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[3 Ways Tax Reform Has Impacted the Muni Market.]

Observers thought the federal law would stifle the sale of municipal bonds — and in effect infrastructure projects. But it hasn't been that bad.

SPEED READ:

- The impact of the federal tax overhaul on the municipal bond market hasn't been as bad as many feared.
- But the elimination of so-called advanced refunding bonds has reduced the overall supply of municipal bond offerings.
- While banks are retreating from the muni market, taxpayers in high-tax states are sheltering more of their income in municipal bonds.
- States are on pace to issue 20 percent more new debt this year.

When Congress passed the tax overhaul last December, some worried that it would ultimately hurt the way governments finance major infrastructure projects by making the municipal bond process more expensive.

In some ways, it has. But there have also been some pleasant surprises. Overall, 2018 has been a good year for governments issuing bonds.

Look at Detroit, which was recently able to sell bonds backed by the city's own credit for the first time in decades. It not only did so with a junk bond rating, but it also got a lower interest rate on the debt than it expected simply because of low supply — thanks to the federal tax law. Investor demand for the higher yield that comes with riskier securities like Detroit was also a factor.

Here are three ways tax reform has impacted the municipal bond market in 2018.

Muni Bond Supply Is Down

Far and away, the most notable effect that the tax overhaul had on the municipal market this year was through the elimination of a valuable cost-saving tool for municipalities. Called [advanced refunding bonds], the tool allowed governments to refinance debt earlier, thus letting them take advantage of lower interest rates years sooner.

Losing this benefit has pushed down supply. By some estimates, it's cut refinancing activity by as much as 20 percent.

Overall, Municipal Market Analytics' Matt Fabian is predicting that total bond issuance this year will be around $320 billion — down about $100 billion from 2017. While he and other analysts thought that governments would find a way to replace the savings opportunity with other types of bonds, that hasn't happened. "The dominant response," he says, "has simply been to not [refinance] the bond."

Taxpayers Turn to Muni Bonds as Banks Retreat

Historically, banks and insurance companies buy a lot of municipal bonds, making up 28 percent of the market. But since the tax bill passed, banks' muni holdings have fallen every quarter this year.

That's because the law slashed the corporate income tax rate from 35 percent to 21 percent. That, combined with rising interest rates, has made low interest rate muni bonds less attractive relative to other investments.

Observers initially feared that, at a minimum, muni rates would have to go up in order to be competitive. That, or corporations would start selling off their municipal debt.

Neither has happened. According to data from Municipal Market Analytics, banks' total municipal bond holdings have only fallen 7 percent over the last year.

Meanwhile, tax reform's caps on state and local tax deductions offer taxpayers in high-tax states an opportunity to shelter more of their income in municipal bonds. That's helped pick up the slack. "Individual investors are chomping at the bit," says G. Joseph McLiney, a municipal bond consultant. A lack of volume this year and an appetite for tax-exempt income, he says, has worked in the market's favor and kept costs steady.

States Issue More New Debt

While the overall supply is down, governments have already surpassed last year's total of $203 billion in new municipal bonds and are on pace for a 20 percent increase for the year.

The tax overhaul played an indirect role in this development in that it helped state revenues grow by more than was expected this year. The improved economic conditions led some governments to pull the trigger on long-awaited projects. "It's important to keep in mind that in November of 2016 alone, [voters] approved roughly $60 billion in new bond offerings," she says. "Often, it takes a few years for those projects to culminate, and this year we saw some of that materialize."

The jump in new money is a bit of a surprise to Payden & Rygel's Ksenia Koban, though. She expected the elimination of advance refundings and some other bond programs to take a bigger slice out of the new money market.

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