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The Potential Impacts of the Trump Tax Bill on Municipal Bond Investing

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Deutsche Asset Management

The bill approved by Congress on December 20, 2017, should have significant supply and demand effects on the municipal bond market, and the changes in relative value in relation to the taxable bond market will likely require insurers to reconsider their portfolio strategies in important ways.

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Executive Summary

The Trump tax bill will have some important supply and demand ramifications for the municipal bond market. These include:

- The reduced corporate tax rate will eliminate municipal bonds' tax equivalent yield advantage over taxable corporate bonds, most likely reducing future institutional demand for new issues.
- Existing bonds have yield, diversification and accounting advantages for institutional buyers, so the tax bill is unlikely to precipitate wholesale selling.
- Supply will be affected by the elimination of advance refundings, which have comprised about a quarter of new issue activity in recent years.

The bill will also affect the relative value of muni bonds compared with taxable alternatives for property casualty insurance companies. They will need to consider how to modify their portfolios in response, including:

- Portfolio managers should determine their bonds' tax-equivalent yields, in the context of their credit and duration, to determine whether to sell or retain them.
- Diversification, sector allocation and other issues need to be considered before deciding whether to swap tax exempt for taxable investments

Market Demand Effects

The tax bill will reduce municipal bonds' benefits to both property casualty insurance companies and banks – the main institutional buyers in the muni bond market – due to the bill's lowering of the corporate tax rate from 35 percent to 21 percent.

Under the old tax regime, with a 35 percent corporate tax rate, municipal bonds had yield advantage over taxable corporate bonds on an after-tax basis. Over five years, municipal bonds offered, on average, a tax equivalent yield advantage of 50 basis points or more. With a 21 percent corporate tax rate, a muni bond's tax equivalent yield will be the same or actually lower than credit and duration-equivalent taxable corporate bonds. This means that, on average, it will not be as attractive for property casualty insurance companies, or banks, to buy new munis going forward.

However, we do not expect a great deal of wholesale municipal bond selling, because most muni bonds currently in property casualty portfolios have book yields that are higher than comparable corporate bond yields. These bonds remain attractive investments for some investors. Also, even those muni bonds that have book yields that are comparable to taxable corporate bonds might remain attractive if they are older bonds, meaning those yields are

on shorter-duration instruments. It would be difficult to achieve similar yields on equivalent-tenor instruments in the new issue market.

Property casualty insurers as a group have kept stable allocations to municipal bonds, making up about 9 percent of the market since 2009. Banks, however, have added about \$100 billion to their muni bond holdings since 2014 by channeling excess deposits into the sector. They now make up 15 percent of the market. However, they too are unlikely to sell in large quantities, since they like the diversification muni bonds provide and there is the possibility that munis will be accounted for as high quality liquid assets for bank liquidity coverage ratio tests.

Therefore, both property casualty insurers and banks are unlikely to find new muni bonds very attractive, lowering demand in the future, but they are also unlikely to be big sellers of their existing holdings. Also, looking at market demand more broadly, insurers and banks only account for a third of the demand for muni bonds – the rest comes from individual investors and mutual funds. Individual tax rates are not falling as dramatically as corporate rates under the tax bill, so the bulk of the demand for munis should remain reasonably stable.



Market Supply Effects

The bill eliminates tax exempt financings for advance refundings. Most municipal bonds with maturities beyond 10 years give the issuer a 10 year call option. If an issuer wants to take advantage of market conditions prior to the call date, up to now it could do an advance refunding, issuing new tax exempt bonds, then investing the proceeds in Treasuries in anticipation of eventually using them to fund the call on the outstanding issue.

Advance refundings increase net supply, since the original bonds remain outstanding until the first call date. This has been a significant source of supply in recent years, accounting for 25 percent of issuance. Going back 10 years, it has averaged about 20 percent of annual issuance.

We estimate, based on calculations and industry research, that the muni market will see supply in 2018 of \$290 billion, and net supply – new supply minus maturities and calls – of negative \$30 to \$60 billion. In 2017, prior to a major rush to market in December, the market was on track to have \$385 billion of total supply and net supply of about \$30 billion.

Issuers have reacted to the new tax bill by rushing to market as many advance refunding bonds as possible. To qualify for advance refunding, bonds have to be issued and settled by the end of the year. A record \$62 billion came to market in December,

beating the previous record from October 2016, when issuers were trying to get in ahead of the election and Federal Reserve rate increases.

Despite this huge issuance and mutual funds' selling of shorter-term bonds to make room for new issues, muni to treasury ratios are lower than they were at the start of 2017. This is because the market anticipates ongoing performance because of lower supply and steady demand. It does not appear to be concerned about a serious decrease in demand from P&C insurers and banks.

Longer term, we expect to see supply normalize with a quiet first quarter due to new issues having already been brought to market in late 2017 to take advantage of the last opportunity for advance refundings.

Portfolio Considerations

Generally, the decision whether to invest in, hold or sell muni bonds was one of simply ascertaining the tax equivalent yield and, if the muni had an advantage and met diversification, maturity, sector allocation targets and so on, the portfolio manager bought or held it. Now, with tax-adjusted yields reduced by the tax bill's new corporate tax rate, and its elimination of the AMT, this crossover analysis is even more important. An accurate analysis of tax equivalent yield alternatives under the new tax regime is crucial to meeting portfolio goals.

Nonetheless, whether to hold a muni or sell out of it and swap into taxable bonds still depends on the muni bond's book yield. Portfolio managers need to look at their taxable incomes for holding the municipal bond (using new tax rates) and compare it to the after-tax income they would get for swapping to taxable bond with similar credit and duration.

Portfolio managers also need to consider any gain or loss they might realize in determining the reinvestment amount, and need to consider capital gains impacts on income. Generally, selling at a gain in 2017 may be less favorable than selling at a gain on January 1, 2018 (depending on the effective date of the new tax rates). Generally, older bonds with higher book yields could remain favorable to hold.

However, it remains important to consider issues in overall portfolio management such as diversity, maturity, sector allocation, etc.

Portfolio restructuring has to be done carefully to ensure sector allocations and diversity goals are maintained, credit and duration targets are met, and that the best after-tax yields are achieved. ❁

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