Municipal Bonds

Tax Reform Rocks the Muni Market

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We focus on quality as the effects of unintended consequences from the tax overhaul loom large.

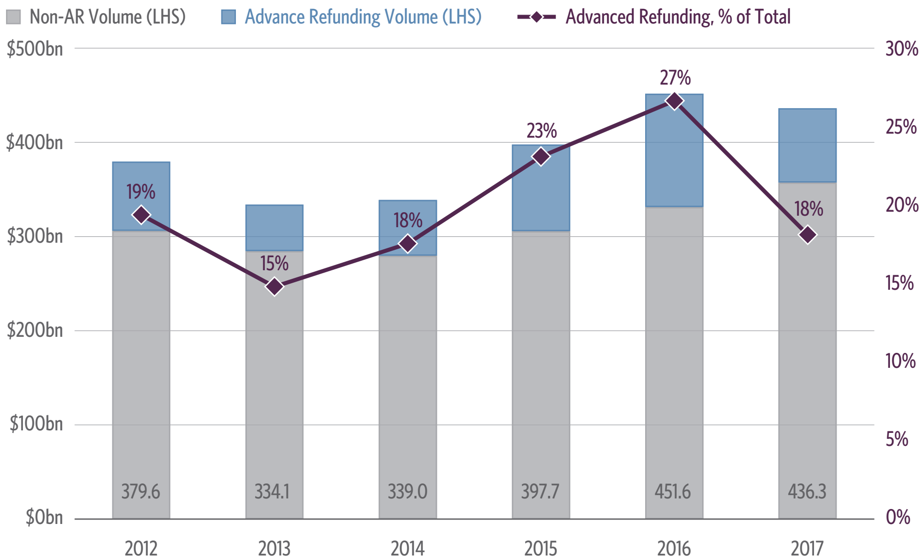
Since the first tax reform bill was proposed in November 2017, the municipal market has been fixated on provisions that would directly and indirectly impact tax-exempt municipal bonds. Not surprisingly, December 2017 generated $62.5 billion of new-issue supply, an all-time monthly record, as issuers reacted to proposals surrounding qualifications for tax-exempt issuances. This highlights once again the outsized influence of federal policies on municipal bonds. The elimination of advance refunding bonds immediately reduces upcoming years' supply expectations (see chart, top right).

Behavioral changes in response to the tax plan may ripple through the market's composition and credit quality. For example, increases in federal Medicaid funding, on which state and local governments have become increasingly dependent, may prove difficult to maintain given projected federal budget deficits. The $10,000 cap on state and local tax (SALT) deductions may enhance the relative value of tax exemption, but more migration from high-tax states to low-tax states would reduce the municipal market's natural demand base. From a credit quality perspective, such migration will also impair the financial flexibility of high-tax municipalities (see chart, bottom right).

The Bloomberg Barclays Municipal Bond index posted a 0.8 percent gain during the fourth quarter of 2017, with longer-maturity bonds continuing to outperform the short end and lower-quality bonds outperforming higher quality. BBB-rated and A-rated municipal bonds returned 1.4 percent and 0.9 percent, respectively, versus 0.7 percent for AA-rated bonds and 0.5 percent for AAA-rated bonds. Municipal bonds were up 5.5 percent for the year.

In order to soften supply reductions, investment bankers may be prompted to deliver comparable financing solutions with non-standard features (e.g., shorter calls, non-5 percent coupons). Further, a lack of alternative financing options may encourage issuers to revisit strategies of using derivative contracts to manage interest rate risk. The municipal market's changing dynamics are highlighted by the preservation of private activity bonds (PABs). Although PABs were eventually saved by a narrow margin, the legislative process underlined that unique features cherished by the municipal market are not sacrosanct. We continue to emphasize uncovering value through credit fundamentals.

Advance Refunding Dropped in 2017 from 2016 Peak

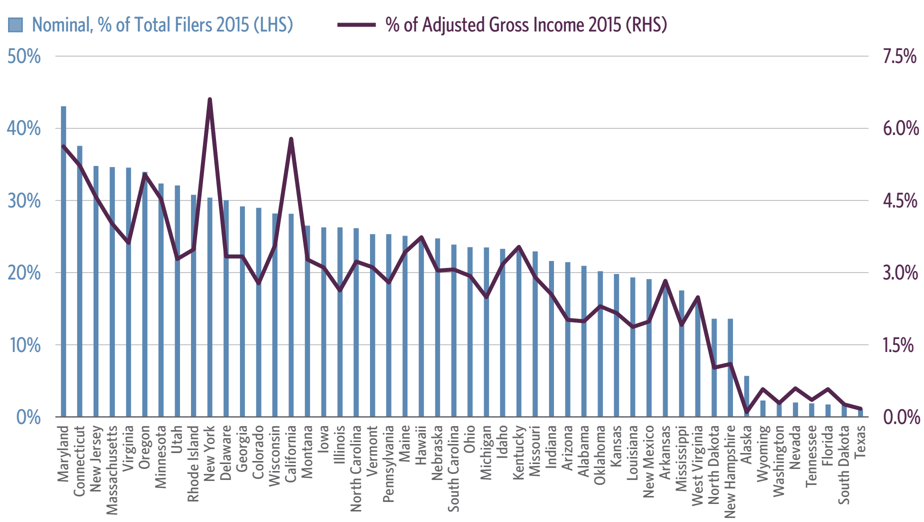


Source: Thomson Reuters, Guggenheim Investments. Data as of 1.25.2018.

The elimination of advance refunding bonds will immediately reduce supply expectations. Further, a lack of alternative financing options may encourage issuers to revisit strategies of using derivative contracts to manage interest rate risk.

SALT Deductibility Limits Will Reshape the Muni Market

State and local taxes as a percentage of total personal tax liability and income.



Source: Internal Revenue Service, Guggenheim Investments. Data as of 1.25.2018.

The $10,000 cap on state and local tax deductions will likely incentivize more migration from high-tax states, such as Connecticut and New Jersey, to low-tax states, such as Florida and Texas. Such migration would reduce the municipal market's natural demand base and, from a credit quality perspective, will also impair the financial flexibility of high-tax municipalities.