WHITE PAPER

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Municipal Bonds in a Tax Cut World

Congress passed and the President signed sweeping changes to the U.S. tax law in late December. Even though the Tax Cuts and Jobs Act reduced the top income tax rate, we believe the net effect of overall changes in tax law are not material enough to impact the benefit to top income earners of holding quality portfolios of municipal bonds. In the end, if municipal bonds made sense for individual investors before, recent tax law changes do little to dampen their appeal while some may find them even more compelling.

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Congress lowered the top Federal individual income tax bracket from 39.6% to 37% and preserved the exclusion of municipal income from the 3.8% Medicare tax. However, because new tax law severely limits the amount of state and local taxes that can be deducted, top earners have the potential for a higher combined effective tax rate than before. Since the attractiveness of tax-exempt municipal bonds relative to comparable taxable bonds is driven by the effective tax rate of the investor, doing the math is essential.

As of this writing, the benchmark yield of the taxable seven year AA Corporate index stood at 3.2% according to Thomson Reuters, while the yield of the AA Municipal G.O. was 2.0%. Under the new law, the taxable equivalent yield (TEY) of the municipal would be 3.4% using a combined effective rate 40.8% (37% + 3.8%). Hence, the relative value of municipals despite a slightly lower overall tax rate.

If the municipal in this example were exempt from say a 6% state income tax as well, the taxable equivalent yield would climb to 3.8%. This is a result of adding the full amount of the state and local tax (SALT) pushing the combined effective tax rate higher to 46.8% (40.8% + 6%). In both cases, the municipal offers more in relative value, but for the investor to be able to pick up an additional 0.6% of yield by buying the comparable municipal bond, the example should be persuasive.

Besides individuals, the tax law change could impact the tax equivalent yield of other buyers of bonds, impacting overall demand and the rate on bonds. Today, individual investors hold approximately 66% of the $3.8 trillion municipal debt market through outright purchases and mutual funds. Historically, the percentage of individual ownership has oscillated in the 65% to 75% range. Much of the rest of the market is held by banks and insurance companies, both of which benefit from a much larger corporate tax rate cut from 35% to 21%. Because of this, insurance companies will most likely hold fewer municipal bonds going forward, but will still have a presence due to the greater availability of high quality longer maturities versus corporate bonds. Banks, however, may hold more. Currently, banks hold approximately

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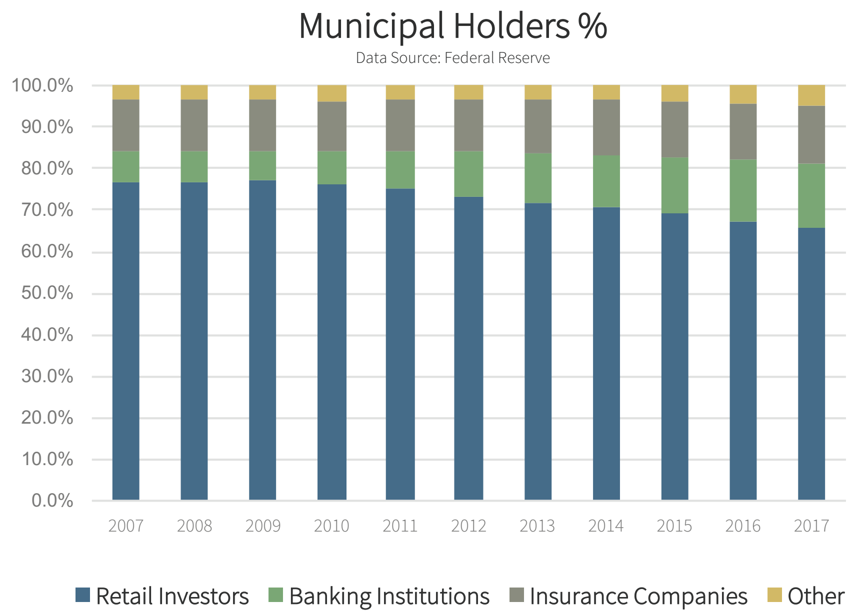
Important Notes And Disclosures

15% of the municipal market and have more than doubled their municipal bonds holdings over the last ten years as a result of a more stringent regulatory environment. In 2018, banks may have more incentive to add to holdings if municipals are included in legislation that would broaden liquidity coverage requirements.



The combination of more demand from individuals and banks should balance out a likely decline in demand from insurance companies. Overall, we believe the demand for municipal bonds will remain near current levels relative to comparable taxable bonds. If not, we may see a slight rise in municipal yields that would benefit municipal investors with ample cash and short-term holdings.

We would also contend that if the demand from larger institutional buyers is diminished the bid/ask spread may widen for municipal bonds making the role of a professional advisor more important to ensure the best trade execution.

Regarding supply, issuers of municipal bonds may need to reformulate the structure of future offerings to cope with the elimination of "advanced refunding"* and the likely decrease in demand for bonds maturing beyond fifteen years, the preferred choice for most insurance

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**Advanced refunding refers to the ability of a municipality to refinance a bond issue earlier than 90 days before the call date of the issue. The repeal of this feature reduces the flexibility of issuers to potentially lower borrowing costs and manage outstanding debt. Refundings have accounted for nearly 15% of municipal supply over the last several years.*

companies. In other words, the structure of municipal supply may shift to appeal more to individual investors and banks that prefer maturities shorter than fifteen years. This shift would also provide issuers a way to better cope with the loss of flexibility to call bonds if opportunities to refinance arise.

Bottom Line: Individual investors will continue to benefit from the tax-exempt income of municipal bonds in a diversified portfolio tailored to their unique needs. Vigilance over credit quality, trade execution and a portfolio structured to handle a gradual rise in interest rates will continue to reward investors over time.

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