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SALT Shift Bolsters Munis' Appeal to Wealthy in High-Tax States.

- **With deductions capped, investors may look for new tax breaks**
- **Analysts expect uptick in demand from states like California**

Residents in New York, New Jersey and Connecticut who waited in queues to pay their property taxes early and take advantage of an expiring tax deduction may be lining up in 2018 to buy municipal bonds issued in their home states.

Strategists from Barclays Plc and Charles Schwab Corp. say demand for munis could increase from wealthy residents of high tax states this year because the Republican tax bill caps state and local property and income tax deductions at $10,000.

That kind of money doesn't go a long way in Manhattan, where the average deduction per tax return is about $25,000 or Marin County, across the Golden Gate Bridge from San Francisco, where it's about $17,000, according to the Tax Foundation. So residents may be eager to find other ways to reduce what they owe to the federal government.

"What are the remaining tax havens? Munis are still one of them," said Mikhail Foux, the head of municipal strategy for Barclays in New York.

Californians, who pay a top income-tax rate of 13.3 percent or residents of New York City, which has a combined state and local rate of 12.7 percent, now have even more incentive to buy local debt because the interest is exempt from both state and federal taxes, he said.

Fewer Bargains

By increasing the cost of state and local taxes to wealthier residents, the federal shift may make it more politically difficult to raise taxes and curb the pace of bond sales backed by such revenue. Just four states — California, New York, New Jersey and Illinois — account for about 42 percent of long-dated, fixed-rate municipal bonds, Citigroup Inc. analysts led by Vikram Rai said in a Jan. 11 note to clients.

"A pullback on debt issuance by any of these states can cause a scarcity shock in the space for long-dated municipals," they wrote.

At the same time, the increased demand for tax-free income may bring greater attention to mutual funds targeted at specific states.

Nuveen Asset Management's California High Yield Municipal Bond is the best-performing open-end California municipal bond fund over the past 10 years, according to Morningstar Direct. It invests 36 percent of its assets in real-estate-related debt and has benefited from a run-up in property values since the Great Recession, said John Miller, Nuveen's co-head of fixed income, who oversees $131 billion of muni debt.

Municipalities in California can sell bonds backed by assessments on homeowners to pay for roads and sewers in new neighborhoods.

“There’s really nothing that actually went into default in the last cycle in California in this type of bond,” said Miller, whose fund delivered annual returns of 6.25 percent for the 10-year period ending Dec. 31. “Some of these districts did trade 50-60 cents on the dollar. Now you have heavy, heavy overcollateralization.”

Miller said it will become harder to find bargains in the municipal market once the federal tax bill stokes even greater demand for higher-yielding California bonds. At the same time, limits on the ability of states and local governments to refinance their debt are promising to cut the pace of new sales.

“It’s going to get more challenging because pricing is tighter,” Miller said.

Low Defaults

Nationally, high-yield bonds offer a spread of about 2.7 percentage point more than AAA rated debt, but the premium is narrower for risky municipal debt issued in California, Miller said. And muni defaults remain low, with only $500 million defaulting for the first time in 2017, the least since 2008, he said.

“A growing economy tends to narrow spreads and low defaults tends to narrow spreads,” Miller said. “If spreads are narrowing, all else being equal, high-yield has an opportunity to outperform. You still have to pick the right credits.”

Delaware Funds Tax-Free New York Fund is the best performing New York retail fund over the 10-year period ending Dec. 31, returning 4.7 percent, according to Morningstar.

Almost half of the fund’s assets are invested in bonds in the A or BBB category, with about 15 percent in junk-rated or non-rated bonds. The largest portion of its holdings, 23.1 percent, is in the education sector.

New York offers investors a diverse range of bonds, said Greg Gizzi, who helps manage Delaware’s New York fund. For example, in the higher-education sector, the state has more than 100 private colleges and universities, from AAA rated Columbia University to BB rated Metropolitan College of New York.

“We’re going to seek to diversify into those lower investment grade and those below investment grade categories despite the fact that we exist in a world that has constrained supply,” Gizzi said.

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