Tax Cuts and Jobs Act: What Does it Mean for the Municipal Bond Market?

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Several key provisions of the Tax Cuts and Jobs Act (TCJA), which became law in December 2017, are expected to have a direct impact on the municipal bond market, as it may affect investors and issuers. While we believe the structure of the TCJA is unfavorable for tax-exempt bonds in aggregate, we do not expect it to have an extraordinary impact on valuations, nor should it result in significant deterioration in credit quality.

Since the passage of the TCJA, the municipal market has sent very few signals that it is adapting to the new tax law provisions. Aside from pulling forward an estimated $40 billion in planned issuance from the first quarter of 2018 to December 2017, issuers and underwriters have yet to make any modifications to their planned financings in 2018. This initial muted reaction may foreshadow how inconsequential the law could ultimately be to the municipal market. While we do not anticipate any change in our approach to sector allocation and issuer concentration, we will remain vigilant in monitoring investor behavior and issuer credit quality for any signs that warrant a change in strategy.

Below we highlight the key tax law changes that may affect the municipal bond market.

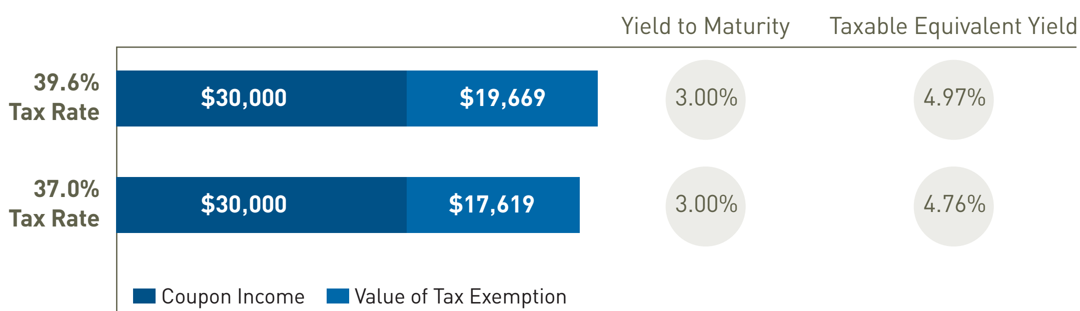
Lower Individual Tax Rates

EXPECTED IMPACT:
NEGATIVE

The TCJA lowers the individual tax rate for most federal income tax filers, with the top marginal rate falling to 37.0% from 39.6%. With a lower tax burden, investors' need for tax-exempt income may decline, leading to lower demand for municipal bonds. However, we believe it is unlikely that investor demand patterns will materially change, as the reduction in top tax rates may not be enough to offset the benefits of holding municipal bonds.

The Value of Municipal Bond Tax Exemption

Estimated based on a $1 million non-callable municipal bond priced at par with a 3% coupon



Source: PNC Capital Advisors analysis

Lower Corporate Tax Rate

EXPECTED IMPACT:
NEGATIVE

One highlight of the TCJA is a permanent reduction in the corporate statutory federal income tax rate from 35% to 21%. While financial markets generally welcomed this development, the lower corporate tax rate could have negative implications for the municipal market. Similar to individual taxpayers, corporate entities could have less need for tax-exempt income due to their lower tax burden. This dynamic is especially true among banks and insurance companies, which currently hold almost 30% of outstanding municipal debt.[1]

Increase in the Federal Budget Deficit

EXPECTED IMPACT:

NEGATIVE

The Congressional Budget Office forecasts the TCJA could lead to a $1.4 trillion increase in the federal budget deficit over 10 years.[2] We believe two adverse effects could accrue to the municipal market. First, an increase in the budget deficit could lead to higher benchmark Treasury rates, as the government issues increasing amounts of Treasury securities to fund its shortfall. This would result in higher borrowing costs for municipal issuers. Second, should the government set out to find new sources of revenue, the municipal tax exemption could once again come under scrutiny, as lawmakers could decide it is too costly to indirectly subsidize state and local borrowing.

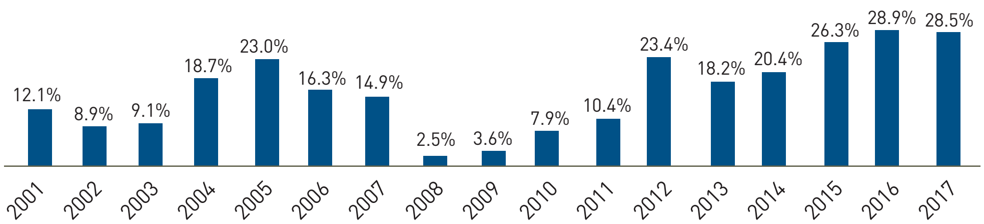
Alteration to Advanced Refundings

EXPECTED IMPACT:

SOMEWHAT NEGATIVE

Prior to the TCJA, municipal bond issuers employed advanced refunding strategies, whereby they would issue new debt obligations to refinance existing bonds ahead of their call dates to achieve economic savings. Between 2001 and 2017, advanced refundings accounted for an average of 16% of total supply. During the past five years it was even higher at 24%, on average. The new tax legislation prohibits using municipal bonds for this practice, with issuers instead having to use slightly more expensive taxable debt to effect an advanced refunding. This change could also marginally increase the cost of new financings, as more costly call structures are employed or investors discount the value of their ability to benefit from an advanced refunding. Moreover, there could be a noticeable impact on overall issuance from this provision. Thus far, there has been minimal evidence of changes in call structures on new bond issues in early 2018, but it remains to be seen if advanced refundings decline to the low levels seen in 2008 and 2009.

Advanced Refundings as a Percentage of Total Municipal Bond Issuance



Source: SIFMA, SDC, Bloomberg, Barclays Research, PNC Capital Advisors analysis

Limitations to State and Local Tax Deductions (SALT)

EXPECTED IMPACT:

MIXED

The TCJA imposes a $10,000 cap on individuals' SALT deductions, which we expect will have a mixed effect on municipal issuers and investors. Viewed in isolation, the decrease of a major itemized tax deduction should make the tax exemption of municipal bond income marginally more coveted. Conversely, heavy issuance state and local governments, including those in California, New York, and New Jersey, which have been large beneficiaries of SALT deductions, may face reduced revenue-raising capacity. New Jersey has already reconsidered a new "millionaires' tax" as a direct result of the law change. Also, the trend of prepaying 2017 state and local taxes, ostensibly to temporarily preserve the deduction, if the federal government does not challenge these efforts, will result in unexpected cash windfalls for many municipalities and will require disciplined cash management.

Reduction in Alternative Minimum Tax (AMT)

EXPECTED IMPACT:

SOMEWHAT POSITIVE

One potential positive impact on municipal investors and issuers is the overall reduction in corporate and individual AMT. The TCJA repeals the corporate AMT outright and increases the exemptions and phase-outs of the individual component, both of which serve to benefit the municipal market. In particular, this change should favor tax-exempt bonds that are subject to the AMT provisions, which total 3.88% of all municipal debt outstanding as of September 30, 2017.[3] The reduction of AMT liabilities for corporations and individuals should promote higher prices (lower yields) for these securities, as they converge in value with traditional tax-exempt obligations. Additionally, the issuers of AMT bonds — largely private-activity issuers — should stand to benefit from relatively lower interest costs on new debt.

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[1] Board of Governors of the Federal Reserve, data as of the third quarter 2017, https://www.federalreserve.gov/releases/z1/current/html/l212.htm.

[2] Congressional Budget Office, cost estimate for Tax Cuts and Jobs Act (November 8, 2017), https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/hr1deficitsanddebt.pdf.

[3] Securities Industry and Financial Markets Association (SIFMA), Municipal Bond Credit Report, fourth quarter 2017, https://www.sifma.org/wp-content/uploads/2018/02/US-Municipal-Report-2018-02-23-SIFMA.pdf.

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