Potential Tax Hikes Add to Appeal of Municipal Bonds

Proposed changes to U.S. tax rates could increase demand for tax-exempt municipal bonds. Even if taxes stay the same, we think the asset class remains attractive.

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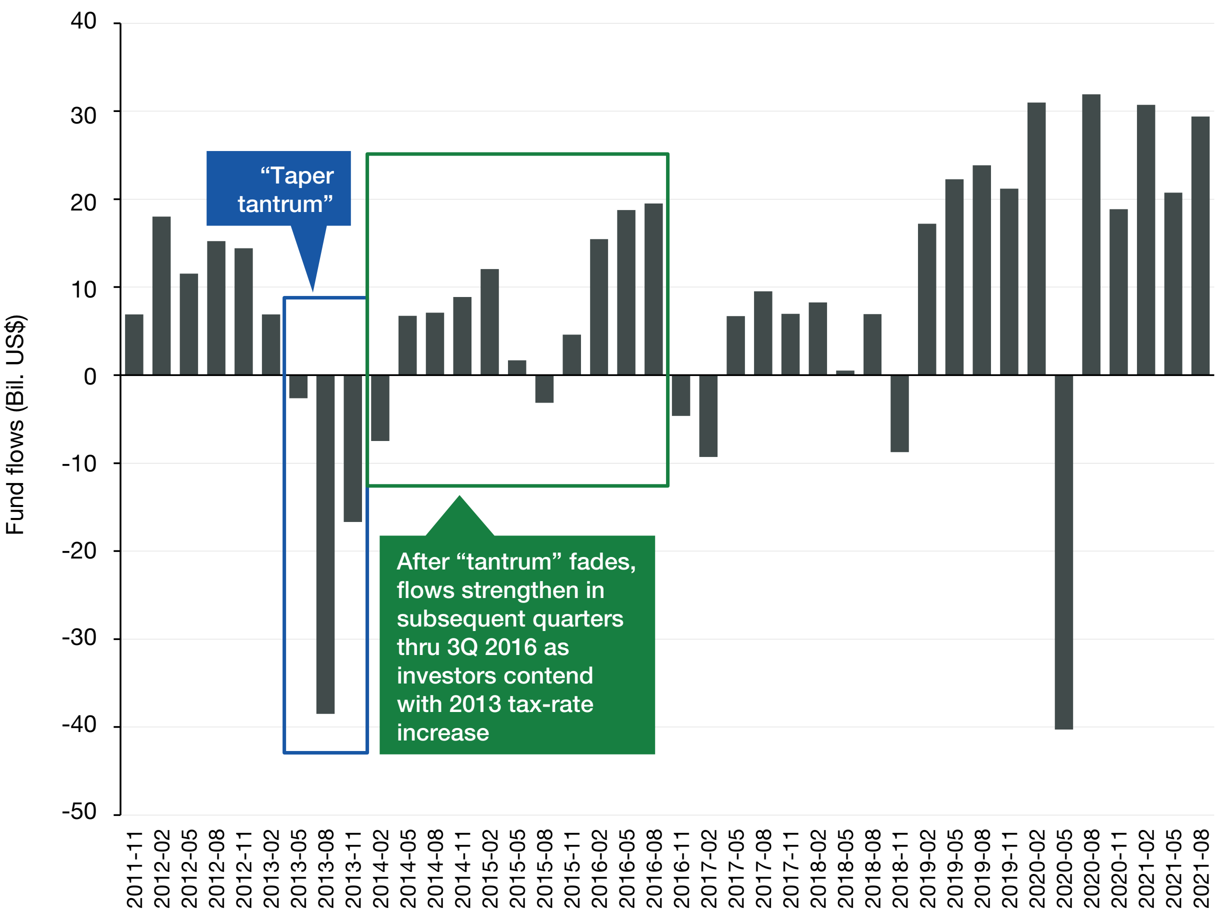
Figure 1. How Might Proposed Tax Changes Affect Demand for Muni Bonds? Post-2013 Period May Offer a Lesson

Estimated net flows into municipal bond mutual funds (quarterly), November 30, 2011–August 31, 2021



Source: Morningstar. Data as of August 31, 2021 for U.S.-registered, municipal bond mutual funds.

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MUNICIPAL BONDS

Not surprisingly, municipal bond investors pay close attention anytime Congress considers potential changes to the U.S. tax code. Falling tax rates may decrease the attractiveness of tax-exempt municipal bonds[1] relative to taxable bonds; rising tax rates may make these munis more desirable.

Right now, the latter scenario appears to be a real possibility. The House of Representatives' Ways and Means Committee has drafted legislation that, among other measures, would increase the rate on the top individual tax bracket from 37% to 39.6% for individuals earning more than $400,000 and households bringing in more than $450,000.[2] The committee is also discussing increasing capital gains taxes for incomes above $1 million, and an increase in the corporate tax rate from 21% to 26.5%.

Why might higher tax rates spark demand for municipal bonds? First and foremost, as munis are exempt from income tax on interest earned through coupon payments, the upward adjustment to the top individual tax bracket rate could potentially allow high earners an even better, tax-equivalent yield compared to taxable fixed-income securities. This may potentially lead to a higher demand for tax-exempt municipal bonds.

The last time the top individual tax bracket was raised was in January 2013, with the rate increasing from 35% to 39.6%. Recent research from Putnam has found that after that increase, municipal bond mutual funds saw net inflows for the most part over the next three years, except for the periods impacted by the 2013 "taper tantrum," which led to increases in yields across taxable and tax-free, fixed-income investments. (Of course, demand for munis has remained generally strong after that three-year window, with positive flows in 16 of the 20 quarters through the second quarter of 2021.)

Additionally, a rise in the capital gains tax could motivate investors to find an offset to decrease their tax burden, potentially resulting in further demand for municipal bonds. And while the municipal bond space is dominated by retail investors, financial firms such as banks and insurance companies also have significant holdings; an increase in the corporate tax rate may result in growing demand from these firms for tax-free bonds.

The news of potential tax increases comes at a time when current demand for municipal bonds is already substantial. Through September 30, year-to-date flows into municipal bond mutual funds of $88.5 billion would rank as the second-highest annual figure in terms of full-year inflows since 1992, the first year this data was compiled. Most notably, municipal bond funds have seen inflows in 71 of the last 72 weeks, amounting to $150 billion. (Fund-flow data from JP Morgan.) Due to the asset class's performance and resilience during periods of market turmoil over the past 18 months, combined with the anticipation of potentially higher taxes in the near future, demand for municipal bonds does not seem to be slowing down any time soon.

A Final Word

Of course, there are no guarantees that U.S. tax rates will actually change this time around. In any case, we believe that municipal bonds remain attractive. In a previous Market View, Lord Abbett Partner & Director of Tax-Free Fixed Income Dan Solender noted the solid fundamentals of the muni market, including the strong demand mentioned earlier and the positive impact of U.S. economic growth and fiscal stimulus on muni issuers' credit quality.

And what about the potential for new tax legislation? "Tax rates are either going to stay the same or rise," said Solender. In his view, "either outcome should favor municipal bonds."

[1]All references to municipal bonds in this article pertain to tax-exempt municipal bonds.

[2]Jacob Pramuk, "House Democrats Propose New Tax Hikes to Pay for Their $3.5 trillion Bill: Here Are the Details," cnbc.com, September 13, 2021.

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Glossary Definitions

Taper tantrum is a term popularly used to describe the 2013 increase in U.S. Treasury yields which resulted from the U.S. Federal Reserve's use of tapering to gradually reduce the amount of monetary stimulus in the economy.

The **tax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of the tax-exempt yield on a municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond to see which bond has a higher applicable yield.

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