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JULY 9, 2021

Municipal Bonds

Municipal bonds at midyear: Could rich valuations get even richer?

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Boston - *In a series of midyear outlook blogs, Eaton Vance fixed income investment experts present the market themes and headlines they expect to track during the second half of 2021, beginning with municipal bonds.*

Infrastructure spending

Muni bond investors have closely followed the negotiations in Congress on President Biden's infrastructure spending plans — from the original proposal of $2.25 trillion to a tentative agreement for $1.2 trillion. Then on June 24, the White House struck a bipartisan deal closer to $1 trillion, which would omit the clean energy initiatives for now, leaving them and the "human infrastructure" investments in child and elder care to future proposals. Miscommunications about the sequencing of subsequent bills put this deal in some political jeopardy before the White House walked back those statements, still the debates may continue throughout the summer.

"If there were no further flows during the second half, 2021 would still rank as the third largest year on record for inflows into muni funds."

Tax reform

Agreeing on how to pay for the infrastructure spending bill is likely to be even more elusive than compromising on its price tag. In the American Families Plan announced this past spring, Biden proposed increasing capital gains taxes and personal income taxes for the highest earners —with the potential to drive up investor demand for tax-exempt municipals. The Made in America Tax Plan would raise the corporate tax rate from 21% to 28%. Even a compromise of 25% could revive demand from a buyer base that faded away after the Tax Cut and Jobs Act (TCJA) of 2017, which lowered the top corporate rate from 35% to 21%.

So far, it looks to us like lawmakers are nowhere close to accepting Biden's tax proposals. In particular, Republicans appear to have drawn a line in the sand against any attempt to increase corporate taxes to generate revenue.

As we have discussed before, other potential provisions in the pending tax reform plans would have implications for muni bonds. Here are the topics that we think could be the most pertinent in relation to new issuance, supply and demand:

Build America Bonds. Reviving a permanent government subsidy, similar to the temporary BABs program[1] back in 2009, could help the taxable muni market grow. We see continued interest from non-U.S. buyers for taxable munis — especially anything earmarked as U.S. infrastructure.

Pre-refunding and advanced refinancing. Allowing issuers to again refinance

tax-exempt muni bonds with tax-exempt munis would likely increase tax-exempt supply relative to taxable issuance. Since the TCJA took away this ability in 2017, the workaround has been pre-refunding tax-exempt issues using taxable munis, leading to the massive increase in taxable issuance we have observed in recent years.

State and local tax deduction. Eliminating the $10,000 cap on the state and local tax (SALT) deduction could shift demand in high-tax states from in-state municipal issues to portfolios that are more diversified across the U.S. This has been a top priority for legislators from traditionally Democratic states like California, New York and New Jersey, where even middle-class property owners felt the pinch after the TCJA limited the tax break. Other progressive lawmakers from lower-tax states have argued that only the wealthy stand to benefit from reinstating the deduction, and the Biden administration has yet to take a position on the issue.

Interest rates

Interest rates are difficult to predict. Until quite recently, the consensus had expected that the expanding U.S. economy and fiscal support from the government would put upward pressure on U.S. Treasury (UST) rates — eventually. What seemed to be less certain was whether increasing UST rates would force municipal interest rates to follow in the same direction.

Supply/demand technicals have steered the muni bond market and will likely continue to do so in the second half of 2021. We also think that any sustained rise in UST yields may be impacted by global rates — especially while trillions of dollars of sovereign credit remain in negative-yielding territory. With each country's economy slowly reopening as its citizens gain access to the vaccine, we anticipate that global rates could stay low.

In the meantime, U.S. Federal Reserve policymakers have taken a slightly more hawkish stance than before, indicating that there will be no rate hikes until 2023. Tapering purchases of UST and mortgage-backed securities (MBS) could start late this year or in early 2022. That announcement may come during the Jackson Hole economic policy symposium at the end of August —depending, as always, on the data.

Bottom line: Year to date through June 30, we have seen about $60 billion of inflows into muni bond mutual funds. If there were no further flows during the second half, 2021 would still rank as the third largest year on record for inflows into muni funds. Of course, demand is only half of the technical picture in our market, with supply being the other critical half. Suppose the prospect of rising rates — or something else —raises the alarm among retail investors, then we could see those gears flip to outflows. Put another way, muni valuations are rich, but could they get even richer? That's what we will continue to watch throughout the rest of the year.

[1] Created by the Obama/Biden administration in April 2009, the subsidized Build America Bonds (BABs) program was responsible for $181 billion in taxable muni issuance before expiring in December 2010.

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