Shadows of Tax Reform Loom over Municipals

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Now that talk of tax reform has taken center stage in Washington, the biggest concern for municipal investors is whether the upside of lower taxes could spell downside for their municipal bond valuations. The good news is that not every proposed change is likely to have a negative impact.

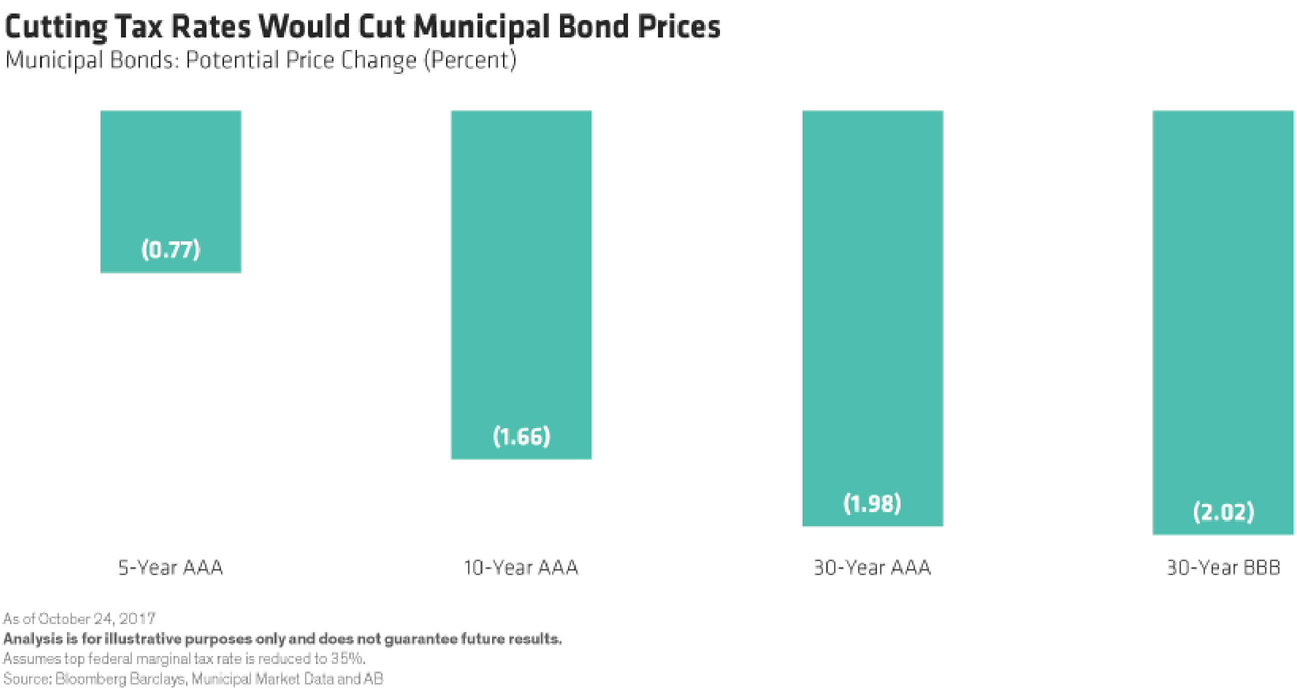
House and Senate Republicans are rushing to land a tax reform bill on the president's desk before Christmas. Speaker Ryan hopes to have the House version passed as early as Thanksgiving, and House leaders are preparing to socialize it in early November. Senate leaders have promised to be quick on their heels, now that they've passed a major budget agreement. That agreement prevents Democrats from filibustering any tax bill.

Vanishing Fog

While visibility remains limited—after all, what (other than healthcare, perhaps) could be more complex than federal tax codes?—we can provide a few guideposts for municipal investors. Let's look at the major proposals outlined by President Trump and Republican Congressional leaders that directly affect individual taxpayers:

Cutting the top marginal rate to 35%. There's a pretty straightforward relationship between individual tax rates and the value of municipal bonds. A tax-rate cut reduces the value of the tax-exemption component of a municipal bond, which in turn results in lower municipal bond prices.

We've estimated the potential price decline from such a cut in the *Display* below. Longer municipal bonds would experience more than twice the price decline of intermediate-maturity bonds.



In the event that the top federal marginal rate is lowered to 35%, we expect the *after-tax* yield advantage of a 10-year municipal relative to Treasuries to decline from 0.7% to 0.5%. That's not a massive disruption to the muni market, however. The after-tax yield advantage has averaged 0.8% over the past five years and has ranged from 1.4% to 0.5% over that period.

Eliminating state and local tax deductions, known as SALT. We suspect that SALT elimination would drive investors into in-state municipal bonds, especially in high-tax states. After all, these investors would no longer have the ability to deduct state taxes on out-of-state income on their federal returns, so investing in municipals from other states would no longer provide that advantage for them.

Theoretically, the effect of such an investment shift could be to reduce yields of bonds (and increase prices) in high-tax states as demand for those municipals increases. Conversely, demand for bonds in low-tax states could decrease, causing their relative yields to rise.

Eliminating the alternative minimum tax, or AMT. Existing bonds subject to the AMT would likely increase in value as they come under greater demand.

What wasn't included among the proposals? There was no mention of eliminating or capping the municipal tax exemption. That would have hit muni prices hard and across the board, so its absence is a relief and good news for muni investors.

It's Still Harvest Time

Overhauls of federal tax code don't happen overnight. What we now think of as the Reagan tax cuts unfolded over the course of six years. Their final element—major legislation enacted in 1986—took nearly a full year from introduction through Reagan's signature. Sizable tax cuts under George W. Bush made it through in two installments spanning three years.

The legislative timeline established by today's Congress is aggressive. Nonetheless, we think it's unlikely for any of these proposals to pass so quickly, if for no other reason than that tax code is highly complex and major overhauls are difficult. Time is on investors' side as the market digests the impact of proposed legislation during the process.

And, of course, there's no guarantee that the legislation will pass at all. Two Republican senators have already signaled they won't vote for any tax bill that increases the deficit or hurts the middle class, leaving little to no margin for failure in what is already partisan tax reform.

In the meantime, as investors wait to see how tax legislation could unfold, it's important that they remain in active strategies and choose flexible mandates that invest dynamically as conditions change. In particular, the ability to use taxable bonds—whether Treasuries or corporates—opportunistically can help preserve capital during volatile periods. Such strategies also help keep municipal bond investors out of the shadows—and focused on harvesting opportunities.

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