Will Short Term Pain Yield Long Term Gain?

Earlier this year, having assessed the risks in the municipal bond market and the potential for reward, we reduced the duration (measure of interest rate sensitivity) of our client portfolios to the lowest levels since 2005. At the time, the prospect and implications of tax reform played only a modest role in that risk reduction decision. Now, as we prepare to close our books on the year, tax reform may be opening up the door for an opportunity in 2018.

Background

While the Tax Reform Bill is still making its journey through Congress, the impact of the proposed legislation is creating uncertainty for issuers of municipal bonds. In fact, while the month of December has traditionally been a relatively quiet time for tax-exempt supply to enter the market, December 2017 is setting up to be quite a bit different. As Congress plans to prohibit certain types of borrowers from issuing debt on a tax advantaged basis, municipalities are lining up to beat the ban. Although the final passage of a tax reform bill is not a given, issuers that could be affected are in motion.

Essentials: House or Senate Bill Could Stifle 2018 New Issue Supply

The House version of the tax plan would eliminate the tax-exempt status for Private Activity Bonds (PAB) after Dec. 31, 2017. Private Activity Bonds are issued on behalf of a state or local government in order to provide financing for such projects as airports, hospitals and nonprofit colleges. Disallowing these tax-exempt financings would cause a significant reduction in the number of bonds "priced" in the municipal market as roughly 20% of new issues priced in 2016 (source: Bond Buyer) were PAB's. In contrast, the Senate version of Tax Reform preserves the ability of PAB borrowers to issue tax-exempt bonds.

That's not all. Both versions of the Bill would however eliminate a type of financing known as an "Advance-Refunding". In these transactions, municipalities capitalize on a declining interest rate environment by retiring callable bonds ahead of their scheduled call date. Specifically, new bonds carrying lower yields than the outstanding bonds are issued. The proceeds are then invested in government bonds (primarily U.S. Treasury securities) and when the older bonds become callable they are paid off with the invested proceeds.

Potential Opportunity

While each of us can assign our own probability on the Tax Reform Bill becoming the law of the land, issuers of municipal bonds aren't wasting their time pontificating. New issues that would have been brought to market next year are instead slated to be jammed on to the calendar during the month of December. This temporary supply to demand imbalance should create an investment opportunity by putting upward pressure on tax-exempt yields, resulting in lower prices for outstanding bonds.

We at RSW, are poised to capitalize on these declines by extending our clients' average maturity and/or duration (where appropriate) thereby locking in higher levels of tax-exempt income for the future. The extent of the opportunity will largely be determined by the volume of issues that are actually brought to market.

Furthermore, in 2018, assuming no material changes in U.S. Treasury bond yields, tax-exempt yields should fall (prices rise) as investor demand should be met by a relatively light supply of new municipal offerings throughout the year.

Conclusion

Current bondholders could experience short term pain as bond prices are likely to fall during the remainder of the year. For this event, we are well positioned as our interest rate risk exposure is at the lowest levels since we have been managing our core strategies. The anticipated price declines should provide our management team with an opportunity to restructure a portion of our current holdings into bonds affording higher yields. As the supply glut clears the market this year, a meaningful opportunity to capitalize on the depressed prices should be realized.

In RSW's 2018 Outlook (to be released in the first week of January), should a Tax Reform Bill become law, we will cover additional conflicting topics such as:

A Provision That Could Reduce Demand

At the core of their proposed Tax Reform Bill, both the House and Senate Bill lower the corporate tax rate from 35% to 20%. This rate reduction could curb the appetite of Property and Casualty (P&C) insurers who hold roughly 9% of the total outstanding municipal debt. Furthermore, the demand from banks could be squelched as an investment in taxable bonds might look more appealing given their lower corporate tax rate.

Repeal of the State and Local Tax Deduction (SALT) Could Increase Demand for Bonds in High Tax States

Another significant proposed change would directly impact individual taxpayers who reside in high tax states. Both the House and Senate versions eliminate an individual's ability to deduct the payment of state and local income taxes (SALT) on their federal tax return. Furthermore the deductibility of property taxes remains in the crosshairs as well. The Republican proposal calls for capping the deductions for property taxes at $10,000 per year, while the Senate bill eliminates this deduction completely.