NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Tax-Reform: Game Changer for Munis?

This *Quick Takes* explores potential tax changes of the new administration and their effects for holders of municipal bonds, specifically property and casualty insurers.

OVERVIEW

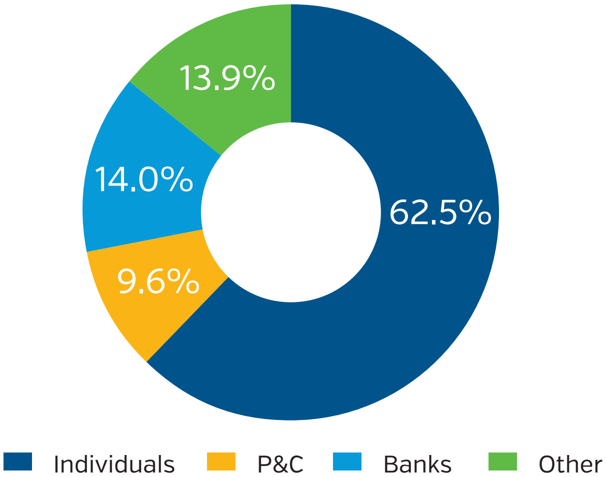
Potential tax changes appear aggressive for both individuals and corporations, yet tax-exempt municipal bond valuations are unlikely to change substantially relative to taxable alternatives. Market segmentation, specifically with respect to individual investors, should help keep municipal valuations in check. Regardless, corporate tax cuts would result in less favorable tax-adjusted muni yields for institutional investors though still competitive relative to taxable bond alternatives.

Exhibit 1. Summary of Key Tax Proposals Which Could Impact Muni Bond Demand

	Current	Trump	House of Representatives Plan
Highest Federal Corporate Tax Rate	35%	15%	20%
Highest Federal Individual Tax Rate	39.6%	33%	33%
Medicare Surtax on Investment Income	3.8%	0%	0%
Individual Taxable Interest Income	43.4%	33%	16.5%

Source: Better.gop, NEAM

Exhibit 2. Municipal Market - $3.8 Trillion (as of 12/8/2016)



Source: Federal Reserve

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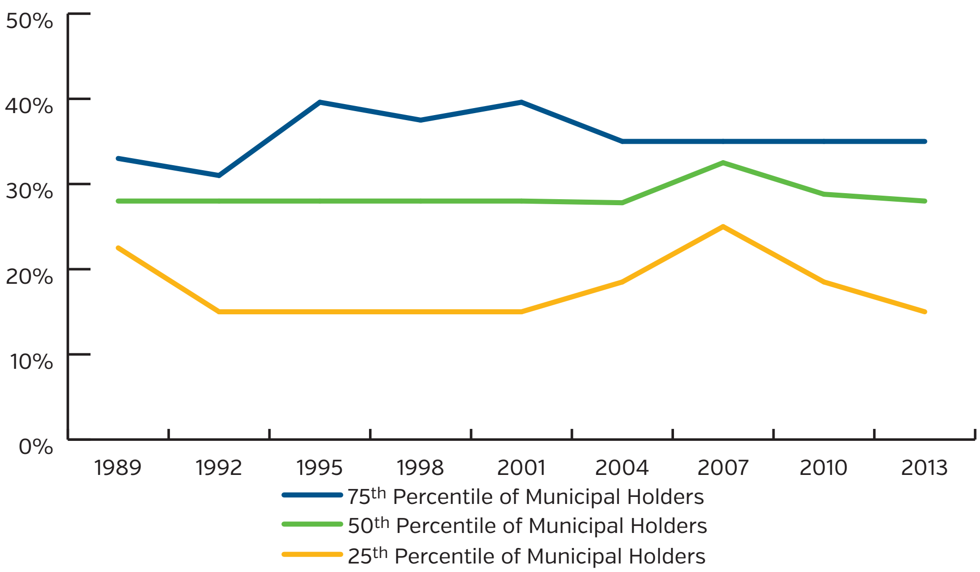
MARKET DRIVEN BY INDIVIDUALS

The municipal market is dominated by individual investors who have tended to be less sensitive to yields relative to taxable alternatives. History has shown that personal income tax rates in the current range have not been a key driver of relative value in the muni market. One possible explanation for this is that the 50th percentile of retail owners has historically been in the 28% tax bracket (Exhibit 3), with a significant majority well below the current highest marginal tax rate. Many of these investors may reside in states with high state and local taxes where munis provide a significant tax shelter. If the Trump/House proposals come to fruition, the majority of retail investors will not experience a dramatic loss of tax-adjusted yield because they already fall below the proposed 33% Federal tax rate. Consequently, cuts in individual income tax rates of the magnitude currently being discussed aren't likely to derail the muni market for any extended period of time.

Exhibit 3. Marginal Tax Rate Cohorts of Retail Muni Investors



Source: Brookings.edu

On the other hand, corporations that own municipals would accrue a smaller tax advantage if the discussed corporate tax policy is adopted. While proposed tax rate changes would not materially diminish municipal's relative attractiveness for the majority of retail investors, municipals *would* be less attractive for corporations, such as property and casualty insurers. At lower tax rates, P&C companies will be more price sensitive with regard to adding tax-exempts than they are at the current 35% tax rate. Hence, at a hypothetical price, municipals would be significantly less attractive to P&C investors than they would be to retail investors, a circumstance that does not exist when both individual rates and corporate rates are as close to one another as they've been for the last 30 years. If the proposals in exhibit 1 (or similar) are eventually adopted, we would anticipate higher turnover in the sector, driven by institutional buyers who would be more likely to engage in "crossover" trading between taxables and tax-exempts.

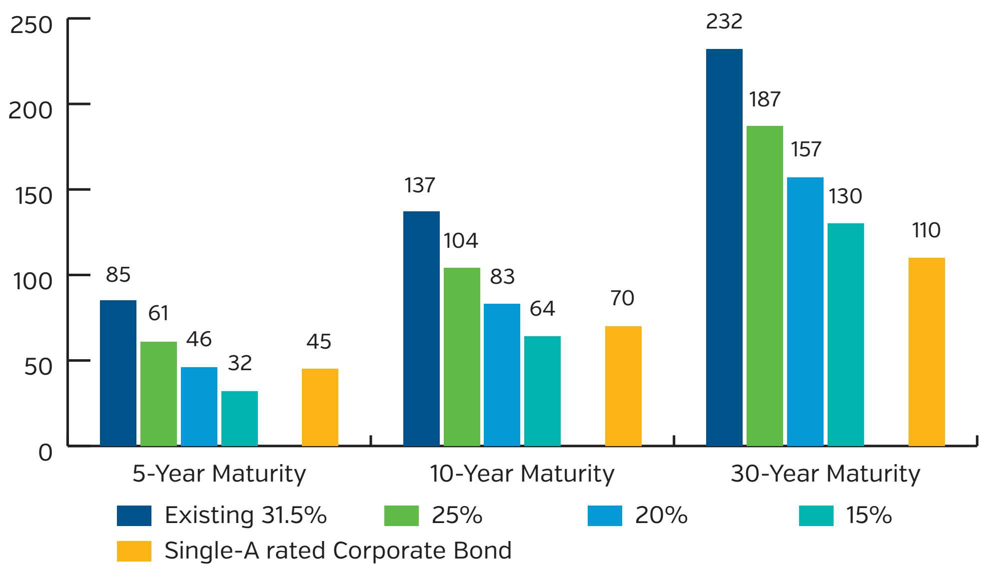
OTHER TAX CONSIDERATIONS

Both the House and Trump propose elimination of the 3.8% Medicare surtax which would be a modest negative for munis as their income is exempt from the levy. Also, the House plan calls to tax individual income at half of ordinary income tax rates. This would amount to a 16.5% tax on interest from taxable investments for individuals in the highest proposed tax bracket, much lower than the current 43.4% rate. By lowering the tax rate on investment interest, tax-exempt yields would be less attractive on a comparative basis.

UNCERTAINTY AND ITS PREMIUM

For years, the muni yield curve has remained steep, offering a generous premium to taxable alternatives when taking tax rates into account. A portion of that premium was offered to compensate investors for tax uncertainty in a high tax jurisdiction at a time when other advanced economies were lowering rates. Ultimately, lower tax rates reduce the embedded tax uncertainty premium in munis. As a result, taxable equivalent spreads should more closely approximate those of taxable alternatives, such as corporate bonds. As illustrated in Exhibit 4, AA rated municipal bonds should still offer additional tax-adjusted yield over single A rated corporate bonds in lower corporate tax scenarios, particularly in longer maturities.

Exhibit 4. Insurance Companies: AA Muni Taxable Equivalent Yield Spreads (bps) at Lower Tax Rates



Based on observable market data as of 1/16/17.

Source: NEAM

WHAT'S NEXT?

The muni bond market has stabilized following the post-election sell-off, but we expect volatility to remain heightened as investors continue to discount the potential impact of lower tax rates. While history has shown that tax rates are not the primary driver of muni relative value, we do expect tax-related headline risk to remain elevated. Aside from tax risk, municipal credit remains on relatively solid footing and net supply is projected to remain manageable in 2017.

KEY TAKEAWAYS

- Muni market discounting heightened tax risk
- Institutional investors more tax sensitive than individuals
- Ongoing demand from individuals for tax-free income should keep relative valuations in check
- Institutional demand could moderate; insurance companies, banks, etc.
- Tax rate uncertainty diminishes at lower tax rates, as does expected spread
- Muni spreads remain attractive relative to taxable alternatives in lower tax scenarios

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