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Municipal Bonds May Get a Boost From Congress's Final Tax Bill.

- **Curb on advance refundings could cut issuance by one-quarter**
- **Corporations may still be buyers, even with big tax cuts**

The final tax bill hashed out by Congress promises to provide a boost to the U.S. state and local government bond market by reducing sales of new tax-exempt debt beginning next year. It could also increase demand for the securities from investors in high-tax states such as California, New York and New Jersey, where residents would be hardest hit by limits on the ability to deduct state and local taxes on their federal returns.

Bond prices were little changed Monday, with the bill largely shaping up as analysts and investors had anticipated. Here's the major impacts:

Fewer Bonds

The final bill will take less of a bite out of issuance than the version passed earlier by the House because it preserves the ability of businesses such as hospitals and airports to issue so-called private activity bonds.

But it will still have a considerable impact by banning sales of tax-exempt debt for advance refundings, a refinancing technique that accounts for tens of billions of dollars of sales each year. If the curb on advance refundings is enacted, supply next year will be about $270 billion, compared with $380 billion to $400 billion if the deals were left intact, according to Barclays Plc.

"The big story next year is just simply the technical picture — supply and demand," said Duane McAllister, senior portfolio manager at Baird Advisors, who expects the change to advance refundings to cut supply by a quarter next year.

The risk posed by the legislation also spurred a rush to borrow by the end of the year that will contribute to a dearth of bonds early next year. Municipalities have sold $46.5 billion in bonds so far this month, a nearly 147 percent increase compared to the same month a year ago, according to data compiled by Bloomberg.

More Demand Seen

The drop-off in supply, paired with steady demand, will make municipals more valuable relative to U.S. Treasuries, McAllister said. He expects the 10-year muni-Treasury ratio — which measures the yield of municipal bonds against Treasury bonds — to decline to 75 percent next year, compared to 85 percent now.

The new conference bill would cut the top marginal personal income tax rate to 37 percent from 39.6 percent. That is likely too small a change to affect demand from individual investors who are the biggest buyers of municipal bonds, said Gabriel Diederich, portfolio manager for Wells Fargo

Asset Management, which oversees about $41 billion of state and local debt.

“With this plan, the retail muni investor should look at the market and say, ‘Wow, this is a pretty tax-efficient security type for me,’” he said.

The revised tax bill would limit taxpayers’ ability to deduct state and local taxes at $10,000. That could heighten demand for municipals from investors living in higher-tax states, analysts say. In seven, including California, New York, Connecticut and New Jersey, the maximum effective tax rate could increase as a result of the changes, according to a Dec. 17 note by CreditSights analyst Pat Luby.

Still, demand from banks and insurance companies could decrease as a result of the revised tax bill, which proposes cutting the corporate tax rate to 21 percent. But Longer-dated municipal bonds may still lure corporate buyers, John Mousseau, director of fixed income at Cumberland Advisors, said in a Dec. 18 report.

“Most companies have paid lower taxes than the stated 35 percent in any case, so the fallout here may not be as great as pundits think,” he wrote.

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