2017 Municipal Market Outlook Part 2: Adapting to an unstable equilibrium in a year of disruptive change | *by George Friedlander*

In last week's Perspective, the 2017 Outlook, we addressed most of the key issues that we expect to affect the municipal bond market during 2017. In this second part, we emphasize other key factors that have continued to color our thinking. They are the following:

1. **Trump Administration impact on the markets.** Trump's victory has boosted stocks and hammered bonds. The sustainability of this trend remains tenuous, at best, in our view.

2. **Unfunded pension liabilities.** Even in the brief time since last week's piece, it is increasingly clear that pension problems will have an expanding impact on perceived credit quality, and will remain strongly in the public eye.

3. **Accelerating technological change.** This is a theme that, in our view, will begin to affect relative credit strength over a period of years, but that may begin to show up during 2017: given its implications for economic growth, incomes, employment, pensions, relative strength of cities and states and a host of other issues.

4. **Pressures on state and local budgets.** Initiatives that may come out of the Administration and/or Congress that could directly impact local credit quality.

5. **Tax Reform and the muni market.** We reiterate that any eventual tax provisions will have a varied impact on the municipal market, depending upon tax rates, permitted deductions and the treatment of interest income for individuals.

6. **Tax Reform's impact on State and Locals.** We believe that state and local governments will have to battle to maintain current Federal support, including the tax-exemption on munis and deductibility of state and local taxes on the Federal return. There is a certain irony in these anticipated battles, in the sense that they fly in the face of the strongly stated goal of the Trump Administration to boost spending on infrastructure.

7. **Resurgent demand for munis.** It appears fund flows are beginning to rebound. They finally turned positive, after a long, ugly post-election negative period of nearly $16 billion of outflows.

<u>Anticipated Trump Administration policies</u>: Uncertain impact on economic growth and interest rates

The outcome of Trump's policies on the economy and rates depends on whether Congress enacts a highly stimulative Tax Reform plan with significant tax cuts for the middle class, and leading to higher deficits. It is not yet clear that what outcome will occur, but we offer the following scenarios for your consideration:

- **A full Tax Reform plan** which mainly cuts higher income tax bills, without putting substantial additional after-tax income into the hands of the middle class, would, we think, have a negligible impact on municipal demand.
- **A partial Tax Reform** that cuts corporate tax rates, the effect on economic growth might be modest. And, as we discuss below under Technological change, there remain many drags on GDP and income growth, as well as a global picture that won't help by generating additional foreign demand for U.S. goods.

The bottom line is that we believe that there is a real possibility that GDP growth will remain moderate, and that inflation will not accelerate sufficiently to push long-term interest rates significantly higher. To be sure, Treasury yields have already eased off a bit from mid-December peaks, with 10- and 30-year yields down 24 and 18 basis points, respectively, and long-term muni yields are off about 30 basis points, for reasons we have articulated previously.

<u>Unfunded pension reform</u>: Attempts will remain strongly in the public eye.

Several events have occurred very recently which highlight the importance of this issue.

City of Chicago's "squabble" with Moody's over the latter's below-investment-grade rating of the city reflect heightened rating pressure and scrutiny. The City's lack of success in ameliorating the pension crisis is reflected in market yield levels supportive of Moody's analysis, with spreads to high-grades in the 250-300 basis point range. **Although payments to the pension system are up dramatically, it is not enough.** Chicago's $1 billion 2017 payment is still less than half of Moody's $2.3 billion estimate of what's needed for the plans just to halt growth in the unfunded liability, and will remain about $800 million short once ARC payments begin in 2021. (See page 8 for more on Chicago and other problematic issuers.)

Rockefeller Institute's widely read Policy Brief, **"How Public Pension Plan Investment Risk Affects Funding and Contribution Risk,"** released last week, illustrates that plans failed to appropriately reduce investment assumptions, even as interest rates declined sharply in recent years. Instead, plan administrators increased the use of riskier assets in an attempt to maintain returns at prior historical levels. As a consequence, the study notes, "We estimate that at today's level of risk, with $3.7 trillion in public pension fund assets, there is about a one-in-six chance of a single-year shortfall of more than $425 billion for the United States as a whole. As we discussed last week, if the required discount rate were to be reduced, the size of the aggregate unfunded liability for state and local plans—and resultant annually required contribution—would increase sharply:

Measure)	Discount Rate						
						Risk-free rate:	
	7.6%	7%	6%	5%	4%	2.75%	2.3%
Total liability ($tr.)	$4.5	$5.1	$5.8	$6.6	$7.5	$8.1	$9.4
Actuarial assets ($tr.)	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Unfunded liability ($tr.)	1.2	1.8	2.5	3.3	4.1	4.7	6.0
Percent funded (Traditional rules)	74%	65%	58%	51%	45%	42	36.1

On the “good news” side, Second Court Of Appeals in California affirmed that, despite the state guarantee of pension benefits, **governments in the state have the ability to eliminate certain practices that have caused annual individual pensions to rise sharply.** These practices include the purchase of additional pension credits and the practice of pension “spiking,” whereby individuals could increase pensions by sharply increasing overtime incurred during the last three years of employment, when post-retirement pension levels were determined.

<u>Accelerating technological change</u>: The impact will begin to show up more dramatically, in ways that could affect relative credit strength.

This phenomenon will receive considerable focus in coming reports. For now, however, we see major risk from technological changes in the immediate future. Patterns now receiving significant attention include: a) the imminent potential of car-sharing and then self-driving cars and trucks, b) pressures on many retailers, such are the well-publicized job cuts at Macy’s and the full-blown shutdown of The Limited chain; c) the growing dominance of the so-called “gig economy” as a source of net new jobs, and d) increasing automation in a variety of industries. The patterns aren’t all negative, with so-called “smart cities” beginning to become a key factor in urban change. Nevertheless, we believe that the sum of these patterns—including the relatively positive ones for some cities—will begin to affect relative credit strength over a period of years, but that may begin to show up during 2017.

Over time, increasing competition from automation will also affect economic growth, incomes, employment, pensions, relative strength of cities and states and a host of other issues. The November 18, 2016 ***MIT Technology Review*** (“Manufacturing Jobs Aren’t Coming Back”) was aptly subtitled, “President-elect Trump’s promise to bring back production jobs ignores the realities of advanced manufacturing.” We expect that 2017 will be the year that municipal market participant begin to focus more heavily on these concerns—and the way they create winners and losers among credits.

<u>State and Local Budget Pressures</u>: Risks Grow

Serious risks include the well-publicized potential for repeal of the ACA without a simultaneous replacement (which has already been approved in the Senate earlier in the week and today by the House), but also attempts to reduce Medicare, Medicaid, and a variety of income supports and programs that help children.

The fundamental concern is that reductions in such programs might be a source of revenues to pay in part for Tax Reform, but would also result in a pressure on many states to increase spending to offset the cuts.

Tax Reform and the Muni Market

We discussed this in greater detail last week, but want to reiterate two points. First, while corporations would likely to continue to purchase municipals with lower tax rates, they would require higher yields relative to taxable bonds to do so.

Second, one of the key threats to the relative cost of borrowing for state and local governments is a widely discussed potential provision of Tax Reform that would put the maximum tax rate on taxable bond interest at half of the maximum individual income tax, or 16 1/2 %.

We will follow the Tax Reform process very closely for signs as to where tax rates are likely to end up, and whether this latter provision is incorporated.

Tax Reform: Federal Aid Impact on State and Local Governments.

Within the tax reform process, we believe that state and local governments may have to battle to maintain current Federal support, including the tax exemption on munis and deductibility of state and local taxes on the Federal return. There is a certain irony in these anticipated battles, in the sense that they fly in the face of the strongly stated goal of the Trump Administration to boost spending on Infrastructure.

Any outcome which affects these two existing benefits for governments would tend to reduce capacity to fund infrastructure spending, by raising borrowing costs in the first case, and increasing pressure to reduce state and local taxes in the second case.

Financing versus funding: A Key Concern

As the Administration and Congress address the issue of increased support for infrastructure spending, it will continue to be clear that the key issue for infrastructure renewal will be funding—how the projects get paid for—rather than financing—the specific techniques used to attract capital, although we concede that both will play a role.

Legislation in this arena will play a key role. We note that Transportation Secretary-designate Elaine Chao testified in favor of increased access to private sector financing for state and local projects. And yet, as a recent Treasury Department study noted, "Forty proposed major transportation and water infrastructure projects on a list commissioned by the Treasury Department could produce up to $1.1 trillion of economic benefits from their total estimated capital costs of $334 billion." But that 39 of these 40 projects face funding challenges.

A key point here is that these projects need funding support, not merely access to new or innovative financing vehicles.

Muni Demand: Rebound Begins

Fund flows finally turned positive, after a long, ugly negative period. In our view, there is likely to be widespread demand for munis at the somewhat higher rates that currently prevail. The challenge however, is that concerns related to the elimination of the ACA (for hospitals, but also for some governments) and Tax Reform could dampen that demand to a degree, or at least keep yields higher than would have otherwise been the case, in order to clear the market.