



THE AFTEREFFECTS OF TAX CUTS ON MUNIS

The municipal bond market was a bit schizophrenic as the debate over the tax bill reached its final stages late last year. Would the enacted bill squeeze the muni issuers and eliminate their ability to take advantage of falling interest rates on outstanding bonds? And how will it affect buyers' appetites if tax rates fall to much lower levels? While several proposals could have considerably changed the market, the most negative—in particular, limiting the issuer base—fortunately were not enacted. But those that were—the elimination of advance refunding and the change in the corporate and individual tax rates—could alter the muni market. How will they impact muni returns in the years ahead?

MUNI BONDS—A PRIMER

Before we discuss the tax bill, let's briefly discuss the municipal bond market. Munis are tax-exempt bonds offered by state and local governments to fund infrastructure projects. They offer the same attractive features as taxable corporate or government bonds—current income, a predictable stream of income, and a range of credit qualities, maturities, and issuers.

The one difference from taxable bonds is also munis' defining trait: Munis are generally tax-exempt. Interest income earned from muni bonds is exempt from federal taxes and, in many cases, state and local taxes for in-state purchasers (lenders). For that reason, pretax yields are lower. Munis also have a lower default rate compared with taxable corporate bonds. And in a rising rate environment where the hikes are generally well telegraphed by the Fed (as we have today), munis have historically performed well. Actually, there have been only two negative years in the last 30 years—1994 and 1999—that coincided with periods of Fed tightening, and during the last tightening cycle, between 2004 and 2006, munis generated positive returns. So in essence, investors can often receive a higher net yield after taxes when buying tax-exempt municipal bonds compared with taxable bonds, with lower default and interest-rate risk.

THE PULL FORWARD

Last year, the House of Representatives bill proposed eliminating advanced refunding and restricting the ability of not-for-profit entities—namely, hospitals, universities, and senior living facilities—to offer muni bonds. In the end, the bill eliminated only advanced refunding, preserving tax-exempt financing for not-for-profits.

But the ambiguity surrounding which of the proposals the final tax bill would adopt created a lot of angst for issuers and caused tax-exempt entities to issue a greater than normal number of bonds in the fourth quarter, even if they did not need to do so at that time. In fact, December saw the largest month of supply on record. Demand for these bonds, though, was strong, keeping prices from falling amid the new supply glut. However, this pull forward in supply will likely reduce issuances in 2018. Coupled with still-strong demand from buyers, this limited supply should support prices.

A WIN...

Advanced refunding bonds are issued to lock in lower borrowing costs before issuers can retire previously issued bonds, either through calling the bonds or at maturity. Think of it this way: When you own a mortgage, unless you have a prepayment penalty, you can decide to refinance that mortgage at a lower interest rate at any time, racking up significant savings over the life of your loan. The Tax Cuts and Jobs Act of 2017 essentially removed that option for issuers. Why does it matter?

Advanced refunding represented roughly 16% of bond issuances in the market over the last 10 years. So a direct consequence of this provision should be a reduction in the number of muni bonds that are sold into the market. Simple economics suggests that reduced supply with no change in demand will drive prices higher. This provision should be supportive of the market in the near term—a win.

A LOSS...

In addition to eliminating advanced refunding, the tax bill also reduced the corporate tax rate to 21%. Lowering the federal income tax rate may have an unintended consequence for the muni bond market as demand from companies may decline over time.

Approximately one-third of munis are owned by companies (predominately insurance companies and banks). These institutions historically paid an average tax rate of approximately 28% (blended rate). Going forward, they will pay 21%. At this new tax rate, they will receive less benefit from owning tax-exempt bonds relative to corporates or treasuries. Let's examine this further.

Last year, a corporation that was considering buying a tax-exempt municipal bond with a yield of 3.2% or a taxable bond with a yield of 4.5% would have been indifferent (assuming everything else is equal), since, on an after-tax basis, their yields are the same (3.2%) (*Display 1*). This year, however, using a corporate rate of 21%, the after-tax yield on that same corporate bond is now higher, at 3.6%.

We believe that corporations will not sell their existing municipal bond holdings in the near term. Instead, we expect these companies to shift their asset allocation away from muni bonds over time, so that longer term, they will own fewer munis. This shift will result in lower demand for munis—a loss.

...AND A PUSH

Individuals own the other two-thirds of outstanding municipal bonds. Their tax rates were also lowered in the tax bill. The highest bracket, 39.6%, was brought down to 37%. Will these reductions have a similar impact on the muni market, as the reduced corporate rate may?

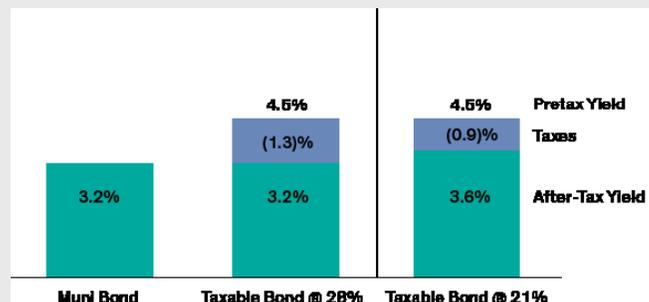
We don't think so. Individuals in the top brackets tend to be the primary buyers of tax-exempt municipal bonds. Although the rate has been reduced, it is only marginally lower, as the highest brackets remain in the mid-to-high 30% range. Tax-exempt bonds still make sense at these high tax levels relative to other bond investments. Tax rates for high earners will be high enough that yields for munis are still attractive—a push.

OVERALL NET NEUTRAL

Overall, we see the tax bill legislation as a net neutral for the muni market. The reduced supply from eliminating advanced refunding will be somewhat offset by reduced demand as some corporations no longer find tax-exempt muni bonds attractive relative to taxable bonds. However, supply tends to be more impactful in the near term, potentially resulting in a stronger market for munis in the short run. We've already seen this play out. Munis delivered positive returns in December, after being negative or flat for the prior three months. Overall, the tax bill legislation should have a minimal lasting impact on the muni market as the majority of buyers—individuals—continue to demand these tax-free instruments.

Display 1

BOND COMPARISON—AN EXAMPLE



For illustrative purposes only
Source: AB

Market Update

POSITIVE EQUITY RETURNS...YET AGAIN

Stocks	Jan 2018
US	5.7%
Int'l Developed Markets	5.0
Emerging Markets	8.3
Bonds	
Municipal	(0.5)%
Taxable	(1.2)
Alternatives	
Hedge Funds	0.9%*
Commodities	4.9
Real Estate	0.0

Past performance is not necessarily indicative of future results.

US stocks are represented by the S&P 500 Index; international developed-market stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-market stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Bloomberg Barclays US Aggregate Bond Index; hedge funds by the Hedge Fund Research Inc.'s (HFRI) Fund of Funds Composite Index; commodities by the MSCI ACWI Commodity Producers Index; global real estate by the FTSE EPRA/NAREIT Developed Index. An investor cannot invest in an index. These figures do not reflect the deduction of management fees and other expenses an investor would incur when investing in a fund or separately managed portfolio. See "Information About MSCI" at the end of this report.

*As of December 31, 2017

Source: Bloomberg Barclays, FTSE, HFRI, Lipper, MSCI, S&P, and AB

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