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Municipal Bonds

Seeing opportunity in taxable muni issuance

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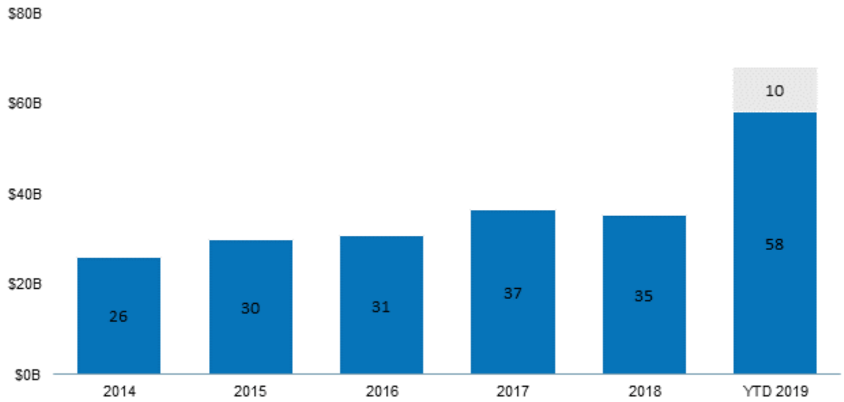
New York - The municipal bond market is witnessing the biggest surge in federally taxable muni issuance since the Build America Bonds program expired in 2010.[1] Over the last five years, taxable supply has accounted for roughly $30 billion annually. This year's total could double that pace, with over $60 billion expected by the end of 2019. And most of this debt has just been issued during the past few months.

"Taxable munis present opportunities for investors who value high credit quality, diversification and attractive income relative to other taxable fixed income sectors."

Federally taxable municipal issuance climbing in 2019



Source: Bloomberg as of December 3, 2019. Eaton Vance estimate of $10 billion issuance for the rest of 2019 based on conversations with leading underwriters.

Issuers choose to borrow on a taxable basis and pay a higher interest cost relative to tax-exempt issuance for a variety of reasons, but primarily because it allows for more flexibility in the use of loan proceeds. For example, taxable municipal debt could be used for working capital, to finance for-profit infrastructure or development — that's, private business use — or to bolster unfunded pension plans.

Cost savings on existing debt

We can attribute the recent spike in taxable issuance to cost savings on existing debt. As part of the Tax Cut and Jobs Act (TCJA) of 2017, municipalities lost the ability to ***advance refund*** — or refinance — outstanding tax-exempt debt with new tax-exempt bonds at lower cost. However, the law still allows for refinancing to occur with new issuance of taxable debt instead.

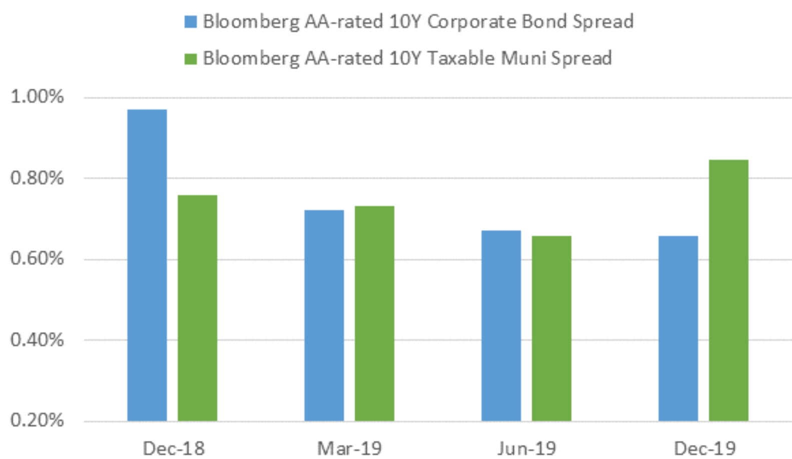
Given the dynamics of low interest rates in both taxable and tax-exempt markets, along with a flat U.S. Treasury yield curve, issuers are finding great savings by refinancing outstanding tax-exempt debt with taxable debt.

For example, on November 11, the State of Texas sold $705 million of taxable refunding bonds on behalf of its Texas Transportation Commission. The proceeds of this sale were used to purchase U.S. Treasury securities, which were deposited into an escrow account that will pay interest and principal for debt issued in 2012 until the first call date on that older loan. In this advanced refunding process, the interest costs on the new taxable debt are lower than the outstanding interest costs on the existing tax-exempt debt. By bringing down its overall borrowing costs, Texas has been able to realize large savings.

Cheaper valuations for taxable munis

As a result of the increased supply, taxable muni yields and spreads have increased relative to U.S. Treasuries and U.S. corporate bonds. According to Bloomberg data, 10-year AA-rated taxable munis (yielding 2.56%) have a spread to U.S. Treasuries that's 19 basis points (bps) wider than similarly rated U.S. corporates (yielding 2.37%). We feel this could present an opportunity for investors to add incremental yield and diversify credit exposure.

Spreads of 10-year AA taxable munis over 10-year US Treasuries have widened



Source: Bloomberg as of December 3, 2019.

Bottom line: Taxable munis are becoming a larger part of the issuance in the municipal bond market. This phenomenon is presenting opportunities for both institutional and individual buyers who value high credit quality, diversification and attractive income as compared to other taxable fixed income sectors.

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[1] Build America Bonds (BABs) were taxable municipal bonds that offered federal tax credits or subsidies for bondholders or state and local government bond issuers. Introduced in 2009 as part of the American Recovery and Reinvestment Act (ARRA), BABs were intended to create jobs and stimulate the economy after the 2008 financial crisis.

Municipal securities are subject to multiple types of risk. The impact of legislative changes and local and business developments may adversely affect the yield or value of the strategy's investments in such securities. Municipal securities are also *defaults may reduce income distributions. The value of a debt obligation also may decline because of concerns about the issuer's ability to make principal and interest payments. In addition, the credit ratings of income securities may be lowered if the financial condition of the party obligated to make payments with respect to such instruments changes.*

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