April 2019 Muni Market Monthly Report – "Are Munis Worth Their Weight in SALT?"

Munis continue their fast start to 2019, as fundamentals and technicals are in a good spot, proving munis are a great late-cycle performer. They are now considered rich to taxables versus recent ratios, but with an estimated negative net supply of $17.2 billion, we do not anticipate this changing anytime soon and munis historically have room to get richer. This summer may be a good time to sell bonds if you need the liquidity. Otherwise, *"let the good times roll".*

In this month's credit review, we look at the impact that the 2017 tax reform's cap of $10,000 on **State and Local Tax (SALT)** deduction on Federal returns is currently having on the market and how we think it will affect credit rating trends in the future. The **salt trade** helped write the history of colonization and world empire dominance. Will **SALT**, over time, do the same in muniland?

Muni Market Review

The muni market continues its strong start to 2019 and is proving itself to be a good late-cycle performer. The Barclay's benchmark index has a total return of 3.2% year-to-date, and we do not see anything in the next 30 to 60 days that will slow it down. Highlights of this YTD performance are as follows:

- Muni yields are down 21 to 47 bps, with the curve flattening along the way.
- Taxable yields are down 25 to 16 bps, steepening along the way.
- Inflows into muni mutual funds were over $4 billion in April and have been positive for 16 straight weeks now.
- Year-to-date, muni issuance has picked up and is now higher than YTD 2018, but it remains low versus recent history:
    - 2019 is up 4.1% versus 2018.
    - 2019 is down 25.3% versus the last 5 years' average.

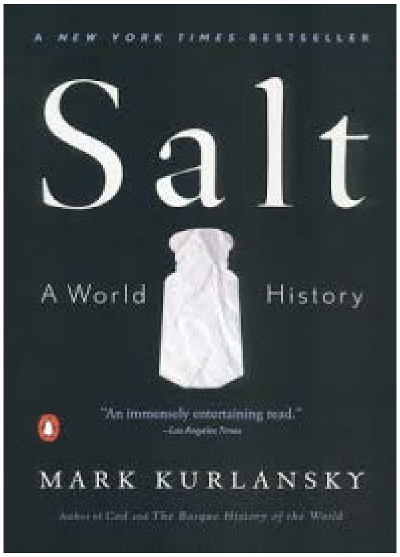
Other than an awkward 2 am tweet, or a major US Treasury sell off, munis are technically primed to remain strong over the next 30 to 60 days with net supply estimated to be at negative $17.2 billion. If you need to raise cash, we recommend using the summer months to sell munis. Please contact us if you need the liquidity.

Market News and Credit Update

- Kudos to Illinois! **Step 1 has been taken.** It was the easiest step, but a step, nonetheless. The Democratic State Senate approved the Democratic Governor's plan for a progressive tax rate to replace the current flat tax of 5%. This would raise taxes on the highest wage earners to 7.99%, while decreasing the lowest to 4.95%. This change is estimated to bring in an additional $3 billion in tax revenues, which the State could badly use. Now, the proposal will be put forward for the State voters to approve in the 2020 general election. Let's hope for the best.
- **News from DC has both parties agreeing on a $2 trillion infrastructure plan.** There are currently no details about where the money is coming from or how it will be provided. We do not see this proposal going very far. The ability to raise $2 trillion is a bit far-fetched. Stay tuned, as we still feel "Revised Build America Bonds II" is the way to go.
- **A recent Pew Research Center study,** identified nine states who have not returned to their revenue levels, pre-economic crisis. These states include Florida, Alaska, Wyoming, Ohio, New Jersey, Louisiana, Oklahoma, West Virginia and New Mexico. The study also highlighted that budget surpluses and reserves were rising, and 10 states remain fiscally imbalanced.

SALT: A World History

- **SALT: A World History** is a book by Mark Kurlansky that details how the salt trade financed the building of empires and helped determine the course of history by defining where colonies were settled. Now, it appears a different **SALT** may be rewriting history.
- The 2017 tax reform placed a $10,000 cap on the State and Local Tax (**SALT**) deduction on Federal returns. This cap has created a large increase in the effective tax rates for residents in high-tax states. The impact of this increase in taxes on migration trends, demographic growth and wealth creation for states like California, New York, New Jersey, Connecticut, and Massachusetts is now open for debate.



US Treasury estimates for 2018 show that roughly $323 billion in state and local tax bills cannot be deducted by 10.9 million filers. That is roughly $30,000 per filer. At this point, much to the dismay of the wealthy, Congress does not look like it is going to change this new tax policy anytime soon.

Studies done in the past by Moody's have shown little evidence that effective tax rates influence migration trends. Many feel job opportunities and demographic trends are a bigger reason for migration. The ability to cut your tax bill could be a motivation to move, but wealthy individuals have historically shown they are less likely to leave the place they made their money, and the social networks they have built.

Migrations can be measured by wealth (flows of adjusted gross income) or people. Just a 1% change in the wealthiest component of the population can have a high impact on state income tax revenues. Is the sudden large increase in the effective tax rate enough to change historical migration trends?

Why are migration and transfers of wealth important to the muni market? Two of the most recent and largest municipal bankruptcies, Detroit and Puerto Rico, came about from a large decrease in their populations. A small trend that begins today, can become a big one later, and lead to adverse financial consequences.

MainLine believes (whether it be short-term or longer-term) SALT will have an adverse impact on the high tax states. Long-term, we believe job opportunities will be adversely impacted. Additionally, demographic growth will slow down, as the effective tax rate increase sucks money out of the private sector. This will negatively impact these states. As job opportunities decrease, demographics will decrease and, therefore, wealth levels will decrease.

On the positive side – these same states will be able to issue new bonds at tighter spreads (lower yield to the benchmark) than in the past. Bonds from these high-tax states are trading tighter to the benchmark than pre-SALT. The value of the state income exemption is even more valuable now, which will provide lower financing rates for the states. This will not offset the wealth migration.

While MainLine is not forecasting the bankruptcy of the State of New York and/or California, we are concerned with the long-term ramifications on State income tax revenue growth, credit ratings and will continue to monitor them. We will continue to avoid buying bonds from these States for investors who are non-residents and cannot utilize the tax benefit. Tighter spreads and a very long-term negative credit trend further justifies our strategy. From an income tax perspective, Florida & Texas are the new top USA states, while States like California & New York have growing tax burdens for their residents. I guess one day we will be able to reflect back on the 2017 Tax Reform and ask, *"Was SALT worth its weight in salt?"*