Russell Investments Helping Advisors Blog

Insights, ideas and information that help advisors make a difference

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Is tax-reform a threat to tax-exempt bonds?

While the U.S. stock market (S&P 500 Index) rallied immediately following the election in November to the end of the year, the muni bond market's initial reaction was to sell off—strongly. Worries about tax reform, a perceived threat to Municipal bond tax-exemption, and the tax implications of the potential repeal and replacement of the Affordable Care Act's 3.8% Net Investment Income Tax drove much of that early reaction.

Since the start of 2017, however, it appears that more rational minds have prevailed. Year-to-date inflows to Muni Bonds stood at a healthy $19 billion as of July 31, according to the Investment Company Institute, which tracks this type of data.

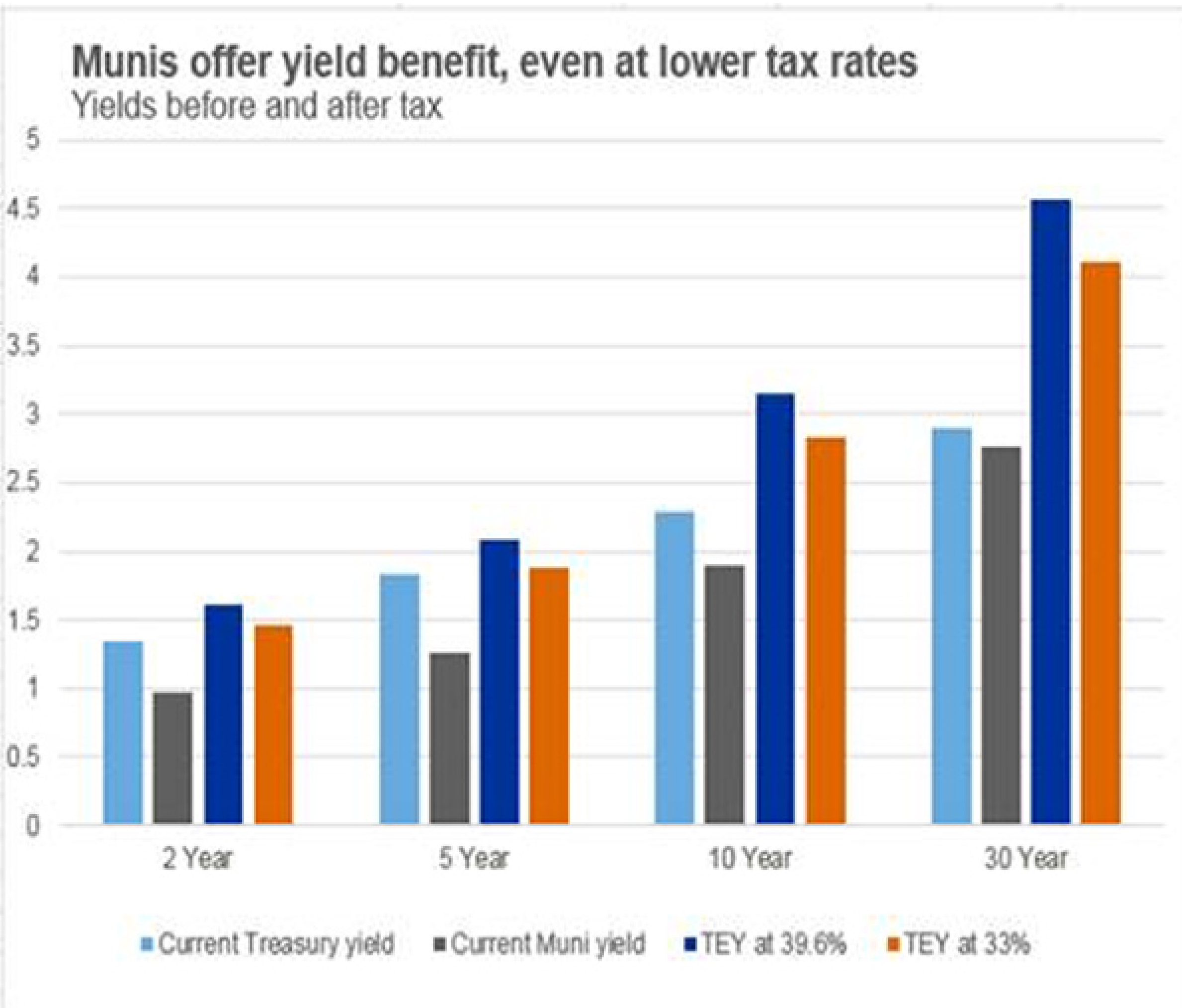
Although most Americans on both sides of the aisle reportedly consider today's federal tax system to be unfair[1], the current Administration's discussions about tax reform has many investors concerned—particularly about the reforms' potential implications for the $3.8 trillion municipal bond market[2]. In contrast, at Russell Investments, we do not think that the currently proposed changes will jeopardize the potential benefits the municipal market offers to investors. Here's why:

1. **Strong fundamentals** When excluding Puerto Rico, muni bond upgrades have consistently outpaced downgrades over the past five year period ending July 31, 2017[3], suggesting strong asset class fundamentals. In addition, state tax revenues have grown 1.4% year over year as of July 31, 2017[4], adding to strength of the Muni market fundamentals.
2. **Compelling valuations relative to Treasuries and Corporates** As of July 31, 2017, the muni/treasury ratio stood at a healthy 95% for 30-year bonds, which is above the average (since 1984) of 93%.[5] Furthermore, currently munis have a beta to treasuries of 0.5, making them defensive relative to treasuries in a rising rate environment.

3. **Attractive yield benefit relative to corporates** The yields (on a taxable equivalent basis) on the Intermediate Term Muni Index (Bloomberg Barclays Municipal intermediate Index) and Municipal High Yield Index (Bloomberg Barclays High Yield Muni Bond Index) stood at 3.20% and 9.52%, respectively, as of July 31, 2017. This is very attractive relative to the intermediate term corporate bond yields (Bloomberg Barclays U.S. Gov/Credit Intermediate Term Index) of 2.38% and especially relative to the Corporate High Yield Index which only yielded 5.41%.
4. **Muni bonds' historical resilience to tax reform** Historically, there has been little or no correlation between muni bond yields and the top marginal tax rate—making muni bonds an attractive option for many investors regardless of the prevailing tax regime. For instance, between 1980 and today, the top marginal tax rate has fluctuated from 28%-70%—with negligible impact on Muni market performance:

- Under President Reagan, the top marginal tax rate was reduced from 50% to 28%. Munis produced a return of 15.2%.[6]
- Under President George W. Bush, the top marginal tax rate was cut from 39.6% to 35%. Munis returned 5.5%.[7]
- Under President Obama, the top marginal tax rate was back to 39.6% plus the 3.8% NIIT. The Muni/Treasury ratios actually increased[8], suggesting underperformance.

In contrast, while the current Administration's tax reform proposal is still in the early stages of development, reductions in the top rate of 39.6% to 33% are often mentioned. Based on current treasury and muni bond yields and today's tight spread environment, tax-exempt yields *[Tax-Exempt Yield=Taxable-Equivalent Yield *(1-Tax Rate)]* would remain attractive at that new top marginal tax rate relative to other fixed income asset classes, such as corporates, corporate high yield and treasuries.



Source: Russell Investments. Current Treasury yield and Current Muni yield data from Bloomberg Terminal. Data as of July 31, 2017.

5. **Elimination of federal tax deductions may benefit muni bonds** The proposal to consider eliminating certain federal tax deductions, including deductions for state and local property taxes, may prove positive for Municipal bonds. Such a change in the tax code would have a significant impact on high income residents of states with higher taxes and high property values, such as New York, California and New Jersey. For these investors, muni bond investments can be among the most efficient ways to manage tax liabilities when losing deductions. Hence, this part of the tax reform proposal could lead to fewer deductions which could increase the value of tax exempt interest income from municipal bonds.
6. **Elimination of muni interest exemption appears unlikely** Another topic that is often discussed in the context of

tax reform is the elimination of Muni interest exemption, which would essentially remove the biggest benefit of holding Munis, potentially making them less attractive as an asset class. However, we think that this is very unlikely:

- Muni bond revenues have long been a cost-effective way for the government to invest in infrastructure. In the past 100 years, roughly 70% of the investment in infrastructure has come from state and local bond proceeds.[9] The federal government would be hurting itself by impeding state and local governments' ability to create jobs and spur economic growth.
- Current investors of tax-exempt muni bonds bought them on good faith that the interest on those bonds will be exempt from federal taxes. Reversing that status would cause a severe breach of investors' trust.

7. **Context matters—especially today** Although tax reform is one of the current Administration's top priorities, it is not the only priority. The timeline for tax reform has already slipped, making meaningful tax reform unlikely before 2018. The country's $14 trillion in debt outstanding (77% of U.S. GDP) and the impending Congressional negotiations to raise the debt limit complicate—and may delay—things further. As a result, the extent of the proposed changes in tax cuts may be less dramatic than currently proposed.

The bottom line

Tax reform is top of mind for many—particularly for muni bond investors. But rather than viewing the proposed reforms as a potential risk for muni bonds, we believe that the potential reforms could be a non-event for muni bonds and may actually *increase* their attractiveness for some. In the meantime, help your client stay focused on their real goals while Washington determines the fate and timing of tax reform.

Disclosures: [1] Source: Pew Research Center, "Top Frustrations with Tax System: Sense that Corporates, Wealthy Don't Pay Fair Share" April 14, 2017. Accessed August 14, 2017. http://www.people-press.org/2017/04/14/top-frustrations-with-tax-system-sense-that-corporations-wealthy-dont-pay-fair-share/

[2] Source: Bloomberg Terminal. As of June 30, 2017.

[3] Source: Moody's Investor Service

[4] Source: Moody's Investor Service

[5] Source: Bloomberg Terminal

[6] Source: Barclays Live Analytics

[7] Source: Barclays Live Analytics

[8] Source: Barclays Live Analytics

[9] Source: http://www.munibondsforamerica.org/resources/what-are-muni-bonds/

Generally for municipal bonds, only interest from bonds issued within the state is exempt from that state's income taxes.

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