Taxing Questions For Bond Investors.

Last week, the House of Representatives passed its version of the Republican Party's proposal for U.S. tax reform. If enacted, this reform is likely to have substantial impacts on fixed income markets. While there are still plenty of hurdles – including reconciling different proposals from the House and Senate, and securing White House agreement – it's worthwhile to review some of those likely impacts following last week's important step forward.

Tightening Up the Municipal Bond Market

The most significant impacts of tax reform may end up being on the municipal bond market. We see two key changes occurring.

First, both the House and Senate proposals would effectively eliminate "advance refunding" of tax-exempt bonds. This is when, in order to lock in low interest rates, a trust is created to pay the interest on higher-coupon municipal debt that is not yet callable, and new, lower-coupon debt is issued to fund the trust. In recent years, debt issued to fund advance-refunding trusts has represented 50% or more of total annual new issue volume in municipals. Although a fair amount of higher-coupon municipal debt has already been refunded, the tax law change is likely to have a meaningful impact on future supply.

Second, the House proposal (although not the Senate proposal) eliminates tax-exemption for private-activity bonds. Although the details have yet to be ironed out, traditional municipal market issuers such as colleges, hospitals and airports, to name a few, may lose the privilege of tax exemption.

This is likely to impact the credit quality of certain issuers as the cost of borrowing goes up. For example, if restrictions on private-activity bonds are included in the final legislation, an airport's funding costs may go up by as much as 30% if it needs to issue taxable rather than tax-exempt municipal bonds. Hospitals are likely to experience similar negative credit consequences.

Overall, however, these proposals may result in less supply of tax-exempt municipal bonds, creating a positive technical backdrop for investors. The recent outperformance of munis over taxable bonds suggests that the market is already anticipating this. Jamie Iselin, who leads our municipal bond business at Neuberger Berman, likes to remind me how ironic it is that many of the investors who were running from munis at the beginning of the year because they were unjustifiably concerned about lower tax rates for taxable bonds are now running back again as they realize that tax reform could end up squeezing supply.

Cutting Corporation Tax, but Also Interest Deductibility

For corporate credit, the key provisions center on the reduction in corporate tax rates, either immediately or with a one-year lag, and the disallowance of tax deductibility on interest payments in excess of 30% of EBITDA.

In practice, the change in interest-payment deductibility will leave companies with debt-to-EBITDA ratios of less than approximately 4.0, or with an interest coverage ratio greater than 3.3, unaffected. Only the most leveraged companies are likely to be affected. For a wide swath of investment-grade and highly rated high yield credits that will only feel the impact of the tax cut, this proposal is a clear positive. Even for more leveraged high yield issuers, the outlook will be mixed, depending on the extent to which the tax cut offsets the loss of some interest-payment deductibility.

Winners and Losers

The potential impact on U.S. economic growth is uncertain. On one hand, there are clear positives: Lower tax rates should stimulate some consumption spending, and the ability to fully deduct capital spending for five years, as under the House bill, should strongly incentivize more investment spending.

There are potential concerns, however.

First, it will be important to monitor whether the hoped-for increase in capital spending – the sluggishness of which has been a disappointing aspect of the economic recovery – becomes a reality.

Second, the combined thrust of this proposal is to lower the government subsidy for housing, particularly for homes in high-tax states and for expensive homes. That will raise after-tax effective mortgage rates, leading to lower turnover in expensive homes, more downward pressure on second-home prices and less sensitivity of home prices to changes in interest rates.

And finally, while reductions in tax rates should create, at minimum, a short-term boost to consumption spending, the distributional impacts of this proposal may cause a retrenchment in spending among higher-income groups that offsets higher spending among other income groups.

Overall, tax reform is now “live” and likely will remain an important market issue as we end the year and start 2018. It’s worth taking time to consider who the winners and losers will be within the bond market, as there could be plenty of change on the way.

Seeking Alpha

By Brad Tank

Nov. 20, 2017 5:39 PM ET