Tax Reform and Municipals

Setting Up for a Year End Opportunity

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Regardless of what one might think the odds of Congress actually passing a tax bill are this year, the municipal market is now operating on the assumption that tax reform will occur. While there are differences between the bill passed by the House and the tax plan being discussed in the Senate, the broad provisions of each of the current GOP tax plans are favorable for the municipal market and may present a near-term opportunity for investors.

One key component of both the House and Senate tax plans is that municipalities would lose the ability to "advance refund" their debt in the tax-exempt market. This simply means that after year end, if a municipality wanted to refinance any outstanding debt more than 90 days prior to its maturity, it will have to do so in the taxable market.

Even before this provision appeared in the GOP tax reform plans, expectations were that supply would decline next year as the volume of bonds available for refunding is declining. However, if tax-free advance refundings were no longer allowed, then issuers would be forced into the taxable market to refund their debt, reducing the interest savings a municipality would otherwise realize. Tax-free supply could decline by as much as one-third next year as a result.

It also appears as if there will be little, if any, change in the highest marginal income tax rates for individuals, suggesting the demand for tax-free bonds should remain strong. Less supply combined with strong demand is a favorable formula that could push municipal valuations higher relative to taxable fixed income alternatives.

Not surprisingly, municipalities are already lining up to bring any advance refundings they can to market now, before this calendar year ends. We witnessed a similar event in December of 1985 when $59B of tax-free debt was issued prior to the tax changes of 1986. For comparison, average 2017 monthly issuance through October has averaged $32.5B.

There are other provisions in the two versions of the tax bills that could impact the municipal market in various ways, but the overriding market concern is the potential decline in tax-exempt supply. For example, nothing in the GOP tax plans seeks to address the massive and growing infrastructure needs this country faces. Instead, there seems to be a push, intentional or not, to limit the volume of tax-exempt debt going forward. Those who may be considering an investment in the tax-free municipal market may want to consider this expected rush of issuance before year end as an opportunity to act now rather than wait.

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