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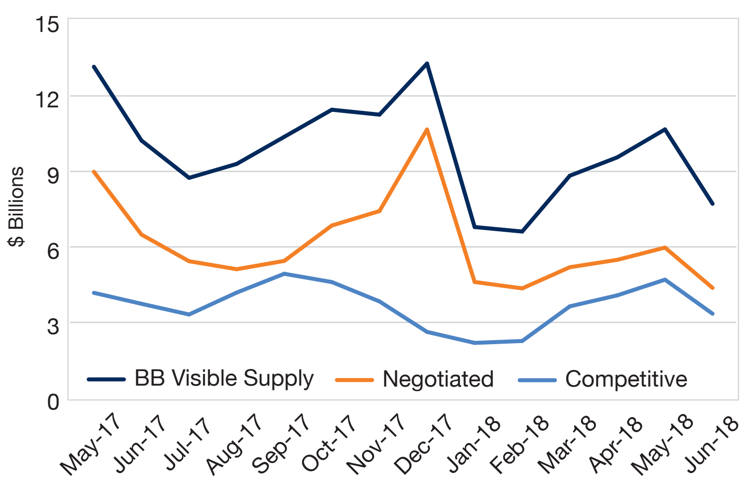
Much Ado About Taxes

THE MUNICIPAL MARKET'S REACTION TO TAX REFORM

In December 2017, Congress passed the Tax Cut and Jobs Act (TCJA)—sweeping legislation that fundamentally altered the U.S. tax code. Highlights include a reduction in the corporate tax rate to 21% from the previous level of 30%, and a reduction in the top individual tax bracket to 37% from 39.6%, with taxes in lower brackets also reduced and the brackets widened. Additionally, state and local tax (SALT) deductions from income, property and sales taxes have been limited to $10,000 per year; and the Alternative Minimum Tax (AMT) was eliminated for many individuals. The changes related to individual taxpayers sunset in 2026, unless Congress takes action to renew them. The corporate tax rate reduction is permanent.

The modifications enacted by the TCJA have already had a profound impact on debt issuance and investor behavior in the municipal space. One such change, the prohibition of advanced refundings, is of particular significance. This mechanism had allowed issuers to refinance their debt to take advantage of lower interest rates and lower annual debt service costs—much in the way a private individual may refinance their mortgage. Over the past ten years, refunding bonds comprised over one-third of total municipal debt issuance. Proposed changes that would limit private activity bonds (i.e., tax-exempt bonds issued on behalf private hospitals, colleges and universities, and other 501(c)(3) entities were abandoned in the final legislation. These proposed changes would have eliminated a significant portion of the municipal market. With discussions for tax reform 2.0 already taking place, investors would be wise to keep apprised of discussions about additional alterations, including possibly allowing advanced refunding to occur once again, and restricting private activity bond issuance.

EXHIBIT 1: BOND BUYER 30-DAY VISIBLE SUPPLY

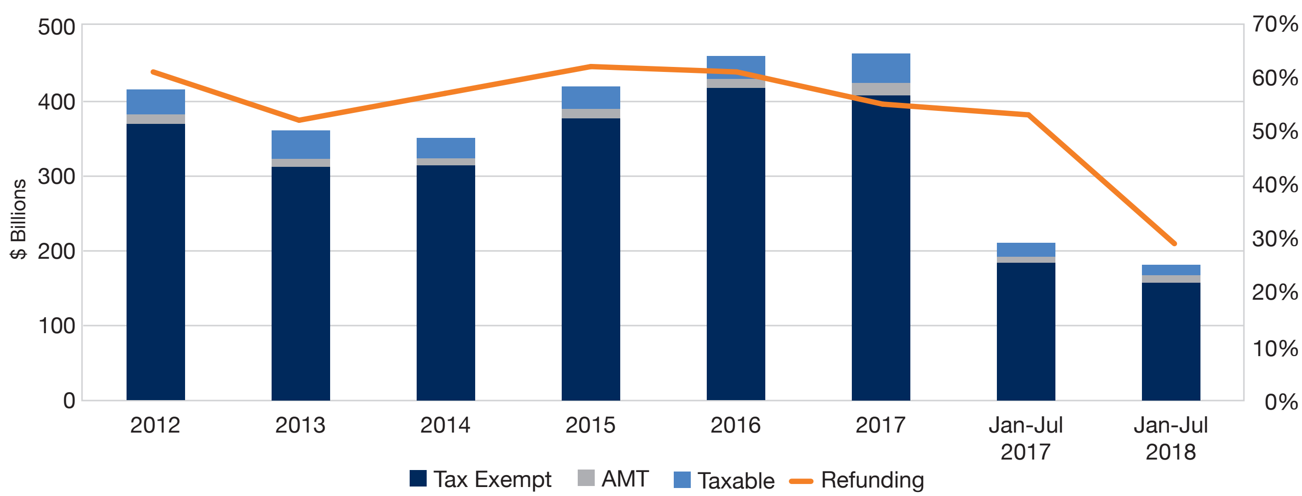


Source: Bond Buyer

The TCJA has impacted issuance trends both for 2017 and year-to-date in 2018. In 2017, municipal bond issuance, including private placements, totaled over $448 billion (Securities Industry and Financial Markets Association (SIFMA)). Due to the impending tax changes, many bond issues were fast-tracked into the fourth quarter of 2017. The volume created by these deals helped to bring issuance to a record level for 2017, as shown in the chart below. Through July 2018, total issuance was $190 million, representing a 16% decline from the same period last year (SIFMA). AMT issuance was over 16.0% greater during the same period (SIFMA). We partially attribute the increase in AMT issuance to large offerings by several of the nation's major airports. As a result of the TCJA's provisions for increased AMT exemptions and higher income limits, significantly fewer investors will now be subject to the AMT. The Tax Policy Center predicts that approximately 200,000 taxpayers will be subject to AMT in 2018, compared to 5.25 million in 2017 ("Who Will and Won't Pay the AMT, America's Rich Person Tax?," *The Wall Street Journal*, May 18, 2018). Because of this, more investors are willing to consider AMT bonds, increasing demand and enabling traditional issuers of AMT debt to issue new bonds at lower interest rates than in previous years.

Through July, refunding bond issues were down 54.5% versus the same period in 2017—clearly a primary driver of the contraction of market supply (SIFMA).

CHART 2: MUNICIPAL ISSUANCE

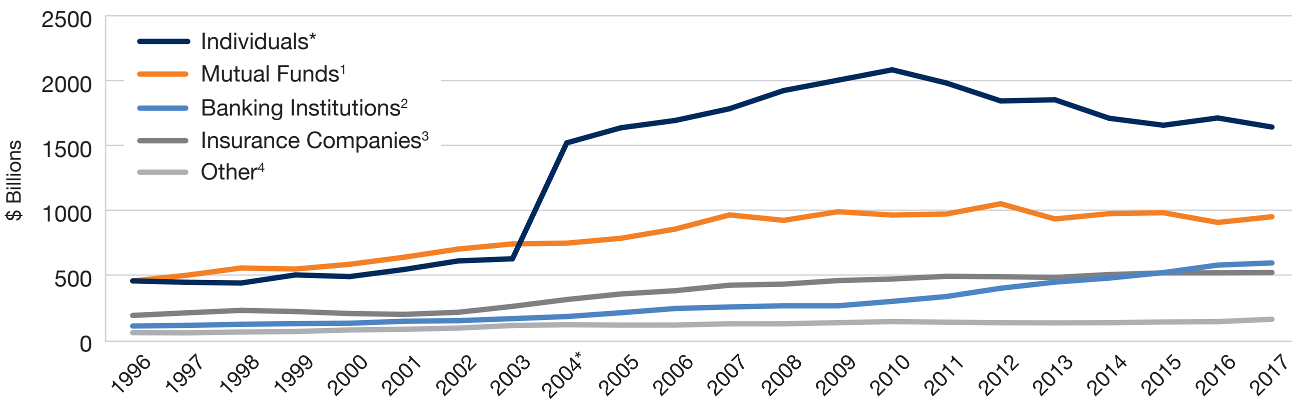


Source: SIFMA

This overall decrease in supply has been a technical boon for the market, resulting in increased scarcity, thereby improving the market's performance year-to-date. Barring the reinstatement of advance refundings, we are likely to see only modest increases in new issuance in 2019 and future years, as market participants complete capital programs. In fact, on a positive note, borrowing for new projects was actually up 27.1% through July (SIFMA).

We have already seen a change in investor preferences as a result of the new tax code and believe they will become more pronounced as the year progresses. The chart below tracks investor participation over the past twenty years. Bank and insurance company holdings have, for the most part, followed an upward trend. However, because of the corporate tax reduction, it is not as advantageous for them to own municipal bonds as it used to be.

CHART 3: HOLDERS OF U.S. MUNICIPAL SECURITIES



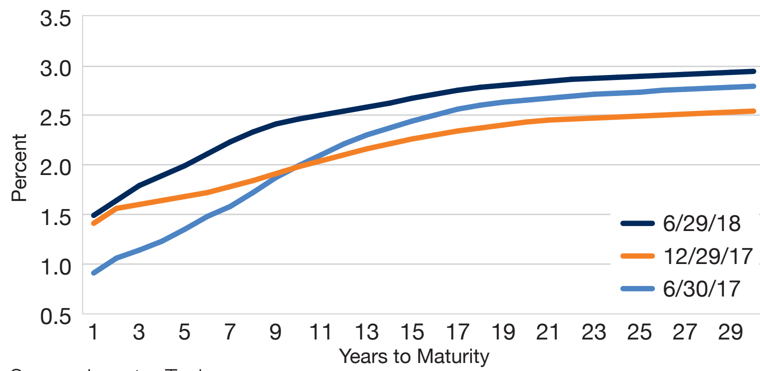
Data source: Federal Reserve System
*Household holdings is revised up by about $840 billion, on average, from 2004 forward. [1]Includes mutual funds, money market funds, closed-end funds and exchange traded funds. [2]Includes U.S. chartered depository institutions, foreign banking offices in the U.S., banks in U.S. affiliated areas, credit unions, and broker dealers. [3]Includes property-casualty and life insurance companies. [4]Includes nonfinancial corporate business, nonfinancial noncorporate business, state and local governments and retirement funds, government-sponsored enterprises and foreign holders.

According to Barclays, banks reported a $16 billion drop in their municipal holdings during the first quarter of 2018. Given the fact that bank holdings are typically long-dated, a substantial portion was actually sold, rather than simply maturing (Barclays, August 10, 2018).

This trend continued in the second quarter, although at a slower pace, with an estimated $6 billion sold, bringing the total for the first half of 2018 to $22 billion—bringing total holdings to below their 2016 levels (SIFMA, Barclays, August 10, 2018). Despite this reduction, banks still account for over 15% of the market (SIFMA). However, they no longer represent traditional buy and hold investors, but instead have become more value-oriented, focusing on technical and ratio analysis. They are more sensitive to the Municipal/Treasury ratio, preferring to enter the market selectively when they believe technical conditions are strong. This strategy is more advantageous, given tax law changes that make capital gains more attractive versus passive interest income. The lack of long-term demand traditionally exhibited by banks has contributed to underperformance in the long end of the curve, as demand has waned.

According to research done by Barclays, the top property and casualty insurers reduced their portfolios by 2.7% in the second quarter of 2018, while holdings by life insurers were virtually unchanged (Barclays, August 10, 2018).

CHART 4: MMA YIELD CURVES



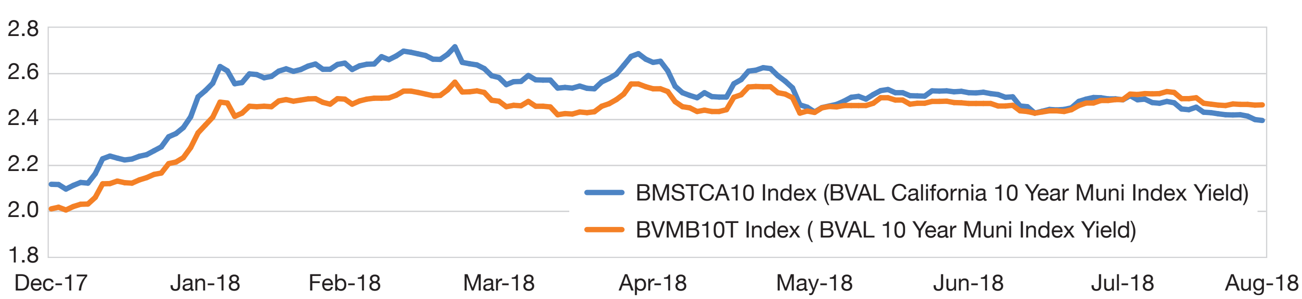
Source: Investor Tools

A recent Bloomberg report notes that, unlike some of other larger insurers, Allstate Corp. reported that it has been increasing its municipal holdings. Foreseeing the 2018 decline in supply, it stocked up on municipal bonds last year in the expectation that prices would increase. “We leaned into buying municipals because we thought the supply would go down in 2018 and in fact it has,” Chief Executive Officer Tom Wilson said in an interview with Bloomberg. “We basically just decided to get ahead of it (“Allstate Piles into Municipal Bonds as Other Insurers Shy Away,” *Bloomberg News*, August 15, 2018).”

Allstate’s buying has continued. At the end of June, its municipal holdings were about $9.45 billion, compared to $8.05 billion at the end of last year. According to regulatory filings, Chubb Ltd., Progressive Corp. and American International Group Inc., all shed tax-exempt holdings (“Allstate Piles into Municipal Bonds as Other Insurers Shy Away,” *Bloomberg News*, August 15, 2018).

We expect retail participation to grow more robust. The changes to the SALT deduction have had a large impact on demand for residents of high tax states such as California, New Jersey, New York, and Connecticut. These investors face substantial increases to their effective federal tax rates and, consequently, will continue to have significant demand for tax-exempt bonds in order to shield more of their income from federal taxes. As a consequence, we have seen bonds from some of these high tax states outperform the market during 2018. Demonstrating this, California general obligation bond spreads have tightened below the AAA Bloomberg benchmark curve, owing to increased investor demand. Outside of high tax states, retail investor demand has been fairly stable year-over-year, as demonstrated by the stability of the one-to-ten year area of the curve, where retail investors typically focus their buying.

EXHIBIT 5: HISTORICAL YIELDS



Source: Bloomberg

Credit impacts from tax reform have been fairly muted. Overall economic activity has expanded across the U.S., with many pundits believing that this is at least partially attributable to tax reform. States have consequently seen year-over-year increases in tax collections for the first two quarters of 2018. Buoyed by this, 49 states enacted their budgets on time, ahead of the pace for the last several years. Many states saw record tax collections for fiscal year 2017, as residents elected to pay their taxes early in order to retain the tax credits before the new law took effect on January 1. While this is a positive for states to receive money early, we see this as a one-time event and have not extrapolated these increases into future year's projections.

Over time, the credit quality of high tax states and their municipalities may be impaired as a result of the SALT limitations. We have already seen stagnant population growth in some high-tax states over recent years, with residents heading to Texas, Florida, and other locations with lower tax rates and a reduced cost of living. For states, a declining population would lead to lower income and sales tax receipts, which are their primary revenue sources. For local governments, whose primary revenue source is generally ad valorem taxes, a decreasing population would lead to lower demand for existing and new housing stock, thereby lowering property values and the taxable assessment base.

Overall, tax reform has had large and far reaching impacts on our market. Reductions in supply, changing demand patterns and a boost in economic activity on a national scale are only the most immediate effects. As the market settles into this new current reality, there could be additional unanticipated changes for investors. We believe that during this time, investing with an active manager who carefully monitors these changes and reacts accordingly is in the best interest of most investors.

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines, and trading strategies with prudent risk management as a cornerstone.

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Virtus Investment Partners (NASDAQ: VRTS) is a distinctive partnership of boutique investment managers singularly committed to the long-term success of individual and institutional investors. The company provides investment management products and services through its affiliated managers and select subadvisers, each with a distinct investment style, autonomous investment process, and individual brand.

Sources

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Definitions

Spread is the difference between the yields of sector types and or maturity ranges.

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