Fidelity Capital Markets (FCM) Municipal Market Note

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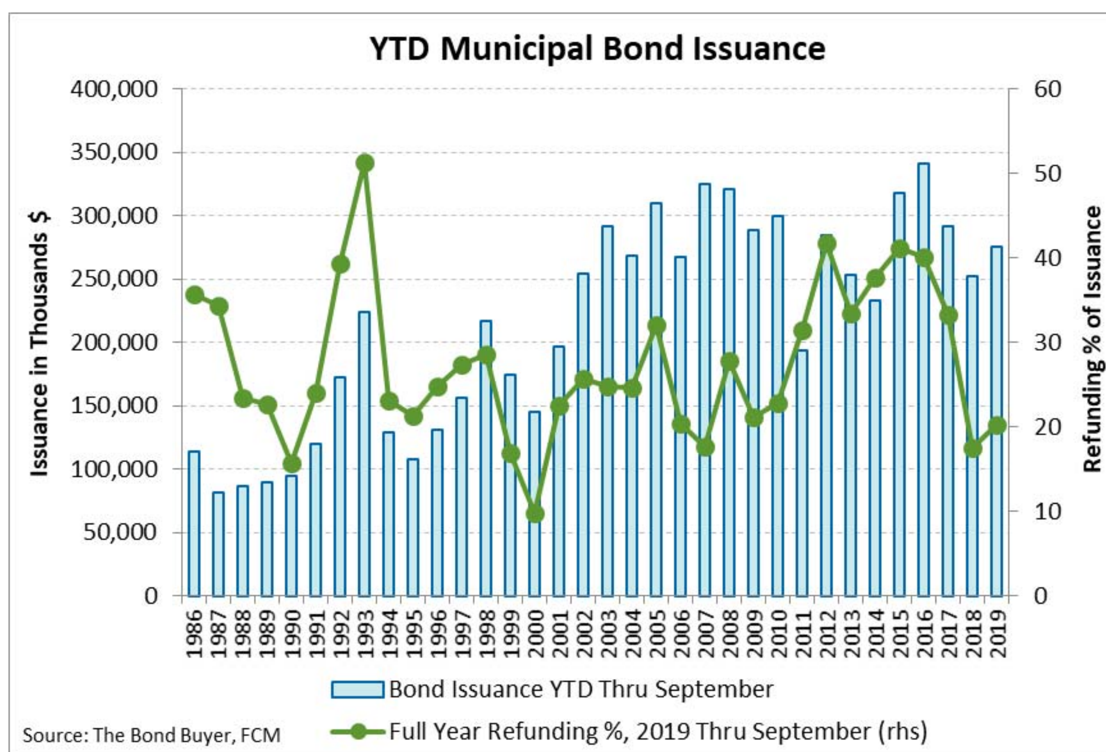
Taxable advance refundings make the current low rate environment even more challenging for tax-exempt investors

2019 has proved to be a challenging one for municipal investors seeking to purchase tax-exempt securities. The Tax Cuts and Jobs Act of 2017 (TCJA) constrained supply by eliminating advance refundings and stimulated demand by capping the individual deduction for state and local taxes (SALT). In the 5 years prior to the TCJA becoming effective issuance for purely refunding purposes represented between 33% and 41% of gross municipal debt issuance. In 2018, the first year of the new law, refundings dropped to 18% of gross issuance, and through the first 9 months of 2019 were 20% of gross issuance.



On the demand side, municipal bond funds have received 40 consecutive weeks of net inflows through the week ending 10 October, totaling just over $37 billion. In terms of its intensity, this streak is the strongest on record, averaging $925 million per week for 40 weeks. There were three prior unbroken inflow streaks that totaled more cumulatively, one that began March 2010, lasted for 64 weeks and averaged $606 million/week, a second that began December 2012, lasted for 67 weeks and averaged $628 million/week, and a third that began October 2016, lasted for 55 weeks and averaged $678 million/week, but none of which came close in its concentration to the current one. From a calendar perspective, 2019's $37 billion inflow through 10 October is the largest of any year.

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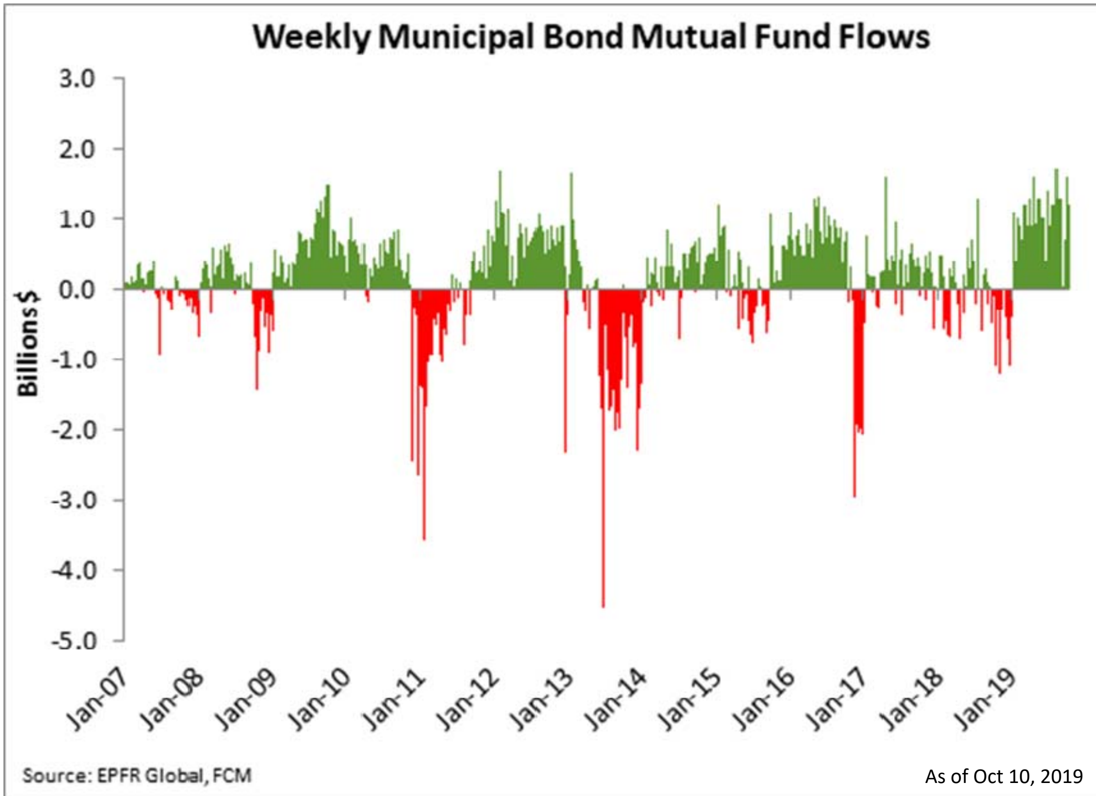
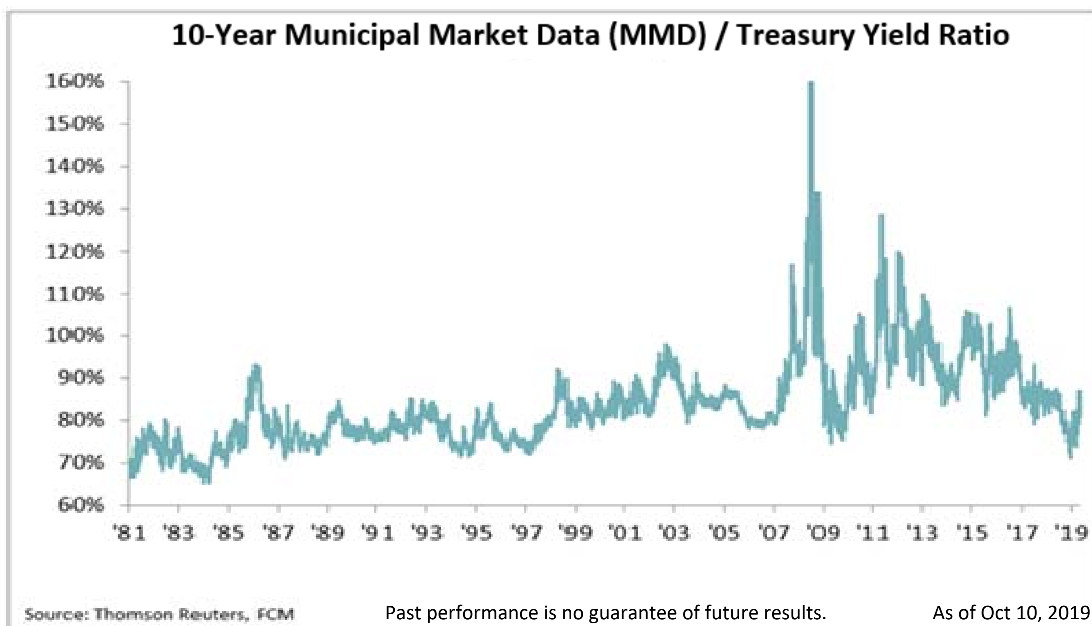
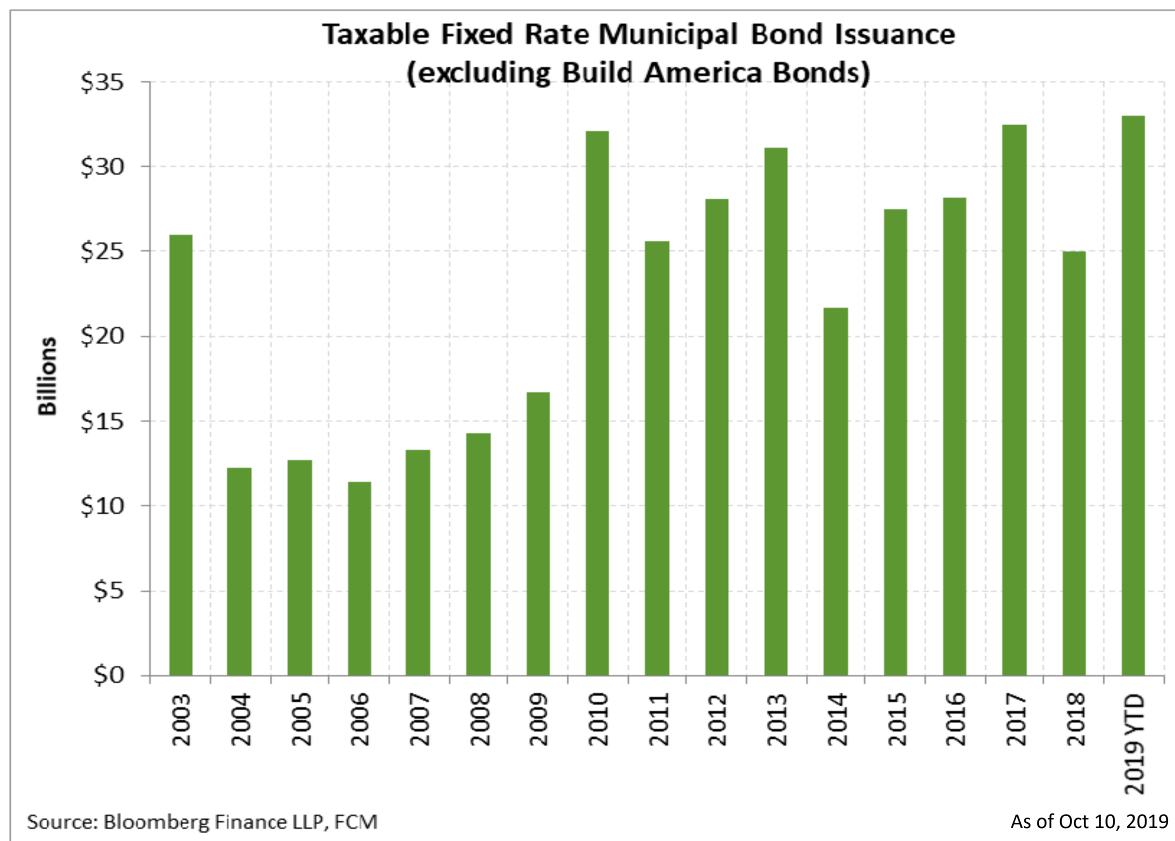


Given the supply-demand picture it may be little wonder that the value of municipals has increased relative to that of Treasury securities. For example, the yield ratio between the 10-year AAA municipal benchmark and the 10-year U.S. Treasury Note fell to 71% in 2019, which was the lowest this measure has been since September 1987 (ceteris paribus, the lower the ratio the higher the value that investors assign to tax-exemption).



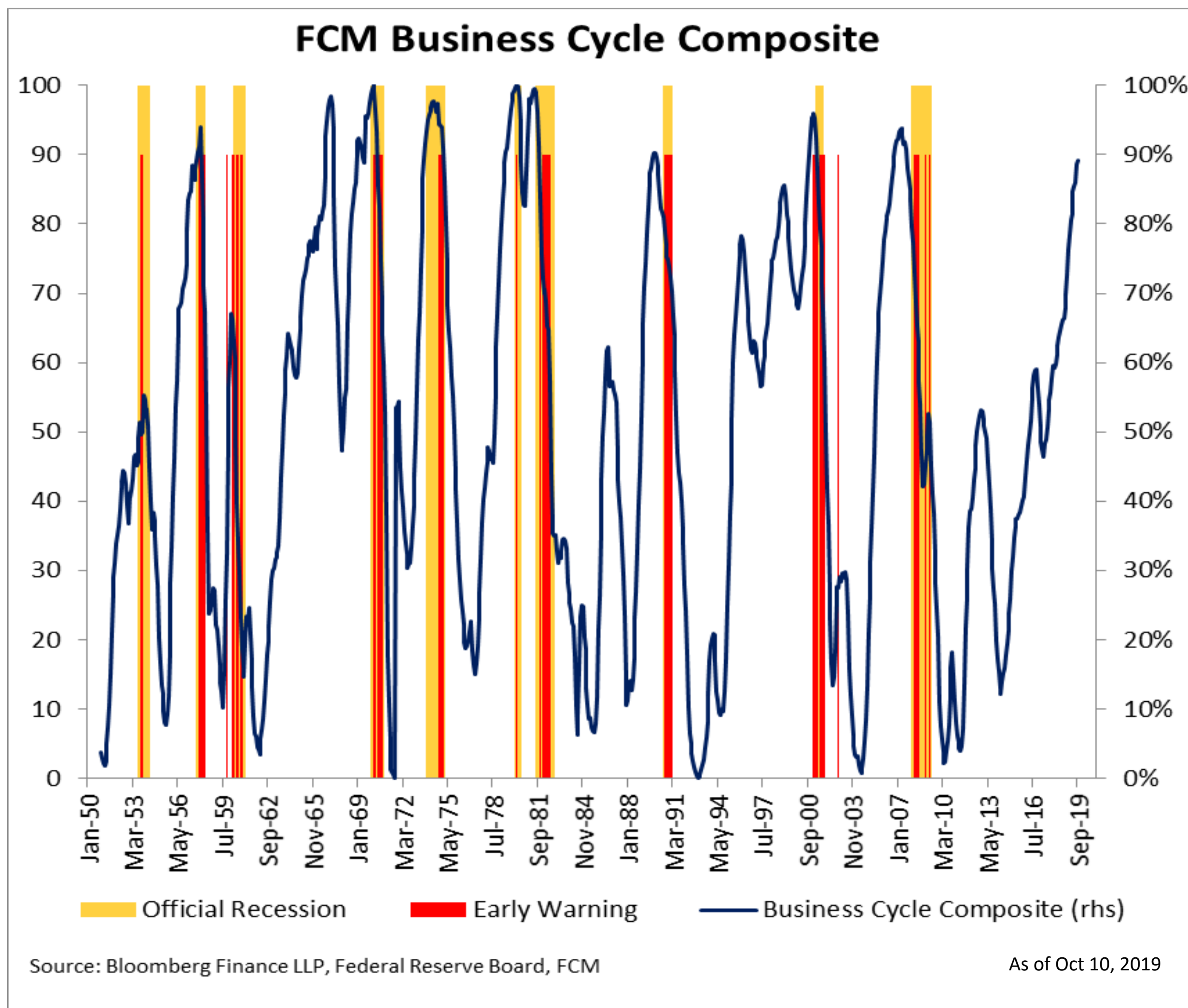
While the ratio has increased recently, it may not last as the picture for supply has changed further as rates have declined to very low levels. This current low rate environment has been driven by a slowing economy, subdued inflation expectations, and interest rate cuts by the Federal Reserve and other G7 central banks, among other global issues. Interest rates have, in fact, declined to such an extent that current taxable rates have fallen below the level at which prior tax-exempt securities were issued. This phenomenon has made it economically advantageous for issuers to sell taxable bonds in order to advance refund tax-exempt securities. Whereas tax-exempt advance refundings were eliminated under the TCJA, taxable advance refundings were not. As a result, taxable municipal issuance through the first week of October this year has already, at $33 billion, exceeded all prior years excluding Build America Bonds issued in 2009 and 2010.



We estimate that approximately 68% of this issuance, or $22 billion, has been to advance refund tax-exempt securities. Taxable issuance only began picking up in earnest after the Federal Reserve's first interest rate cut in July, with over half of this year's issuance (through the first week of October) coming in the 11 weeks in the wake of the first cut. In fact, taxable issuance has comprised one-fifth of the total gross supply of municipals in this 11-week period. This is a trend that many market participants expect to continue through at least the end of the year, and possibly into 2020 as well. If the current run rate continues into next year, we expect that approximately $40 billion to $50 billion of tax-exempt bonds may be refunded through taxable issuance next year. This removal of tax-exempts from the market would serve to underpin municipal performance and make an already challenging environment for finding value in the municipal market that much more difficult. This is particularly relevant because the other two factors (elimination of tax-exempt advance refundings and the SALT cap) continue to place downward pressure on municipal yields relative to Treasury yields and are unlikely to go away in the current fractious political environment.

Of course, much depends on the level of interest rates. Unfortunately, we don't expect appreciably higher rates over the course of next year because our business cycle composite suggests that the current cycle is roughly 89% complete, and interest rates

typically don't rise at this stage in the cycle, but rather fall, as they have been doing for most of the year. Since 1950 there have been 10 business cycles, and the level of our composite at the time that each one ended average to 85% (the median is 91%). The composite is calculated as an exponential moving average (EMA) of the standardized values of a variety of market and economic variables, including credit spreads, the yield curve, stock prices, business sentiment, and employment data. When all the variables in the composite line up at static, prespecified levels (i.e., remain the same in each cycle) our recession warning composite is triggered. To reiterate, the business cycle composite is an EMA of the variables used in the recession warning composite and is currently sufficiently advanced to suggest that a period of sustained higher rates may not be likely until a new cycle begins. Whether or not a recession is forthcoming (the incoming evidence will speak for itself), in our view the environment for finding value in the municipal market may remain challenging for the remainder of 2019 and 2020 given our expectation of low rates and an ongoing constrained supply-demand picture. Investors with a tax-exempt mandate may, with enough hindsight, reflect upon the current moment as being one that was particularly advantageous for getting invested, in our view.



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