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Investment perspectives

Patrick Tucci, CFA
Co-Portfolio Manager
First Investors Tax Exempt Funds

Key highlights:

- Advance refundings lost their tax exempt status while private activity bonds retained their ability to issue tax-free debt
- Banks and insurance companies may have less of an incentive to continue buying municipals
- Potential for shortfall in municipal issuance in 1Q18 and 2018

Municipals and the new tax legislation

Overview

During the recent tax bill negotiations, four key areas affecting the municipal bond market were under serious discussion among Congressional leaders. **Advance refunding bonds,** issued to pay off other outstanding bonds generally at lower rates, ended up losing their tax-exempt status. **Private activity bonds,** although typically used to finance projects for private entities and not backed by a government's credit rating, retained their tax-free status. The **corporate tax rate** of 35%, an issue that President Trump had targeted since his campaign, was reduced to 21%. Finally, the **state and local tax (SALT) deduction,** of any kind of taxes, is now limited to $10,000. Investors will want to monitor the overall supply and demand levels in the first quarter as the impact of the tax legislation presents an unfolding dynamic.

Four areas of focus

The tax-exemption status of **advance refunding bonds** was a casualty of the Tax Cuts and Jobs Act of 2017. An example of this type of debt issuance would be a city, noticing a significant decrease in interest rates, deciding to issue a new bond at a lower rate to essentially refinance its higher-paying outstanding bond. Advance refunding bonds accounted for about 40% of new issuance in 2016, which outpaced the prior year (31%), dropping off to 29% last year.[1]

The second issue was the continued tax exempt status of **private activity bonds (PABs),** which are issued by entities such as colleges and hospitals, and encompass roughly 13-15% of the tax-exempt market. These bonds have a much lower interest rate than their taxable equivalents and have constituted 10-15% of new issue supply over the past five years.[2] Fortunately, PABs, perhaps owing to their use in a broader infrastructure policy (i.e., airports and toll roads) that the Trump administration has recently started to talk about, did not lose their tax-exempt status as the change in the cost of funding for these entities could have been dramatic.

Third, with the **corporate tax rate** having been cut to 21%, banks and insurers (which represent approximately one-fifth of the market) may be losing their incentive to continue buying municipal bonds and, as a result, could cause upward pressure on tax exempt yields. Perhaps offsetting this potential decrease in demand, international entities (see Exhibit 1), such as sovereign wealth funds and other foreign investors, have been increasing their participation in this market. Their motivation is largely rooted in the perceived safety of the U.S. municipal bond market and its accompanying yields, which may be higher than those available in their home countries. Substantiating this sentiment, the five-year municipal default rate since 2007 was only 0.15%, compared to 6.92% for corporates (albeit a sector with lower ratings on average).[3] Another incentive to foreign investors was that municipals offered them some diversification from U.S. Treasury securities which form substantial portions of their overseas portfolios.

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1 Source: Thompson Reuters, 12/31/17.
2 Source: Bond Buyer/Citigroup Research/Bloomberg, 12/31/17.
3 Source: Moody's, 6/27/2017.

(continued)

Exhibit 1: Foreign participation is now part of the municipal market landscape

Source: Citi Research Fed Flow of Funds, 12/14/2017.

Finally, the newly imposed limit on **state and local tax (SALT) deductions,** which in the past allowed state residents to offset their federal tax bills by claiming the amounts paid on their state and local taxes, may be tested across the country. A number of the higher-taxed states are now attempting to circumvent or even challenge the new federal tax law in an attempt to mitigate its effects. For example, Governor Andrew Cuomo of New York has threatened legal action and is exploring the possibility of eliminating the state income tax and possibly replacing it with a payroll tax. In California, there is a proposal to set up a charitable contribution system to allow taxpayers to make donations instead of paying certain state taxes. Naturally, approval of any such plan is likely to be subject to review by the Internal Revenue Service and possibly state legislatures. As a final point, and perhaps ironically, the new limit on SALT deductions could actually have a positive impact on those bonds issued in the high tax states as demand for tax-exempt investments in these states could increase.

What can investors expect in the coming months?

Last year, the uncertainty surrounding PABs and advanced refunding caused a record level of issuance in December of roughly $64 billion which was, ultimately, well absorbed by the market. In addition, many issuers, motivated by the threat of losing advance refundings and PABs as tax-exempt options, rushed to the market in the second half of 2017. For this reason, there is the distinct potential for a drop off in issuance to occur during the first quarter of 2018. We expect this year's municipal bond performance to follow the overall upward trend in interest rates as the Fed maintains its tightening stance. In addition, supply and demand dynamics could take their lead from less supply due to advanced refundings no longer entering the market. That factor, coupled with potentially less demand for tax exempt bonds from banks and insurance companies given the corporate tax cut, is likely to have an impact on price action. We will continue to monitor the impact of the new tax legislation as it unfolds.

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Foresters Financial Services, Inc. | 40 Wall Street | New York, NY 10005 | 800 423 4026 | foresters.com