Tax Reform and the Municipal Bond Market

How Could Tax Changes Impact the $3.8T Municipal Bond Market?

On December 22, 2017, Congress passed the Tax Cuts and Jobs Act of 2017, the first major alteration to US tax law in over 30 years. Since the first signs of potential tax reform arose in 2016, investors have questioned how changes could impact the municipal bond market, where investors have historically turned to source income that is exempt from federal taxes. Now that tax reform has officially passed, we can look to the potential impacts to municipal bond supply and investor demand in order to approximate the potential impact to the market as a whole.

Supply Surged at Year End, but Likely to Fall

In December 2017, new municipal issuance surged as issuers rushed to lock in funding prior to potential issuance restrictions in 2018. New issuance totaled $63B in December, which is nearly two times higher than the average of the prior 11 months.

The new tax plan prohibits municipal issuers from advance refunding their debt, which previously allowed them to refinance existing municipal debt before it became callable. Historically, 10-15% of tax-exempt municipal bond issuance was advance refunded.

In 2018, following the disallowance of advance refunding and the December supply surge, we believe new issuance may fall to ~$325B,\(^1\) down from ~$436B in 2017.\(^2\) In our view, a more muted level of supply should support municipal bond valuations in the long run.

\(^1\)Estimate for 2018 municipal bond issuance represents an average of estimates published by Merrill Lynch, Citigroup, Morgan Stanley, JP Morgan, Loop Capital, RAM, RBC, and Barclays. Estimates as of 12/29/2017. \(^2\)Source: GSAM, Bond Buyer, as of 12/31/2017. Goldman Sachs does not provide accounting, tax or legal advice. Please see additional disclosures at the end of this document. The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this presentation. A callable bond is a bond that can be redeemed by the issuer prior to its maturity. “~” represents an approximation.
**Demand Likely to Remain Stable**

The final tax bill features a slight decline in the top individual tax rate from 39.6% to 37%. In our view, this decline will not cause a meaningful impact to individual municipal bond demand, as tax-equivalent yields should remain attractive relative to corporate bonds and US Treasuries.

The tax bill includes a more significant decrease to the corporate tax rate – from 35% to 21%. As a result, we believe there may be less demand from corporate municipal bond buyers (especially banks and property & casualty insurers) moving forward, but do not anticipate large-scale selling of existing municipal bond holdings.

**A Look at Performance Following Historical Tax Cuts**

Historically, there has been relatively little correlation between aggressive tax policy changes and municipal bond returns. During the most recent tax cut regimes, municipal bonds have generated strong performance.

In the two years following the 1986 tax cut under President Reagan, when the top individual tax rate was decreased from 50% to 28%, municipal bonds generated 5.74%. Subsequently, after President George W. Bush’s tax cut in 2001, when the top individual tax rate was cut from 39.6% to 35%, municipal bonds returned 7.35%.

**Why Now?**

Municipal bond valuations tend to be heavily influenced by the technical environment, determined by supply and demand. With the potential for meaningfully reduced supply and relatively stable demand, the technical environment should be supportive of municipal bond valuations. Further, prior tax cuts throughout history have demonstrated a muted, or even positive impact on the overall health of the municipal bond market. As a result, we believe we will see a continuation of municipal bond strength in the years to come.

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Top Chart Source: GSAM, Barclays Live as of December 31, 2017. Chart shows the Tax-Equivalent Yields of different bonds plotted against the duration of those bonds. Duration is a measure of the price sensitivity of a fixed income instrument to interest rate changes. For each bond type, the chart shows bonds of 3, 5, 10, and 20 year maturities with a line of best fit through them. Municipal is represented by the Barclays Municipal Bond Index, IG Corps is represented by the Barclays Investment-Grade Corporate Bond Index, Treasury is represented by the Barclays Treasury Bond Index which is also a subset of government bonds. The previous tax rate used is 43.4%, representing a 39.6% federal rate and a 3.8% Affordable Health Care Tax. The 40.8% tax rate reflects the latest tax legislation which reduced the federal rate from 39.6% to 37%. Yields shown do not reflect performance for any Goldman Sachs products. Bottom Chart Source: Morningstar, as of 12/31/2017. Return represents Bloomberg Barclays Municipal Index in two years following 1986 tax cut (1/1/1987-12/31/1988). Two years following 2001 tax cut (1/1/2001-12/31/2002). GROWTH OF $100: A graphical measurement of a portfolio’s gross return that simulates the performance of an initial investment of $100 over the given time period. The example provided does not reflect the deduction of investment advisory fees and expenses which would reduce an investor’s return. It is not possible to invest directly in an unmanaged index. Past performance does not guarantee future results, which may vary.
Risk Considerations

Investing in the bond market is subject to certain risks, including market, interest rate, issuer, credit and inflation risk.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

Although Treasuries are considered free from credit risk, they are subject to interest rate risk, which may cause the underlying value of the security to fluctuate.

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