November 2017 Market Commentary

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Tax Reform, Tax Cuts, Tax Increase?

- **Tax Reform may result in a 50% reduction of municipal new issuance annually or $1.5-$2 trillion over the next ten years.**

- **A significant increase in demand for municipal bonds, together with a dramatic decline in municipal bond issuance, will likely result in meaningful outperformance of municipal bonds over the long-term.**

- **The 30-day new issue municipal bond calendar has recently swollen and may exceed $24 billion.**

- **Considerably lower long-term supply, together with increased demand from wealthy investors, resulting from the potential repeal of State and Local Tax (SALT) deductions, will be a driving forces behind, what we expect will be, strong muni performance going forward.**

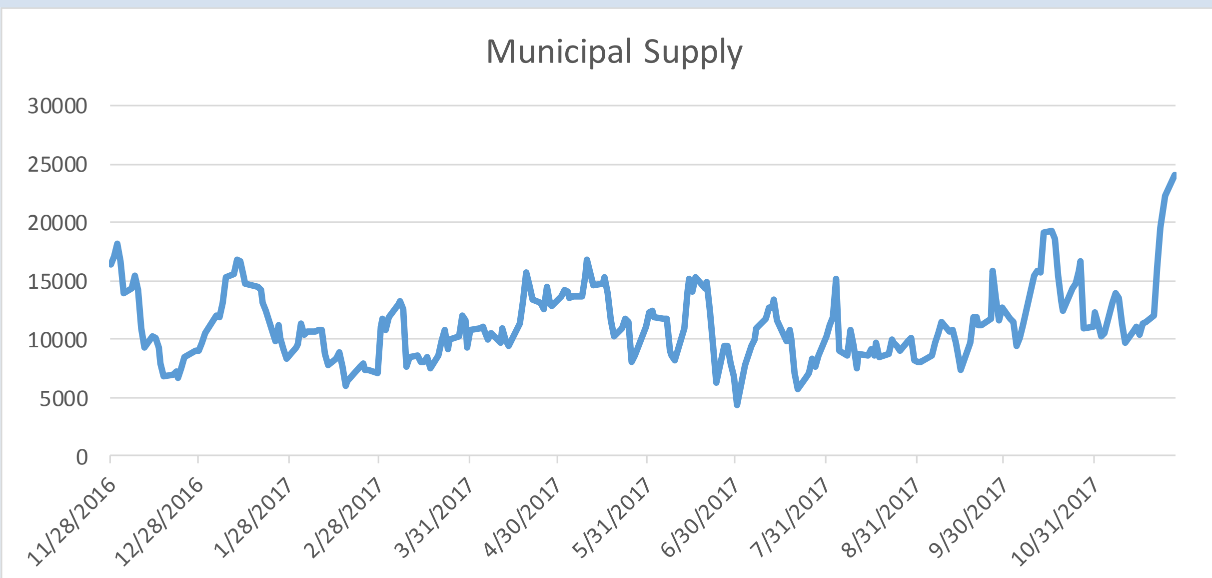
Whether one perceives the recent House and Senate proposals as tax reform, tax cuts, or tax increases largely depends on where you live and whether you are an individual taxpayer or a corporation. One outcome is abundantly clear. The tax law changes Congress has proposed will considerably limit the ability of wealthy investors to reduce their tax burden. Assuming the two proposals, winding their way through Congress, are enacted in a form similar to how they were written, wealthy investors, living in states like CA, NY, NJ and CT, are likely to pay materially higher taxes. The most recent House and Senate tax proposals include provisions which would result in the curtailment or outright elimination of a number of highly coveted, individual tax deductions. These include deductions for State and Local Taxes (SALT) and a limitation on mortgage interest deductions in particular. What surprised many in the municipal bond market, however, was that the proposals would also prohibit municipalities from refinancing their debt. The House bill also eliminates a municipalities ability to issue private activity bonds (PAB)'s, for stadiums, hospitals, airport terminals, and charter schools, to name a few. The impact of these changes, if enacted, would be swift and dramatic, in our view, resulting in a significant reduction in municipal bond issuance going forward. At the same time, the elimination and reduction of popular tax deductions would likely increase the demand for tax-free municipal bonds, as there will be significantly fewer places wealthy investors can go to reduce their exposure to taxes. **In our view, a significant increase in demand for municipal bonds, together with a dramatic decline in municipal bond issuance, will result in meaningful outperformance of municipal bonds over the long-term.**

Municipal bonds continue to enjoy strong returns on a year-to-date basis. The broader municipal bond market was higher by 4.5% according to Barclays as of 9/30/17. For individuals in the highest tax bracket, this equates to a 6.9% return on a taxable equivalent basis (TEB). High yield municipal bonds delivered the strongest returns over the same time period, returning 5.80% or 9.5% TEB. While uncertainty regarding tax law changes have caught the attention of the market more recently, we believe any temporary weakness in the municipal bond market could provide an exceptional entry point for investors, given the potential scarcity of municipal bonds in the future.

In order to provide some context for what we expect could be a meaningful reduction in municipal new issue supply, one must consider the fact that the combined issuance of municipal refinancing activity, together with issuance of private activity bonds, represented roughly 50% of all new issue supply in 2016, according to Barclays. Therefore, were the current tax proposals enacted, total new issue volume would be expected to decline by roughly $150-$200 billion next year. This is down from $380-$400 billion in 2017. **A reduction of annual municipal supply of this magnitude would reduce the outstanding availability of municipal bonds by $1.5-$2 trillion over ten years.** The current size of all outstanding debt in the municipal bond market is roughly $3.6 trillion. We believe the municipal yield curve would flatten dramatically. As a result, investors seeking to reinvest their tax-free income and the proceeds from their bonds as they mature, will be confronted with the realization that there is likely to be insufficient supply to satisfy the increased demand.

We have already begun to see evidence of this new reality settling in. The 30-day new issue municipal bond calendar has recently swollen considerably and may exceed the record issuance last year this time. We expect municipal new issuance could exceed $24 billion, see **Figure 1**. below, over the next four weeks as issuers seek to complete as many deals as possible before the calendar year ends, as the door slams shut for many would-be issuers. The scale of new issue supply is likely to apply meaningful pressure on yields, temporarily, as dealers are forced to raise yields to find willing buyers for the cascade of issuance, providing an excellent entry point for new investors or anyone seeking to reallocate opportunistically, in our view. The supply build is likely to be short-lived, however. As uncertainty dissipates and details regarding ultimate tax law changes, if any, become clearer in the weeks ahead, we believe the municipal bond market will once again normalize, to the benefit of bondholders. If current tax reform bills remain roughly the same, and anything close to either the Senate or House proposals regarding

Figure 1.



Source: Bloomberg

limitations on municipalities to issue debt were to pass, we expect muni new issuance to fall dramatically in 2018 and in the years ahead.

Considerably lower long-term supply, together with increased demand from wealthy investors, resulting from the potential repeal of State and Local Tax (SALT) deductions, will be a driving forces behind, what we expect will be, strong muni performance going forward. If tax reform proceeds as planned, investors with idle cash or perhaps those that have been waiting for the right opportunity to get into munis, may never have a better time to do so.

Please let us know if you have any questions as to how one might capitalize on this unique opportunity.

Best Regards,

Andrew Clinton
Chief Executive Officer

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