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U.S. Muni Market Faces Challenges, Not 'Crisis' With Tax Changes.

CHICAGO (Reuters) – The U.S. municipal bond market emerged bruised but not decimated by the federal tax bill that won final approval in the U.S. Congress on Wednesday, analysts said.

The worst-case scenario of Congress yanking the federal tax exemption for interest earned from debt sold in the $3.8 trillion market used by states, cities, schools and other issuers did not occur. However, some provisions in the bill will pose challenges for munis.

"I don't see the muni market as being in any kind of crisis here," said Philip Fischer, municipal research strategist at Bank of America Merrill Lynch.

The bill sent to President Donald Trump decreases the top individual federal tax rate from 39.6 percent to 37 percent, a level still expected to result in high earners buying munis for their tax-exempt benefits.

However, the drop in the corporate income tax rate to 21 percent from 35 percent would dim the attraction of munis for banks and insurance companies.

The final legislation caps individual taxpayers' deduction for state and local taxes paid at $10,000 – a move seen as punitive to states with high taxes on income or property.

"As a credit issue, it's a negative but the states that are hit the most – New York, California, etc. – are also some of the strongest growing regional economies so I'm not expecting any immediate kinds of repercussions from that," Fischer said.

Fitch Ratings said on Wednesday the cap could lead voters, who no longer can fully deduct their state and local taxes, from authorizing even higher taxes to pay for public services and infrastructure.

ATTRACTIVE AND SCARCER

On the other hand, the effective tax hike for some investors due to the cap could boost the popularity of munis as a means to reduce their tax burdens.

"If people's tax rates go up, that makes muni bonds more attractive relative to taxable alternatives," said Cooper Howard, senior research analyst at Schwab Center for Financial Research in Denver.

The muni market dodged a bullet when the final bill omitted a House provision seeking to end the tax break for private activity bonds. These bonds, which accounted for 27 percent of issuance in 2015, are sold for an array of projects including hospitals, nursing homes, colleges, airports and affordable housing.

However, a practice used by most issuers to refinance bonds on a tax-exempt basis beyond 90 days from their call date for interest rate savings was ended in the final legislation. Advance refunding bonds accounted for 30 percent of 2016’s supply and 18.8 percent of issuance so far this year, according to Thomson Reuters data.

Although a transition period was sought for these bonds, it was not included in the final bill, according to Emily Swenson Brock, director of the Government Finance Officers Association’s federal liaison center. The elimination of advance refundings will pose a challenge for some existing bond issues that were structured with that practice in mind, she added.

Current refundings of debt within the 90-day call date window remain tax-exempt.

The threat to end tax breaks starting in 2018 for certain types of munis in the bills proposed last month by the House and Senate led to a $63.751 billion spike in issuance since the week of Nov. 27. That in turn lifted year-to-date supply to $403 billion, according to Thomson Reuters data.

The year-end supply surge along with the loss of advance refunding bonds were seen by some analysts as depressing muni debt sales in 2018.

But Fischer pegged issuance at a back-loaded $400 billion next year.

“The state and local governments have to finance themselves and they have to finance infrastructure,” he said.

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