Bond Case Briefs

Municipal Finance Law Since 1971

Muni Market's Trusted Buyers Could Disappear After Tax Cuts.

- **Could leave 'demand hole' for debt maturing in 10 to 17 years**
- **Tax rate drop to 21% from 35% makes munis less attractive**

Banks and insurance companies could once be trusted to scoop up state and local government debt. Now, they could start looking elsewhere to invest.

By cutting the corporate tax rate to 21 percent, tax-exempt municipal bonds could lose their allure to corporate buyers. That could have a major impact on the pricing of the longer-dated bonds these institutions tend to buy, analysts say.

"On a 35 percent tax rate, muni bonds look attractive to a corporation," said Jonathan Mondillo, portfolio manager and head of municipal trading for Alpine Funds, which oversees about $1.3 billion in municipals. "At a 21 percent tax rate, I'm not quite sure they do."

Banking institutions' holdings of municipal securities stood at $584.2 billion in the third quarter of 2017, up from $128.6 billion in 2000, according to Federal Reserve data. Property and casualty and life insurance companies have increasingly added to their muni investments as well, holding $530.2 billion at the end of the third quarter, the data show.

Together, banks and insurance companies held 29 percent of the $3.8 trillion in outstanding municipals in the third quarter, according to the Federal Reserve data.

Less consistent demand from banks could cause increased market volatility and less liquidity, according to a Dec. 17 note by George Friedlander, managing partner at Court Street Group.

While separately managed accounts prefer bonds maturing in less than 10 years and municipal bond funds prefer longer-dated paper, there could be a "demand hole" for securities maturing in 10 to 17 years due to the tax cut, he wrote in the report. In order to entice corporate buyers, yields may need to rise to taxable levels, he added.

To be sure, banks and insurance companies may still be attracted to the diversification and stable credit quality that municipals offer, said Gabriel Diederich, portfolio manager for Wells Fargo Asset Management, which oversees about $41 billion of state and local debt.

And while Congress' tax overhaul has the potential to hurt demand from banks, regulatory changes by lawmakers could offset some of the impact.

Bills in the House and Senate would treat municipal debt as high-quality liquid assets, thereby helping banks meet liquidity rules and providing a potential boon to muni demand, according to Bloomberg Intelligence senior government analyst Nathan Dean.

Sean Carney, head of municipal strategy at BlackRock, said the "psychology" of corporate buyers is still uncertain. It could take months or years to figure out their buying behavior as a result of the tax change, he said.

“We don’t see outright selling, but down the road it will be interesting to see what market corrections it may take to entice them to add,” he said. “That’s the question.”

Bloomberg Markets

By Amanda Albright

December 20, 2017, 12:00 PM PST