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U.S. House Tax Bill Would Shake Up Municipal Market Supply and Demand.

CHICAGO/NEW YORK (Reuters) – U.S. tax reform plans are already transforming municipal debt market dynamics, sparking a sharp rally even as details released by Republicans in the U.S. House of Representatives are likely to shift over the coming days and weeks.

Investors are snapping up municipal bonds and driving yields sharply lower because the current plan, unveiled last Thursday, would slash the amount of tax-exempt debt available.

Additionally, the removal of some state and local tax deductions compounds the issue for residents in high-tax states like New York and California, market analysts say.

With potentially new supply/demand dynamics hanging over the market, the yield on top-rated 30-year muni bonds fell 22 basis points in the wake of the plan's release, according to Thomson Reuters Municipal Market Data.

Provisions in the House bill would make so-called specialty state muni bond funds even more attractive for tax reduction purposes, while limiting new issuance largely to borrowings by states and local governments.

Even with changes likely, proposals to end or cap deductions of property and sales taxes from federal taxes and the elimination of tax-exempt status for an array of health care, higher education, housing, infrastructure and refunding bonds have unnerved the $3.8 trillion U.S. municipal market.

John Miller, co-head of fixed income at Nuveen Asset Management, said the House bill as it stands could call into question as much as 40 percent of the market's new supply by making interest earned on certain bonds subject to federal taxation.

Affected debt would include private-activity bonds to fund economic development; revenue bonds sold for non-profit hospitals, colleges, nursing homes and other organizations; housing bonds; and advance refunding bonds that allow issuers to take advantage of lower interest rates before outstanding bonds can be called.

"The market would be less diverse, more (general obligation bond) focused and smaller… a great deal of scarcity and probably less yield," Miller said.

A DEARTH OF REVENUE BONDS

Big unfunded pension liabilities for some states, local governments and school districts, as well as high-profile municipal bankruptcies in Detroit and Puerto Rico, have tarnished the appeal of general obligation bonds backed by a government's full faith and credit pledge.

Chris Dillon, portfolio strategist at T. Rowe Price, said the House bill would eliminate a big pool of non-profit hospital and other revenue bonds that his company prefers.

“If you’re taking right field away from us we’re still going to play baseball, but we prefer to have the full field,” Dillon said.

The House bill retains the 39.6 percent highest individual tax bracket, which is a positive for the market. That and the diminished ability of taxpayers to deduct local taxes would enhance the attractiveness of existing or new muni debt.

Top states for the income and sales tax deductions as a percentage of adjusted gross income are New York, California, Maryland, Connecticut and Oregon, while New Jersey, New Hampshire, Connecticut, New York and Illinois are the tops for property tax deductions, according to Jared Walczak, senior policy analyst at the Tax Foundation.

Most of those states have individual income tax rates of 5 percent or higher and give residents who buy in-state bonds a state tax exemption. As a result, state-specific muni funds would get a boost under the bill.

“In states like New York, New Jersey, California, Massachusetts and some other high-tax states, you’ll see a drift to owning their own state paper,” said John Mousseau, fixed income director at Cumberland Advisors.

On the other hand, the bill’s flat 20 percent business tax rate could make munis less attractive for corporate buyers like banks and property and casualty insurance companies.

”So clearly that will affect their demand to a degree – they will not be buying as much,“ said Barclays analyst Mikhail Foux. ”That’s the bigger negative.”

In the meantime, issuers of bonds that face a potential cut- off of federal tax exemption could fast-track deals, according to Joseph Krist, a partner at Brooklyn-based public finance consulting firm Court Street Group Research.

“I would be really surprised if we did not see a rush to the market between now and the end of the year from issuers who have had any kind of potentially prohibited form of financing,” Krist said.

by Karen Pierog, Laila Kearney

Reporting by Karen Pierog in Chicago and Laila Kearney in New York; Editing by Daniel Bases and Dan Grebler

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