This Week in the Bond Market
12/18/2017

Final Tax Bill Impacts Municipal Market

- Republicans leaders released their final version of tax reform legislation last week with an expectation that the full House and Senate will vote on the bill, sending the reform to President Trump's office for his signature by week's end. Republican leaders believe they have enough votes to pass the legislation even with no support from Democrats. Although there were changes compared to prior House and Senate proposals, some provisions remain that could change supply and demand balances in the near-term and potentially credit-related impacts over a longer period.
- Maintaining the exemption for private activity bonds is the most prominent difference from the House plan that previously advocated full repeal. A surge in primary issuance over the last 3-4 weeks has partially been driven by the concern that hospitals, universities, and airports, which fall under the "private activity" label, would not have access to the tax-exempt market come the New Year. Although these issuers will retain their ability to borrow on a tax-exempt basis, we expect issuance in the first quarter of 2018 to be light, as many potential deals were presumably pulled forward into the current calendar year.

TAX REFORM AND MUNICIPAL BOND MARKET

Key provisions of the proposed tax reform legislation

PROVISIONS	CHANGE
Advance Refundings Bonds	Tax-exemption repealed
Private Activity Bonds	Tax-exemption maintained
Corporate Tax Rate	Cut to 21% from 35%
State and Local Tax Deduction	Capped at $10,000 for property, income and sales tax
Alternative Minimum Tax	Personal retained, higher threshold
Mortgage Interest Deduction	Capped at $750,000 loan

Source: Tax Cuts and Jobs Act

FIXED INCOME INDEX RETURNS AS OF 12/15/2017

	MTD	YTD
Barclays 3Yr	0.38	1.72
Barclays 5Yr	0.63	3.32
Barclays 7Yr	0.88	4.55
Barclays MM Short 1-5Yr	0.43	1.74
Barclays MM 1-10Yr	0.82	3.53
ML US Gov/Corp 1-10 Yr	0.12	1.66

Source: Interactive Data

Muni Market Overview

- The municipal market saw record issuance of $23.9 billion in the week ending 12/15, bringing December issuance to $44.8 billion and YTD issuance to $398 billion. With a further $11 billion expected to price in the last full trading week of the year, the municipal market is on track to eclipse the previous single month issuance record of $53 billion set in October 2016. YTD total issuance would be in the $410-415 billion range, down 3-5% from 2016's $428 billion, after running closer to 15% below 2016's pace for much of the year.
- The municipal market softened modestly in advance of the Federal Reserve's widely expected decision to raise short term rates and also in the wake of this surge in issuance. The 10Yr backed up 10bps to 2.05% through Tuesday's close, before firming back up and retracing most of the move to close the week at 1.99%. The 2Yr rose 3bps to 1.46% in advance of the meeting and held its gains through the week. Overall the curve remains slightly higher and 1bps steeper over the week.
- After five consecutive weeks of inflows, municipal mutual funds saw outflows of $113 million during the week. This trend reversal was largely attributable to monthly-reporting funds; weekly-reporting funds alone continued to see inflows this week, reporting gains of $217 million. Demand appears to remain reasonably strong despite the recent surge in supply.

Taxable Market Overview

- As expected, the Federal Reserve Open Market Committee raised the Federal Funds Target Interest Rate for the third time this year by 25 basis points to 1.50%. The effective rate is currently 1.42%. The key take-away's from the meeting were that the Fed expects to raise rates another three times in 2018 and twice in 2019. Going forward, expectations are for stronger growth, lower unemployment, inflation hovering around 2%, and there seems to be added expectations for fiscal stimulus built into future expectations. Market reaction was muted on the release and the curve continued to flatten. The 10Yr ticked down 2bps to end the week at 2.35%, and the 30Yr fell 8bps to 2.69%.
- There were two dissenting opinions to an increase in rates. Charles Evans (Chicago Fed) and Neel Kashkari (Minneapolis Fed) have both noted that inflation expectations have not yet been met and believe that there should be a pause in raising rates until there was meaningful upward movement in the Fed's benchmark.