FRANKLIN TEMPLETON INVESTMENTS

Topic Paper

October 30, 2018

CHANGING DYNAMICS LEAD TO NEW OPPORTUNITIES IN THE MUNICIPAL BOND MARKET

Perspective from the Franklin Municipal Bond Team

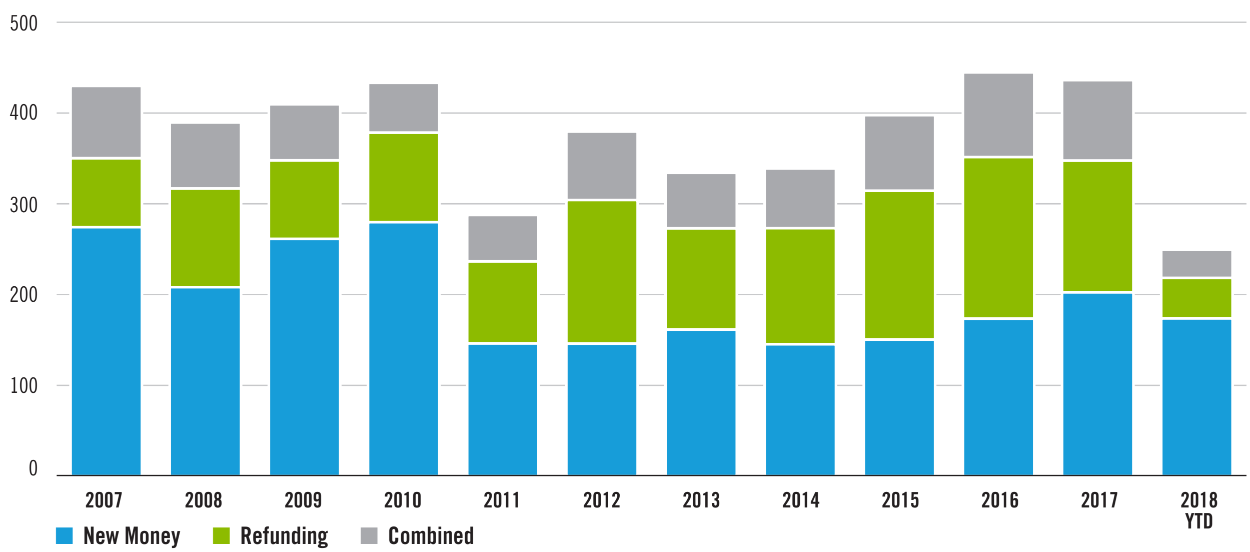
At the beginning of the year, we discussed in our *Beyond Bulls and Bears* blog how the Tax Cuts and Jobs Act of 2017 (TCJA) would likely impact the municipal bond landscape for both issuers and investors. As we expected, tax reform has led to structural changes in the market. Supply is constrained while demand remains high, and the end of advance refunding has led borrowers to issue bonds with shorter non-call periods. New opportunities for investors have arisen though, particularly in issues subject to the alternative minimum tax (AMT).

Magnified Market Technicals

As we anticipated in January, one of the most significant ramifications of the TCJA has been the impact on both new issue supply and investor demand in the municipal bond market. Based on the uncertainty regarding tax policy at the end of 2017, we witnessed a record $62.5 billion in new issues in December as borrowers stampeded to complete financings.[1] This year-end supply push, combined with the inability to complete advance refundings from January 1, 2018 onward, curtailed new issuance in the first half of 2018. Bond Buyer forecast gross supply at $290 billion for 2018, a 33% decline from the 2017 level.[1] As of the end of September 2018, supply was approximately 14.5% below the same date last year. In our view, the market should continue to enjoy strong technical support for the remainder of the year as demand continues to outpace supply.

Municipal Supply 2007–2018 by Purpose

As of September 30, 2018 ($ billions)



Source: Bond Buyer.

1. Bond Buyer, 12/31/17.

On the demand side, we expected an increase from some types of investors and we believe that this remains true. Prior to TCJA, taxpayers who itemized deductions on their federal tax returns could deduct state and local taxes (SALT). In fact, taxpayers could deduct 100% of state and local income taxes as well as 100% of their state and local property taxes. Now though, under the TCJA taxpayers who itemize can deduct only a combined total of $10,000 in local and state income and property taxes. As a consequence, tax-free income from municipal bonds has become much more desirable for taxpayers who previously enjoyed significant SALT deductions.

Despite increasing yields and declines in bond prices, investor demand has remained relatively steady throughout 2018, further strengthening the technical conditions in the market.

End of Advance Refunding Has Bond Structure Implications

For municipal bond issuers, elimination of the tax exemption for advance refunding of bonds has reduced their ability to take advantage of lower rate environments. Advance refundings must now be carried out on a taxable basis and issuers will have to pay higher coupon rates to compensate. This has not only caused a decline in refunding supply in the market, but also reduced municipal issuer flexibility in managing liabilities.

Borrowers have been looking to maintain the financing flexibility they need by issuing bonds with shorter non-call periods. Given that recent market supply/demand dynamics strongly favor issuers, buyers will have no choice other than to accept these shorter call periods. Whereas 30-year bonds have typically been issued with 10-year non-call periods, we have witnessed an increasing number of longer-term bonds with five to eight year non-call periods being issued recently. When managing muni portfolios, the length of non-call periods is an important consideration. A recognition of how such structures may affect the overall portfolio and pricing dynamics has become much more important given these developments.

Opportunity In AMT Issues

The alternative minimum tax (AMT), as the name suggests, is a backup method of calculating federal income tax used to ensure that high-income households and corporations pay their fair share of taxes. Under the law, certain tax benefits such as exemptions can significantly reduce a taxpayer's regular tax liability. The alternative minimum tax applies to taxpayers with high income by setting a limit on those benefits to preclude a situation in which a wealthy taxpayer would end up owing nothing. AMT helps to ensure that those taxpayers pay at least a minimum amount of tax. The Tax Cuts and Jobs Act of 2017 completely repealed the AMT for corporate taxpayers and significantly reduced the number of individuals subject to the tax—potentially by as much as 98%, according to the Tax Policy Center.

Private activity bonds are tax-exempt and typically issued by or on behalf of municipal or state governments to finance certain qualified projects. These projects are private user projects for a public good, for example hospitals, airports, parking facilities and similar projects. Some of these bonds are taxable for bond holders subject to the AMT. These AMT bonds have traditionally been offered at a higher yield compared to non-taxable municipal issues to compensate for the tax liability to some investors. Since the number of AMT taxpayers is expected to decline significantly as a result of the TCJA, we would have expected the demand for AMT munis to increase and spreads to subsequently decrease. Interestingly, we have not seen a significant spread tightening between AMT and non-AMT issues in the market. For example, as of 10/29/18, the Bloomberg Barclays Municipal Bond AMT Index yield to worst was 3.39%, while the Bloomberg Barclays Municipal Bond A-Rated Index yield to worst was 3.17%.[2]

At Franklin, historically we have been very conservative regarding AMT exposure in our strategies because we recognized that a meaningful percentage of our investor base was subject to the AMT. However, with the recent legislation and overall reduction in the number of investors subject to the AMT, we have become more aggressive in buying AMT exposure in our strategies given the yield advantage. The table below offers an example of San Francisco City and County Airport AMT and non-AMT issues that we follow and hold.[3]

San Francisco City and County Airport Comm Comparison of AMT vs non-AMT Bond

CUSIP	TAX	RATING	SPREAD OVER AAA MUNIS (BPS)
79766DLG2	AMT/State Exempt	A+	37.7
79766DLJ6	Fed & State Exempt	A+	17.0

Source: Bloomberg, 10/29/18.

2. Source: Bloomberg. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged and one cannot invest directly in an index
3. There are no material differences between the AMT bond (CUSIP 79766DLG2) and the non-AMT bond (CUSIP 79766DLJ6) except for the yield differential. As of 9/28/18, Franklin California High Yield Municipal Fund holds the AMT bond (0.44% of total net assets [TNA]). Franklin California Tax Free Income fund holds the AMT bond (1.24% of TNA) and the non-AMT bond (0.38% of TNA).

We believe that potentially rising demand from a larger investor base post-AMT modification should cause spreads between AMT and non-taxable municipal issues to narrow. We plan to take advantage of this window of opportunity while it lasts, provided that the AMT bonds offering a spread and yield premium satisfy our internal credit requirements.

Conclusion

With the dust still settling from the Tax Cuts and Jobs Act, it's important for clients to understand how municipal bond investments will be affected. In our view, municipal bonds are a great source of tax-free income for many investors. With an active approach, investors can take advantage of market opportunities while also avoiding potential risks. Additionally, skilled and meticulous credit research is necessary to identify the best opportunities in the market while also seeking to minimize credit risk. We believe that our deep market expertise may help unlock considerable potential value in the municipal bond market.

FRANKLIN TEMPLETON INVESTMENTS

Franklin Templeton Distributors, Inc.
One Franklin Parkway
San Mateo, CA 94403-1906
(800) DIAL BEN® / 342-5236
franklintempleton.com