

# Could corporate tax changes impact municipal bonds?

If you are left feeling slightly dazed and confused by events in the US since President Donald Trump's inauguration in January – from immigration issues; the repeal of ObamaCare; questions about infrastructure spending; to corporate taxation reform issues, including municipal bonds from an insurer's perspective – then you're far from alone. But while the settling in process is only just beginning, it is certainly not too early to look at some of the potential opportunities.

What is becoming clear is that the exemption of municipal bonds from US Federal income tax provides an enhanced area of opportunity for property and casualty (P&C) insurers. It will likely prove to be important to the market as it continues the struggle to generate yield across asset classes. A lower corporate tax rate, which the Trump administration has indicated it is moving towards, can also have a meaningful impact on demand for municipal bonds from insurers and banks, which together make up 24% of the muni market (Federal Reserve data as of December 2016).

## Munis v Corporates

One way to measure the effect is to look at taxable equivalent or after-tax spreads to alternative investments.

The first chart helps to explain the relationship between investment grade munis and corporate bonds, in particular for an insurance company paying taxes on 15% of the tax preferred income.

By converting tax preferred municipal yields to taxable equivalent yields for an insurer, it is possible to ascertain the relative value to similar

comparing "A" rated municipal bonds to "A" rated corporates, the spreads start to look better. For example, the 10-year "A" spread of munis versus corporates at the present 35% corporate tax rate moves up to 86 basis points from the current 52 basis points. It also remains positive by some 15 basis points when looking at a 20% corporate tax rate scenario. For

“The exemption of municipal bonds from US Federal income tax provides an enhanced area of opportunity for P&C insurers”

rated corporate bonds in different tax rate scenarios. A decline to a 25% corporate tax rate significantly lowers these spreads relative to corporates, while for a 20% scenario, the spread is negative for most of the curve, except for the particularly long end of the muni curve.

The example in chart 2 uses "AA" rated municipal bonds because they make up about 54% of the Bloomberg Barclays Municipal Index, representing a large part of the muni market. However, it only represents about 13% of the Bloomberg Barclays credit index, so a much smaller component, through the end of 2016.

If we use the same metric but

"A" rated munis in the same index it is about 27% percent, and represents about 35% percent of the corporate index – a meaningful portion of both markets.

The tax benefit to buying munis would increase at higher interest rates, which would also help to offset a decline in corporate tax rates. For example, if a US Treasury 10-year bond went to 3.5% and the muni ratio stayed at around the 95% percent we see today, with corporates spreads unchanged the 10-year "AA" taxable equivalent yield spread with a 35% corporate tax rate increases to 94 basis points from that current 52 basis points today. If the corporate tax

## Municipals: taxable equivalent yield scenarios

Maturity	AA muni	AA corporate	Corporate tax rate					
			35%		25%		20%	
			Taxable equivalent yield	Spread to corp (b.p.)	Taxable equivalent yield	Spread to corp (b.p.)	Taxable equivalent yield	Spread to corp (b.p.)
2 year	1.27	1.70	1.85	0.15	1.63	-0.07	1.54	-0.16
5 year	1.91	2.45	2.78	0.33	2.45	0.00	2.32	-0.13
10 year	2.51	3.14	3.66	0.52	3.22	0.08	3.04	-0.10
15 year	2.87	3.58	4.18	0.60	3.68	0.10	3.48	-0.10
30 year	3.29	3.88	4.80	0.92	4.22	0.34	3.99	0.11

Source: Thomson Reuters for municipal yields, Barclays Capital for corporate yields, Deutsche AM. Information is subject to change and bonds are subject to availability. Tax equivalent yields do not reflect the deduction of any client expenses such as commissions. Had these expenses were included, the illustrative yields would have been lower.

Tax equivalent yield using 35%, 25% or 20% tax rates on Corporates and 5.25%, 3.75% and 3.00% effective tax rates on Municipals. Past performance is not indicative of future results.

rate moves to 20% under the same scenario, the taxable equivalent yield spread would be at eight basis point from the negative 10 that we estimate.

### Holdings outlook

Municipal bond holdings among P&C insurers have on aggregate remained steady since 2009. For the same period, banks have more than doubled their muni holdings, because of increasing deposits and slow growth in loans, adding more than \$300bn of munis to their holdings.

The weighted average yield while banks were adding to bonds over this time period was about 3%, which is similar to today's "AA" yield for 15-year bonds. However, a lot of these bonds are now of a much shorter duration, so they are likely to have attractive book yields relative to maturity (Yield information from Thomson Reuters and holdings data from Federal Reserve Board, 2016).

However, if the corporate tax rate dropped to 20% and interest rates were to rise, we think P&C insurers and banks would start to sell their muni holdings and add to taxable alternatives to help increase book yield. With continued rising rates it is likely that we will see a shift in ownership to direct retail buyers. We've already seen an increase in demand by individual buyers since rates rose in November.

Overall, a decrease in the corporate tax rate is likely to decrease demand for munis among P&C insurance companies and banks. However, any selling would likely be spread over time and be dependent on the level of interest rates. Depending on the level of corporate tax rates, demand from these investors could be focused even more on longer maturities and in lower credit quality, given the higher after tax yields relative to corporate alternatives.

If corporate tax rates are lowered, we could see increased volatility in the range of muni treasury ratios. Crossover investors would require higher ratios to get to breakeven after tax yields to taxable alternatives. Typically these crossover investors increase their purchases of municipals when other investors are selling. The range would be higher given that the ratio would need to be higher to entice those crossover investors.

So while we may see some volatility in municipal valuations relative to taxables, these offsetting factors

should continue to support the market even with some reduction in demand from insurers. Any rate-related selling would be partially offset by an increase in purchases from direct retail buyers. Also, P&C insurance companies and banks would likely want to keep some munis for diversification purposes.

The lower default rate compared to corporate bonds is also a factor. Default data from Moody's from 1970 to 2014 show this, particularly for the "A" rated notes. The cumulative default rate for "A" rated municipals was only 0.05% versus 2.73% for "A" rated corporates in that period. Municipals also have a negative correlation to equity returns, whereas corporates tend to be more positively correlated.

### Asia Pac and EMEA views

One question that is garnering market attention is the level of interest in US municipal bonds from international institutional buyers, particularly those from Europe and Asia Pacific. We have observed an increase in muni purchasing by overseas buyers, drawn to the attractive characteristics of the muni market.

The main driver is the divergence of rates between the US and much of Europe and Asia. Some insurance investors overseas may also benefit from reduced risk-based capital charges for these types of investments, either by counting them as infrastructure investments or perhaps even classifying them alongside sovereign bonds.

The interest we have seen is in taxable municipals, given that such foreign investors do not benefit from a US tax exemption. In spite of that, if overseas P&C investors begin to benefit from better risk-based capital treatment within this investment class, they may very well bring sufficient volume to absorb some of the excess capital in the space. Munis are certainly an area of interest for European and Asia Pacific investors.

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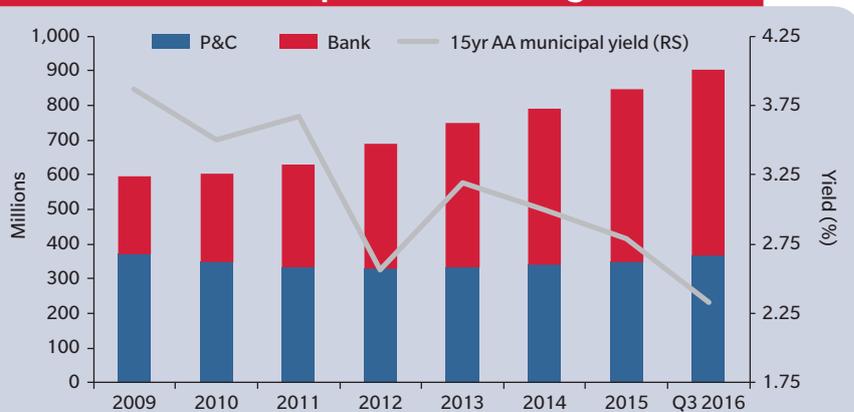
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## Institutional municipal bond holdings vs. rates



Source: Thomson Reuters for municipal yields, Federal Reserve Board for holdings. December 2016  
Past performance or any prediction or forecast is not indicative of future results.

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