T. Rowe Price
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U.S. TAX REFORM COULD AFFECT SUPPLY AND DEMAND IN U.S. MUNI MARKET

KEY TAKEAWAYS

- The passage of tax reform legislation at the end of 2017 removed some uncertainties for municipal bond investors, but questions remain about how the new law will affect supply and demand in the muni market.
- While the reduction in the corporate tax rate has made the tax advantages of holding munis for banks and insurance companies less pronounced, we expect most of these corporations to maintain the majority of their holdings in the sector.
- A provision in the new law that eliminates the tax exemption on advance refunding bonds, which are issued to retire older, higher-cost debt, is likely to reduce the supply of new bonds in the muni market by 10% to 20%.
- If the muni market does experience volatility and yield ratios become more attractive relative to Treasuries, we would generally see this as a potential buying opportunity due to the continued long-term attractiveness of the sector.

The passage of tax reform legislation at the end of 2017 removed some uncertainties for municipal bond investors, but questions remain about how the new law will affect supply and demand in the market in 2018. The reduction in the corporate tax rate from 35% to 21% will likely provide some companies with less incentive to hold muni debt. However, other investors could see increased benefits from tax-exempt income, and an expected reduction in the supply of bonds could support the market. The potential volatility caused by these changes in the technical backdrop could create attractive relative value opportunities for investors in the municipal debt sector.

One question that we are focusing on is how banks and insurance companies will react to the new law. Companies in those sectors held about 29% (USD $1.1 trillion) of the USD $3.8 trillion in outstanding municipal debt as of the third quarter of 2017, according to Federal Reserve data. While the muni market could shrug off a reduced level of demand from banks and insurers due to a drop in supply in the near term, any selling by these companies could cause some temporary volatility in the market.

WILL BANKS, INSURERS CONTINUE TO HOLD MUNIS?

As Barclays pointed out in a recent research note, history shows that banks do have some sensitivity to tax changes. In 1986, bank holdings of muni debt decreased by 57% after the top corporate tax bracket was reduced from 46% to 34%. However, while the tax advantages of holding munis are now less pronounced, we expect most banks and insurers to maintain most of their holdings in the sector.

Banks have more than doubled their muni holdings over the past decade for reasons that go beyond the tax advantages. Munis continue to offer relatively high credit quality. Also, banks have regulatory incentives to invest in their local communities, and municipal bonds provide a means for them to accomplish this goal. Moreover, in the insurance industry, while it is true that property and casualty (P&C) insurers will probably have a reduced appetite for munis, there may be increased demand from life insurers. A recent Bloomberg report noted that under the previous tax regime, life insurers didn't know how much of their income from muni bonds was tax-exempt until they calculated their final tax bill; now they will be taxed on 30% of what they receive from their muni holdings (the same treatment that P&C insurers receive), and the change appears to have made muni investments more appealing for companies in the life insurance segment.

Besides the change in the corporate tax rate, there were other modifications to tax law that could affect the muni market. On the demand side, the new tax legislation includes a USD $10,000 cap on the deductibility of state and local taxes (including property taxes) for federal income tax purposes. Previously, these deductions were unlimited. This change could move some individual investors who live in states with higher tax rates into higher tax brackets and make the tax-free income offered by muni bonds more attractive.

MUNI BOND SUPPLY LIKELY TO SHRINK

Meanwhile, the supply of new bonds in the muni market is likely to be reduced by 10% to 20% by a provision in the new law that eliminates the tax exemption on advance refunding bonds, which are issued to retire older, higher-cost debt. Also, although so-called private activity bonds ultimately emerged unscathed in the final version of the tax bill, many municipalities shifted forward the issuance of this type of debt from 2018 into late 2017 to avoid the potential loss of the ability to issue private activity bonds on a tax-exempt basis. Private activity bonds typically fund such projects such as hospitals and private universities. The rush to issue private activity bonds in 2017 will further reduce market supply in the first half of 2018.

Although tax reform has caused some uncertainties, we believe the biggest risk to muni performance is a significant rise in interest rates and the outflows that are often associated with such a move. If growth or inflation expectations readjust rapidly, munis could underperform Treasuries in the short term, similar to the scenario that unfolded following the U.S. presidential election in late 2016.

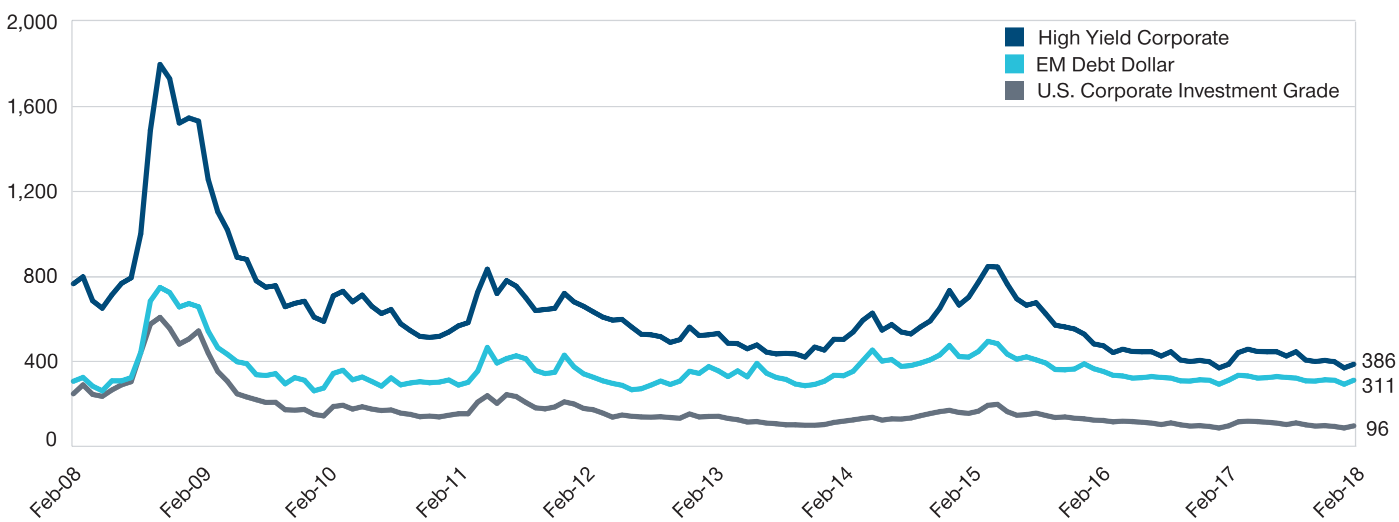
DESPITE POTENTIAL VOLATILITY, LONGER-TERM OUTLOOK REMAINS SOLID

However, if the muni market does experience volatility and yield ratios become more attractive relative to Treasuries, we would generally see this as a potential buying opportunity due to the continued long-term attractiveness of the sector. Either directly or through mutual funds, individual investors own almost 70% of the municipal bonds outstanding. With an aging population, the demand for high-quality tax-exempt income should continue to provide a supportive long-term technical backdrop for the market.

In addition, credit quality in the municipal market remains solid overall, although some of the more challenged issuers, such as Puerto Rico, may continue to generate headlines. Over 60% of the market, as measured by the Bloomberg Barclays Municipal Bond Index, is AAA or AA rated, and municipal bankruptcies remain very rare. While we remain concerned about the pension funding shortfalls that many municipalities are facing, we believe revenue bonds are less impacted by this growing problem. As a result, we normally prefer bonds backed by a dedicated revenue stream over general obligation bonds.

Yield Spreads Over Treasuries (basis points)

February 29, 2008–February 28, 2018



Sources: High Yield Corporate—J.P. Morgan Global High Yield Index, EM Debt Dollar—J.P. Morgan Emerging Markets Bond Index Global, U.S. Corporate Investment Grade—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index.*

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright 2018, Bloomberg Index Services Ltd. Used with permission.

Yield spreads over Treasuries are the calculated spreads between a computed option-adjusted spread index of all bonds in a given rating category and a spot Treasury curve.

*Option-adjusted spread for the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index as of February 28, 2018. Spread-to-worst for the J.P. Morgan Global High Yield Index as of February 28, 2018.

Relative Value Short-Term Outlook

Sector Returns
(As of February 28, 2018)**

Sector	Driver	One-Mo. Return	YTD Return	One-Yr. Return
U.S. Treasuries	U.S. Treasury yields have rapidly ascended on concerns that faster growth and tight labor markets will compel the Fed to raise rates more aggressively to curb inflation. As unemployment trends lower, the Fed is unlikely to deviate from its rate hike path in the near term.	-0.75%	-2.10%	-0.56%
U.S. Treasury Inflation Protected Securities (TIPS)	Inflation data have been firming, placing upward pressure on breakevens; however, a negative move in energy prices or continued Fed tightening could cap break-even spreads and TIPS performance.	-0.97	-1.82	-0.18
Global Sovereign ex-U.S.†	We expect developed market yields to increase through time as global growth momentum continues. The improving European economy and gradually rising inflation are convincing the European Central Bank (ECB) to slowly normalize monetary policy. Meanwhile, the Bank of Japan remains highly accommodative despite positive economic data, and the UK will need to raise interest rates, albeit gradually, as long as political uncertainty associated with Brexit remains under control.	-0.85	2.16	10.50
U.S. Municipals	Municipal yield ratios versus Treasuries widened (outside of short maturities) despite the strong technical tailwind supporting the market. Favorable supply/demand dynamics in the sector are expected to continue, and the impact of tax reform does not appear particularly onerous.	-0.30	-1.47	2.50
Mortgage-Backed Securities (MBS)	Concerns about supply and demand imbalances and uncertainty around federal housing policy have clouded the outlook for agency MBS, though recent volatility has made valuations more attractive. However, a more prolonged increase in volatility is a risk.	-0.66	-1.82	0.16
Commercial Mortgage-Backed Securities (CMBS)	Credit fundamentals in the CMBS sector are largely benign, and from a technical perspective, recent robust issuance has been well received.	-0.62	-1.70	0.75
Asset-Backed Securities (ABS)	The ABS sector continues to benefit from strong consumer fundamentals and should continue to provide a relative safe haven if interest rate volatility were to increase.	-0.27	-0.56	0.63
Global Investment-Grade Corporate	Tight valuation concerns are somewhat offset by supportive fundamentals, a strong economic outlook and an expected reduction in net issuance due to tax reform and lower mergers and acquisitions. ECB tapering could put some pressure on European corporates as support for the sector is gradually reduced.	-1.62	-2.56	2.20
Global High Yield Corporate	Despite rich valuations in the sector, high yield continues to be supported by investor demand for yield, a solid macro backdrop, rising oil prices, and strong company earnings. Potential risks include volatile commodity prices, outflows, weakness in equities, and corporate credit being late in the cycle.	-0.83	-0.16	4.95
Bank Loans	Bank loans, with their floating rate feature, appeal to investors seeking shelter from rising interest rates. Solid fundamentals, low commodity exposure, low default rate expectations, and continued strong demand lead us to be constructive on the sector, but a reversal in technicals is a key risk.	0.21	1.22	4.40
Emerging Markets (EM) Dollar Sovereigns	Although the sector continues to see strong inflows, we are cautious on emerging markets as the Fed may need to tighten further amid higher inflation and tight labor markets. In addition, we are selective in the sector due to continued idiosyncratic political risks (e.g., Mexico, Brazil, Turkey, and Russia) and as risk assets may be challenged in the near term from risk off in global equity markets.	-1.96	-2.15	3.31
EM Corporates	Despite a supportive technical backdrop, recovering fundamentals, and rising oil prices, we are cautious in the near term given the extent of the sector's rally, weaker liquidity profile, and little buffer for idiosyncratic shocks.	-1.01	-0.94	4.19
EM Local	Although we continue to favor countries in interest rate cutting cycles or that offer high real yields, idiosyncratic risks in the sector and the potential for additional Fed tightening lead us to be cautious. Broad-based and resolute global growth, strong inflows, stability in China, and rising oil prices have also supported the sector but provide uncertainty should these factors reverse.	-1.04	3.39	14.43

Sources: T. Rowe Price, Bloomberg Barclays, J.P. Morgan, and S&P/LSTA.

**U.S. Treasuries—Bloomberg Barclays U.S. Treasury Index, U.S. TIPS—Bloomberg Barclays U.S. TIPS Index, Global Sovereign ex-U.S.—Bloomberg Barclays Global Aggregate ex-U.S. Index, U.S. Municipals—Bloomberg Barclays Municipal Bond Index, MBS—Bloomberg Barclays U.S. MBS Index, CMBS—Bloomberg Barclays U.S. CMBS Index: ERISA Eligible, ABS—Bloomberg Barclays Asset Backed Index, Global Investment-Grade Corporate—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index, Global High Yield Corporate—J.P. Morgan Global High Yield Index, Bank Loans—S&P/LSTA Performing Loans Index, EM Debt Sovereigns—J.P. Morgan Emerging Markets Bond Index Global, EM Corporates—J.P. Morgan CEMBI Broad Diversified, EM Local—J.P. Morgan Global Bond Index—Emerging Market Global Diversified.

†European corporates are included in this sector.

Past performance is not a reliable indicator of future performance.

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