DCM Advisors
Municipal Bond Outlook Q1 2018

January 2018

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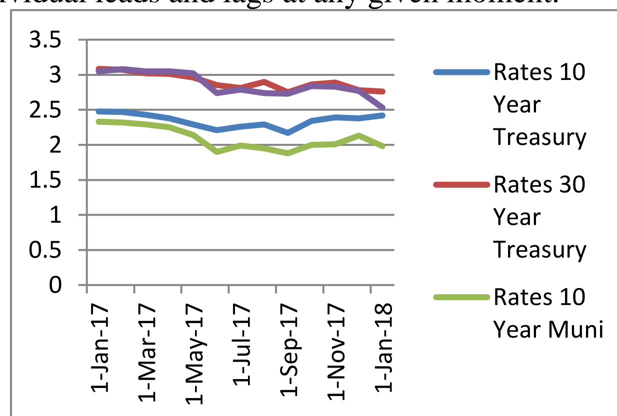
Happy New Year! Welcome to a year that, in our opinion, promises to be filled with cross currents, volatility, and some unique challenges. While many of the questions could be the same on-going issues that we always continue to consider, there is a brand new element to make this year potentially more interesting and filled with possible opportunities.

During most of 2017, the main issue for the fixed income market was the timing of any interest rate increases by the Federal Reserve Bank (the “Fed”.) As background, in an effort to stimulate the economy during and after the last recession, using monetary policy, the Fed had lowered interest rates and bought vast amounts of Treasury and Agency mortgage-backed securities. As economic conditions appeared to improve, there were three interest rate increases in 2017. They took place at the March, June and December Fed meetings. The Fed has targeted a quarter of a percent range as the band for Fed Funds during any period. In January 2017 the band was 0.50% to 0.75%. By year end 2017 it was 1.25% to 1.50%. Additionally, in October the Fed started a partial monthly pay-down of the Treasury and Agency mortgage-backed securities that it had been holding on its balance sheet.

As the following graph shows, for most of the year, municipal bond rates tended to follow Treasury rates*, albeit with individual leads and lags at any given moment.



*The Treasury rates shown are from Bloomberg daily charts and municipal bond rates shown are for AAA securities as reported by the industry leading data source, Municipal Market Data. When month end was on a weekend or otherwise limited by holidays, the nearest available data was used.

At the end of 2017, there was a divergence in the interest rates of municipals versus Treasuries. This was a result of the Tax Cuts and Jobs Act of 2017 (the "Tax Reform Act") that was discussed, passed and then signed into law at year end.

The Tax Reform Act

While there are many components to the new Tax Reform Act, the ones that appear to have the most direct impact on the municipal bond market are the corporate tax change, the individual tax rate change, the curtailment in the amount of deducibility for State and Local Taxes ("SALT",) and the elimination of tax exemptions for advance refunding of outstanding municipal bonds.

1) **Corporate Tax Rate Changes.** The corporate tax rate went from 35% to 22%. While many companies have very elaborate funding and profitability formats, the general reduction in rates draws into question the attraction of municipal bonds to property and casualty insurers in particular. Will a bond that is free from a 22% corporate tax be as attractive as another investment with a higher after-tax possible profitability? What might not be attractive if 35% of its return was taxed could suddenly be more attractive at the reduced corporate tax rate of 22%. Given that property and casualty insurance companies have been active players in the municipal market, if they stop buying tax free bonds, will there be enough other buyers to support the market?

2) **Individual Investors.** Will the change in individual tax rates diminish the desire for municipal bonds? The rate adjustments are not as dramatic as the corporate rate change, but still could be a drawback to some investors unless their individual rates increased.

3) **SALT.** The Tax Reform Act, with a small deductible allowance, effectively limits the ability to deduct SALT. This will specifically hurt states with high local taxes, such as New York, New Jersey, Connecticut, and California. Ironically, this curtailment is an incentive for wealthy tax payers to buy municipal bonds. For example, a New York City resident in the maximum tax bracket currently pays approximately 12.7% to New York State and City. With the former 39.6% Federal tax bracket, there was a net deduction of about 5.3% from their local tax bill, giving a final combined tax bill of about 47.3%. Now, the numbers for a 37% U.S. tax rate are 49.7%, since the local taxes are not being offset against the Federal tax levy. Thus any investment that is free from federal, state or local taxation continues to be very worthwhile.

4) **No Advance Refunding.** Advance refunding is when a municipality issues new bonds, buys special Treasury bonds with maturities that match the older issues, and prepays, to a future call or maturity date, the older bond issues that have the higher interest rates. The issuer is now liable for the new bonds issued at lower yields. The old issues are still outstanding, although backed by special US Treasury bonds to pay them off. As a result, there is an extra set of bonds, paying tax free interest, to finance the project. In November and December, as the threat of eliminating advance refunding became clear, there was a wave of refunding deals being done before the deadline. December volume has normally been about $18 Billion. This year it was $55 Billion. As the above graph shows, municipal rates came under pressure and then declined with the completion of this financing torrent. Prior to the avalanche of year end deals, annually refunding bonds were anywhere from 25% to 40% of new issue supply. Now it will be zero as a result of the Tax Reform Act. This will impact the supply/demand equation in a positive fashion.

In conclusion, it is our feeling that the Tax Reform Act will cause some shifts in demand, but will also provide interesting opportunities. If the Fed stays on course to raise interest rates in 2018, our existing maturities should allow us to gradually increase our yields in the portfolios and take advantage of all the potential cross currents that we think are possible. As always, please feel free to contact me with your questions or if there is anything here that is not clear.

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