ClarkCapital MANAGEMENT GROUP

Portfolio Perspectives

The Tax Law Changes and Their Impact on Debt Markets

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The recent changes to the U.S. tax code are likely to have a ripple effect within several areas of the fixed income markets. We believe most affected will be municipal bonds.

Lower tax rates make taxable bonds more competitive with tax-advantaged bonds when comparing relative yields. Over time, we expect the municipal market will cheapen relative to the taxable bond market.

Though the tax decreases were small for individuals, the decrease in the corporate tax rate to 21% makes municipal bonds substantially less attractive to insurance companies and banks. These institutional buyers represent a significant portion of the demand for municipal bonds, especially bonds with maturities longer than ten years. This is very good for individual investors, as they should be able to get higher yields even though their tax brackets did not change significantly.

Elimination of SALT

The elimination of state and local tax (SALT) deductions makes it more important for investors to buy municipal bonds that are exempt from their home state tax. This is especially evident in high-tax states. As an example, let's look at an investor receiving a 5% tax-free coupon in a state with a 7% income tax.

Under the old tax laws, the investor would have had to pay 35 basis points of state tax on out-of-state bond interest. However, the 35 basis points paid would have been deductible against federal taxes as part of the investor's SALT deductions. Under the 2018 plan, there is no longer a federal deduction. The net result is bonds issued in high-tax states such as California will be relatively more expensive (have lower yields) than the index average yields. This favors active management and customized portfolios.

Advanced Refunding

"Advance refunding" is when a municipal authority issues new debt at lower interest rates to defease old debt. This typically results in an immediate (present value) cash flow to the budget. With the elimination of advance refunding in the 2018 tax code, municipalities will now have less flexibility in managing their budgets.

Historically, advance refunding has been one of the most abused financial processes, with many investigations, sanctions, and fraud accusations. Elimination of advance refunding is an effort to clean up a very dirty corner of the municipal bond business. And this is good for the long-term sanctity of the municipal bond business though a slight credit negative in the near term.

The majority of corporate taxable bonds are held by tax-free accounts. Hence, there should be only a small impact in this area due to the tax code changes. Insurance companies and

banks may be more likely to buy corporate debt over equities, as the new corporate tax rate and the dividend rate gap is mostly gone. As stated above, these entities are now more likely to buy corporate debt over tax-advantaged municipal debt.

The Supply Side

On the supply side, every corporation will have to re-evaluate whether they are better off raising money through debt or through equities. We have no idea how companies will view the decline in value of the interest deduction (due to lower corporate tax rates) compared to equity dilution. But this is the exercise the accountants and actuaries are likely to be going through. Clearly, the higher a company's 2017 tax bracket relative to their 2018 tax bracket, the more likely they are to consider reducing debt sales and increasing equity raises. This can also be impacted by dividends, which are not deductible. The bottom line is that profitable, historically highly taxed, companies with no dividends on equity may shift some capital needs from debt to equity. Only time will tell if it plays out this way.

Finally, the mortgage interest cap for deductible interest was lowered, and this is likely to lead to slightly lower supply. However, we see no major impact to the mortgage bond markets.

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Jon is Clark Capital's Executive Vice President of Fixed Income. During his 30 years as a trader and senior portfolio management leader in the institutional bond industry, Jon has focused on the creation and supervision of actively managed, innovative fixed income strategies. Most recently he was co-founder of Main Point Advisors, where he was responsible for the implementation and management of non-traditional fixed income strategies.

At Clark Capital, Jon is responsible for the development and oversight of actively managed fixed income strategies that address the ever changing challenges and opportunities faced by bond investors. He is lead manager of the Navigator Duration Neutral Fund and a senior portfolio manager on the Navigator Tactical Fixed Income Fund.

Prior to founding Main Point Advisors in 2013, Jon was co-founder, Managing Director, and Chief Investment Officer of Duration Capital Management Advisors, Inc. From 1994 through 2002 Jon built and managed municipal and corporate bond trading at Susquehanna International Group, LP. Jon is nationally known for his publications and presentations including co-authoring *The Handbook of Municipal Bonds* (2008, John Wiley and Sons, Inc.). Jon graduated from Albright College with a BS in Business Administration and Political Science.