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How US Tax Reform will Impact Muni Bonds.

Upcoming tax changes has potential to significantly impact the US muni market

Despite higher Treasury yields and developing tax reform legislation, US municipals have demonstrated some reasonable resilience. Indeed, US Treasury debt lost roughly 40 basis points (bp) since the beginning of September, while munis managed to squeak out a slightly positive return (8bp). Year-to-date returns of 5.4% still exceeds UST by 290bp, and has outperformed AA-rated taxable investment grade US corporate bonds by 40bp. Our high conviction in moving down in credit quality continues to pay off, with Single-A and Triple-B rated muni issuers gaining 5.9% and 8.0%, respectively

On November 2, the US House of Representatives, Committee on Ways and Means released a proposed bill for comprehensive tax reform. Though each provision of the bill is expected to be scrutinized and debated, there are still a number of caveats which could directly (and indirectly) affect the US municipal bond market.

For one, the reduction in corporate taxes from 35% to 20% could impact the demand from banks and property and casualty insurers. Considering these investors focus on longer-dated bonds, and make up nearly 25% of all muni bondholders, any forced selling would likely have a meaningful impact. Long-term yields could rise, as the muni curve steepens.

On the other hand, the proposal to eliminate Federal deductions of state and local taxes (SALT) would essentially raise individual's effective tax rates. In turn, this could make owning tax-exempt municipal bonds even more valuable for high income individuals; especially in-state bonds, in high tax states, including New York and California.

To be fair, the suggested cap on mortgage interest deduction could also negatively impact home prices, thereby reducing property tax revenue. As a result, local governments dealing with higher effective tax rates from SALT may be more limited in their ability to raise taxes (or issue new bond deals), in order to raise necessary income. In turn, this could adversely affect an issuer's credit quality and increase borrowing costs. In our view, this is a longer-term issue, as the years following passage of reform, higher effective tax rates will likely fuel higher muni demand.

Other proposals, such as eliminating the tax-exemption on private activity bonds or advanced refundings, can have meaningful impacts on muni supply. While issuers could flood the market in an effort to get ahead of any new law, a decline in future supply would likely exacerbate an already strong technical environment.

The removal of AMT (Alternative Minimum Tax) would also impact muni bonds where interest is subject to higher AMT rates. Though interest payments are still considered exempt from ordinary income, they are nonetheless subject to AMT. As a result, these bonds carry higher yields. If AMT is eliminated, prices on these securities could rise. Markets have reacted some to this potential provision, but not fully, as the spread between AMT and non-AMT bonds remains wide

For high income earners in North America, US munis are likely to remain a core holding in fixed income portfolios. That said, similar to many other fixed income assets, valuations in munis have also gone up. This is largely due to a significant supply/demand technical imbalance, as the new issuance of US munis has slowed. As a result, yield ratios (or muni yields relative to US Treasury yields) have declined. Still, when compared to taxable bond yields, munis are still compelling for investors in high income tax brackets.

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