

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

March 2018

PNC Capital Advisors Municipal Fixed Income Team

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.

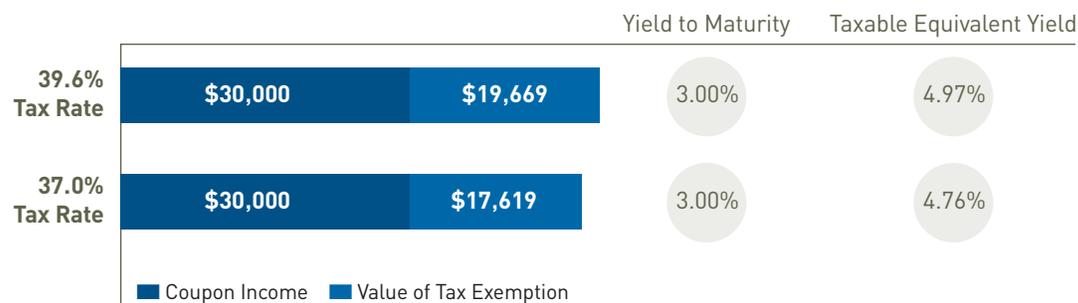
EXPECTED IMPACT:  
**NEGATIVE**

## Lower Individual Tax Rates

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

EXPECTED IMPACT:  
**NEGATIVE**

## Lower Corporate Tax Rate

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.<sup>1</sup>

EXPECTED IMPACT:  
**NEGATIVE**

### Increase in the Federal Budget Deficit

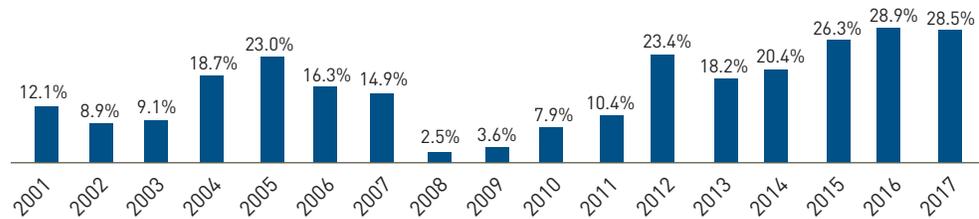
The Congressional Budget Office forecasts the TCJA could lead to a \$1.4 trillion increase in the federal budget deficit over 10 years.<sup>2</sup> We believe two adverse effects could accrue to the municipal market. First, an increase in the budget deficit could lead to higher benchmark Treasury rates, 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.

EXPECTED IMPACT:  
**SOMEWHAT NEGATIVE**

### Alteration to Advanced Refundings

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

EXPECTED IMPACT:  
**MIXED**

### Limitations to State and Local Tax Deductions (SALT)

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.

EXPECTED IMPACT:  
**SOMEWHAT POSITIVE**

### Reduction in Alternative Minimum Tax (AMT)

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.<sup>3</sup> 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.

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

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

<sup>2</sup> 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>.

<sup>3</sup> 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>.

This publication is for informational purposes only and reflects the current opinions of PNC Capital Advisors, LLC as of March 2018. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice, a forecast or guarantee of future results. To the extent specific securities are referenced herein, they have been selected by the author on an objective basis to illustrate the views expressed in the commentary. Such references do not include all material information about such securities, including risks, and are not intended to be recommendations to take any action with respect to such securities. Indices are unmanaged, do not reflect the deduction of any fees normally associated with an investment management account, including investment advisory fees. Indices are not available for direct investment.

The information provided is not directed at any investor or category of investors and is provided solely as general information about the products and services of PNC Capital Advisors, LLC and to otherwise provide general investment education. None of the information provided should be regarded as a suggestion to engage in or refrain from any investment-related course of action as PNC Capital Advisors, LLC is not undertaking to provide impartial investment advice, act as an impartial adviser, or give advice in a fiduciary capacity. PNC Capital Advisors, LLC does not provide legal or tax advice. The information contained in this piece should not be considered legal or tax advice; questions regarding your specific situation should be directed to your legal or tax advisor.

This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. If you are an individual retirement investor, contact your financial advisor or other fiduciary about whether any given investment idea, strategy, product or service may be appropriate for your circumstances. **Past performance is no guarantee of future results.**

PNC Capital Advisors, LLC is an SEC-registered investment adviser, offering an array of investment strategies. Registration with the SEC does not imply any level of skill or training. PNC Capital Advisors, LLC is an indirect subsidiary of The PNC Financial Services Group, Inc. PNC Capital Advisor's strategies and the investment risks and fees associated with each strategy can be found within Part 2A of the firm's Form ADV, which is available at <https://pnccapitaladvisors.com>.

PNC Capital Advisors, LLC serves as investment adviser and co-administrator to PNC Funds and receives fees for its services. PNC Funds are distributed by PNC Funds Distributor, LLC, which is not affiliated with the adviser and is not a bank. PNC Funds Distributor, LLC is a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. ("FINRA").

***Before investing in any mutual fund, you should consider the investment objectives, risks, charges and expenses carefully before investing. A prospectus or summary prospectus with this and other information for PNC Funds may be obtained at 1-800-622-FUND (3863) or [www.pncfunds.com](http://www.pncfunds.com). Please read it carefully before investing.***

The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Fixed income investments may be subject to call risk, which is the risk of a bond being called prior to maturity. Fixed income investments may also be subject to prepayment risk, the risk that the principal of a fixed income security that is held may be prepaid prior to maturity, potentially forcing the reinvestment of that money at a lower interest rate. Certain events can impact a municipal issuer's financial situation and ability to make timely payments to bondholders, including economic, political, legal, or regulatory changes and natural disasters. Event risk is unpredictable and can significantly impact bondholders. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.

**INVESTMENTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE**

© PNC Capital Advisors, LLC. All rights reserved.