Munis: Implications & Opportunities amid Changing Reform and Legislation

Joined by Purva Petal, CIMA®, Senior Vice President, Client Portfolio Manager — Nuveen Asset Management and Robert Amodeo, CFA and Head of Municipals – Western Asset, we discuss the outlook for municipals throughout a year of rising interest rates and changes to federal legislation.


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The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on April 16, 2018.

LH: **Good morning, I'm Libby Hastert. Today is Monday, April 16. With tax day officially tomorrow, we want to help listeners get a jump start on their planning for next year, largely focusing on a discussion around tax-free income and the municipal bond market. We brought in some experts on the matter. But before I introduce today's guests, I want to try to capture the sentiment of the market.**

Here's a quick look at where we are.

- **Municipal bonds have faced some shifting market trends, with the Fed expected to continue raising interest rates.**
- **Tax reform has also been lowering rates, also reducing local and state tax breaks and infrastructure requirements across the nation, which potentially brings both issues and opportunities.**
- **Yet, in spite of all this, munis are remaining strong. In fact, this year high yield municipal bonds performed well in relation to other fixed income offerings, which begs the question of whether muni bonds has a potential to continue with this pattern of out-performance.**

With that in mind, I'd like to go ahead and introduce today's speakers. From Nuveen Asset Management (Nuveen), we have Purva Patel. She is senior vice-president and client portfolio manager at Nuveen. Also joining is Robert Amodeo, CFA and Head of Municipals at Western Asset.

Robert, if I could start with you. The Federal Reserve is expected to continue to raise interest rates this year three times, and possibly four times. How is this impacting the broad municipal market? Robert?

RA: Sure. Well, thank you very much for being part of this conversation. I look very much forward to being informative, as well as trying to be somewhat interesting. Obviously, public finance is a very interesting subject.

Yeah, I think there will be multiple stages here. One is, obviously, the Fed is now squarely in a tightening cycle. It's been so since 2015, although that was one and done. Now, we seem to be more squarely in the midst of a Fed tightening cycle. Obviously, they are talking about raising their short-term borrowing rates multiple times this year and looking forward to the out years and continuing in that trend.

I think there is some uncertainty as to how this will unfold. I think one of the things that there's less uncertainty about is the Fed messaging. I think they have done an outstanding job, for a number of years now, in messaging their monetary policies. So, there should be some less uncertainty from the market perspective, in terms of messaging. Therefore, the potential for lower volatility. In fact, over the last 30 days, when you look at the rolling 30-day volatility in the municipal bond market, it has dropped and dropped precipitously from those elevator levels that we witnessed at the beginning of this year. That's good news, and again, that's in the face of a Fed tightening and further tightening ahead.

When you look back to the past Fed tightening cycles, '94, '99 to 2000, '04 to '06, and now, '15 through 2018, you can call out some very difficult and challenging environments. If you'd look to 1994, that, I think, is a very different type of Fed tightening cycles, and one that we're unlikely to witness here in '15 and through into whenever they eventually finish their Fed tightening cycle. More importantly, as I've mentioned, the messaging is so much improved since 1994. But, '94 was obviously a very challenging year for fixed income.

Then, if you look at '99, 2000, '04 to '06, and now, more recently, it's been very good. Even in the face of said tightening, it's been very good for fixed income investors. Granted, '99 and 2000 was okay. It wasn't off the charts great. But, you look to '04 to '06, maturities and, actually, lower credit quality and more credit spread in your portfolio, you performed extremely well.

That would go against most people's perspectives, especially the retail investor, who seems to be always fearful of Fed tightening cycles. I think, if you look over the last, almost handful of Fed tightening cycles, it doesn't necessarily mean calamity. In fact, there might be some good opportunities in a marketplace. I think today's marketplace is one of those.

LH: Great. Now, Purva, with these Fed-tightening cycles, would you say that some of this is already priced in at this point?

PP: It's tough to say that with 100% certainty. But, I think what we have seen as the Fed has tightened, is that the short end of the curve is very sensitive to what the Fed is doing. Whereas the long end of the curve and Robert mentioned this, the long end of the curve in 2004 to 2006 did something opposite of what investors had expected. I think you may experience something similar to that with this market and just as we experience the next few Fed rate increases. It's tough to make a case for the 10-year treasury and the 30-year treasury to be at significantly higher levels than what they are right now without a lot of inflation.

With that said, we think maybe a lot of the pricing in, if you will, the Fed rate raises may have already been priced into the market on the intermediate and the long part of the curve, but the short part of the curve will still probably see some sensitivity to what the Fed does for the rest of the year.

LH: Great. Robert, obviously as we said, tax season is top of mind for everyone. If we could just take a little bit of a deeper dive, and you could speak to how the muni bond market has been impacted by the various components of tax reform, legislation as a whole.

RA: Yeah, investors are asking what tax reform means for the municipal bond market, broadly. At Western, as we expected, the plan is the net positive for most municipal bond investors, because ... Ironically, I've been doing this almost 30 years. The latest tax reform, now tax law, did not take away the municipal bond tax exemption. I'd be hard-pressed to point to a past budget cycle or tax reform rhetoric. It'd be tough to point to another time when the tax exemption was not squarely in the crosshairs of public policymakers, as to a potential avenue of opportunity to raise revenue.

I say that, when you look at tax reform, obviously taxes can be very complicated. Perhaps to oversimplify the landscape, we think there will be really three stages of impact on the municipal bond market. The first one, we witnessed at the latter part of 2017, as there was a rush to the marketplace, in terms of new issue supply. December 2017, we really saw an onslaught of supply hit the municipal bond market. In the face of that supply, outside supply, again, municipal bonds rallied and rallied mightily. Obviously, some of that supply being dragged away from the current year into the prior year, that should improve the technicals of the BALANCE between supply and demand. Away from tax reform, we are seeing steady cash flows into open-end mutual funds, so the technicals are actually in very good shape here. Part of it, also, is when you look at the supply of new issue supply, the elimination of advance refunding as a result of the tax reform, that should also reduce the new issue supply in the marketplace. Again, you're looking at a favorable technical environment. You look at the secondary effect and it's going to improve the technicals in the marketplace.

The third point and this is one that's just going to be ongoing: the municipal marketplace, like all marketplaces, will adjust to the new economic realities that surface over time and the changes in the economic realities that surface over time. The municipal bond market will have to deal with this tax reform over time, because there is some provision in there that, when you talk about the level of rates, exemptions, and all the things, again on a net basis, is a positive for municipal bond investors. Because, frankly, there are fewer ways to shield income from taxes, other than municipal bonds now.

Also, the significant reduction in the level of corporate tax rates ... We're not overly concerned about the modest drop in individual tax rates, because we think they will remain a steady source of demand for municipal securities. If we are concerned about any element of tax reform, it's the bank appetite for municipal bonds, as well as insurance company appetite for the municipal bond. I'd say with the lower corporate tax rate of 21%, the value of municipal income drops from an institutional perspective.

When you look at who owns municipal securities, they own, depending on which segment of the marketplace you speak to, banks and insurance companies, own 15 to 25% of the marketplace. Our view there is, we have seen some modest selling from banks in the early part of 2018.

But, insurance companies, we believe, there'll be less appetite for them to sell outright. I think it'll happen over time, as the seasoned higher book yields, that insurance companies really to hold onto to income in their portfolios, not necessarily to look for an absolute total return. As their seasoned higher book yields, higher income on their balance sheets, they are going to try to hold on to those for as long as possible. We're not seeing outright selling from insurance companies.

I think, as the market progresses and it evolves over time, it'd be more challenging for municipal securities to compete with other markets, such as single A corporates, or even triple B corporates, but we'll say single A corporates. With that, I think municipals, in order to attract the institutional demand, say from banks and insurance companies, due to the lower corporate tax rate, have to stay a little bit cheaper. Insurance companies may look to invest in alternative minimum tax securities because they are no longer subjected to that potential tax penalty. They, perhaps, will look to lower quality or perhaps different structures that offer a yield advantage over just the general marketplace.

I think overall, I would think that it'll happen, the impact of tax reform will occur over time. Some of it is already in the marketplace and valuations have adjusted for it. But, there'll be an ongoing adjustment and valuations in the years ahead. We think it's a net positive for municipal bond investors, except that we're watching very closely the institutional demand.

LH: Yeah, I think you raise a lot of good points, Robert. I'm interested, Purva, from the portfolio management perspective, is this affecting your outlook on muni bonds as a sound long-term portfolio investment?

PP: No, not at all. Actually, I think, taking it back to the investor, too, is that the investor doesn't feel that either. We have seen over $10 billion go into municipal mutual funds as an industry, so that tells me that investors are still seeking out municipal investments as part of their overall portfolio. Volatility has dropped in the race market in the near past. I think a lot of it has to do, too, with the fact that volatility has picked up in the equity markets. That's pointing investors in the direction of fixed income as, perhaps, a bigger allocation or a new allocation to their overall portfolios. We think, as a long-term investment strategy, as well as part of an overall asset allocation for an individual investor, municipal bonds still make a lot of sense.

We ran a study that looks at municipal investments as part of an overall allocation of funds and equities. We found that municipals reduce the volatility of an all-equity portfolio by a third, as well as give you about the same total return as an all-equity portfolio. With those kinds of risk-reducing benefits, it still does make a lot of sense to own municipal bonds.

LH: Then also, Purva, Morningstar has reported that 25% of the muni bonds and ETFs invest in single-state portfolios. This is largely attributed to the fact that native state-owned munis are often exempt from state and local taxes, providing that triple threat tax reduction that investors love. With that in mind, how should investors weigh these benefits against broader diversification of a national muni fund?

PP: We actually run several state-specific portfolios, pretty much in every state that has a state income tax, and we can find enough bonds to run a diversified portfolio. It does pay. I think with the new changes in tax law, especially the state and local deduction cap at $10,000, it's going to make in-state portfolios a little bit more attractive to those investors in high tax states, especially like a California or New York, where they are going to be limited in terms of deducting state and local taxes from their federal income tax.

We think that's going to be another source of demand, potentially in the second half of the year, as we get through this tax year, 2017's tax year tomorrow. And, look to 2018's tax year, and talk to our CPAs and figure out what our potential tax liability might be next year. We think it makes in-state portfolios look a little bit more attractive. Of course, diversification outside of the state, depending on which state you're talking about, could also benefit investors.

Because, certain states, at the state level, may be struggling a little bit. There are a few states, like Illinois and New York that you want to be very selective in, in terms of where you're purchasing different credits. With those types of environments, you may want to elect to have a portion of your overall municipal bond portfolio invested outside of the specific state's municipal bond markets. Depending on where you live and what your tax situation is, I think that determines whether you do a state-specific portfolio or whether you do a blend of in-state bonds and out-of-state bonds

LH: **Thanks. If we could just slightly pivot over to the infrastructure realm. Robert, we're hearing a lot about the rebuilding of the nation's infrastructure, but details of this financing are still unclear with federal funding, state funding, and even the private-public partnerships all being a part of the discussion. Do you think municipal bond financing will have a significant role in the longer-term infrastructure solution? If so, what issues and opportunities might this present for muni investors?**

RA: Yeah, great question. In fact, it dovetails very nicely with the tax reform question that we covered just briefly a few moments ago.

One of the reasons why municipal investments, or tax-exempt income more specifically, was not in the crosshairs of tax reform, is due to the lack of financing that's available for infrastructure investing here domestically. I agree. Widespread conversations regarding America's need to retool, rebuild, and modernize its infrastructure are ongoing. I would say just very straightforwardly, the best scalable and successful funding mechanism for investing in domestic infrastructure is municipal bonds. Our view is that municipal bonds will remain the cornerstone for financing the most complex public works system in the world and U.S. infrastructure.

However, infrastructure investing is evolving in the United States. As you think about the federal plan, and some people might even say a lack of a plan, a trillion-and-a-half, which turns out to be about $200 billion, and probably less than that because of Congress, there's less appetite for funding the infrastructure. Frankly, because the public sector is deep in debt. You have to look at the realities. Where is the cash going to come from?

It's likely to be that funding projects through private-public partnerships, or P3s. That's the emerging trend in United States. I think P3s can be complex in their mechanics. I think finding the right balance between a public policy that fits within the business, legal, and financial framework to really bring the best value to all parties is important. It's key as we approach this new Renaissance of the American infrastructure.

I say the P3s, the benefit of those is they don't burden public balance sheet with new debt. They do bring in private sector involvement, and with that, you can make the claim that you'll see added efficiencies that private sector can very often bring to the public sector. Most importantly, I think, if you don't give up the ownership to the private sector, so the public maintains ownership of the public asset, it transfers the economic risk to the private sector for a set period of time.

I think there will be an American model of the private-public partnership that you see globally. One where there will be primarily three, I think, avenues of opportunity. One would be private equity, which would be, generally, a relatively small proportion of the total investment. What we're seeing today is around 10% in the form of private equity. Municipal bonds, as I said, will remain a significant cornerstone to financing public assets. Then, I think, more importantly, we're starting to see some private debt opportunity. I think all three opportunities will continue in the years ahead.

LH: **Thanks. Robert, Purva, I think you've given investors a lot to think about. I do appreciate you making time for today's call. Yeah, I look forward to seeing where munis are headed in the next year. Thank you.**

RA: Thank you.

PP: Thanks, Libby.

Speaker: **Thank you for joining us. We hope you will stop by again for news on this ever-changing space. Until next time, connect with us on Twitter at @cefassociation or by searching for the Closed-End Fund Association on LinkedIn and YouTube.**