TAX CUTS AND JOBS ACT BENEFITS MUNICIPAL BONDS

A year and a half after the Tax Cuts and Jobs Act of 2017 (TCJA) was signed into law, we believe market and credit conditions have reached an equilibrium that allows for support of municipal bonds which will persist as long as the TCJA remains intact.

President Trump signed the Tax Cut and Jobs Act of 2017 into law in December of 2017. Though major provisions of the law centered around reducing corporate and personal tax rates and changing certain elements of the tax code, the legislation had both direct and indirect effects on the municipal bond market. After a year and a half, we expect that the law's consequences will continue to contribute to municipal bond outperformance. Specifically, we see three reasons why municipal bond valuations should be positively affected. Upward demand-side pressure from tax-sensitive investors, reduced supply due to the TCJA's elimination of advance refunding, and improved state fiscal health may all contribute to further yield compression, in our opinion.

SALT Deduction Cap Propels Demand for Municipal Bonds

The TCJA capped the State and Local Tax (SALT) deduction at $10,000. For wealthy individuals who exceeded this cap, the inability to deduct a higher sum necessitated greater tax sensitivity in their portfolios. Many investors looked to increase their allocations to tax-free municipals in an effort to offset what would be a higher tax bill. This effect has been especially pronounced in high-tax, wealthy states such as California, Connecticut, New Jersey, and New York, resulting in rising valuations for tax-free bonds from these states.

It should be noted that the SALT cap has been one of the more politically contentious aspects of the TCJA. This provision could be vulnerable to reversal, depending on how the political landscape shakes out following the 2020 election. A lawsuit challenging the legality of this provision is still making its way through the courts, but we believe it is largely quixotic and the deduction cap unlikely to be changed through judicial channels.

Elimination of Advance Refunding Throttles Muni Supply

The TCJA disallowed the advance refunding of municipal securities. What had once been a common and frequent supply-side practice, particularly in a declining rate environment, has been completely eliminated. Investors must now fight a limited supply environment. As investor hunger for bonds grows, higher bids and thus higher valuations should be expected as refunding supply is persistently limited by the inability to refinance municipal debt.

We believe that this provision will remain intact as attempts to dismantle the TCJA will likely focus on more fundamental aspects of the law. Other supply drivers are difficult to identify, with a federal infrastructure bill yet to be introduced in either chamber. Thus, supply-side constraint should continue to be the prevailing market condition for the next several years, in our view.

Higher AGI Leads to More Tax Revenue in State Coffers

The TCJA fundamentally changed the way tax deductions could be claimed in two important ways including the capping of State and Local Tax deductions at $10,000, while eliminating personal exemptions and making it less beneficial to itemize deductions. Combined, these changes have led to higher adjusted gross incomes (AGI), specifically for wealthier individuals who exceeded the $10,000 SALT threshold.

Recent empirical evidence has clearly shown that states have collected an increasing amount of tax revenue in 2018 and 2019. The ten most populous U.S. states that levy income taxes all saw April 2019 revenue spikes, on average collecting 40% more revenue in April 2019 compared to April 2018. An analysis from Pew Charitable Trusts shows that all but five states saw a rise in tax revenue in Q3 2018, bringing the number of states with collections exceeding pre-crisis values to 41.

An increase in tax revenue benefits state credit quality, at least in the near-term. There is always a possibility that state officials accelerate expenditures beyond the pace of increased tax collections, however, under normal circumstances we believe increased tax revenue is a credit positive. An improvement in credit quality will narrow credit spreads, leading to further municipal outperformance. This has been particularly supportive for lower-quality State bonds, as evidenced by recent credit compression in Connecticut, Illinois, and New Jersey paper.

We believe the upward shift in adjusted gross income on tax returns as a result of elimination, capping, or otherwise disincentivizing deductions should prevail as long as TCJA remains intact. This should continue to exert upward pressure on municipal security valuations, in our view. While the SALT cap could be politically vulnerable, any other deduction provisions in TCJA would likely be eliminated only as part of a complete rollback of the law.

Arguments have been made that increased AGI is not a significant driver of the spike in state tax revenues. Some suggest that recent favorable spikes in collections are due to a combination of favorable economic conditions and lumpy timing of tax payments. The belief is that state income tax revenues could fall back in the event of an economic downturn and/or more efficient tax planning, as individuals better understand the law over time. While both of these events are possible, we believe AGI has significant impact on tax collections and indicate a more permanent upward shift toward increases in state revenues.