Current top federal income tax bracket(s) are likely to stay the same, or very close, which is positive for tax-exempt munis
- Municipal bond interest income will continue to not be subject to the 3.80% Obamacare surtax on investment income
- Possible elimination of the deduction for state and local income tax is likely to create more demand for tax-free income in high-tax states, supporting muni demand

Why does it matter?

Depending on whether the final tax reform bill is closer to the House or Senate version, new issuance going forward from January 1st could be 20%-30% lower. In a technically-driven market like munis, this reduction will be very supportive of performance after tax changes take effect. Not to mention that January 1st is a major rollover date in the muni market, with many bonds maturing or being called.

We appear to be in the midst of a temporarily volatile period, but with a backstop in sight on January 1st. The December municipal market is likely to experience continued heavy issuance, spiking yields and underperformance. We would highly recommend consideration of initiating new municipal bond allocations or adding to existing positions amid the current market disorder.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

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