From MacKay Municipal Managers™

Capitalizing on Municipal Value in High-Tax States: California and New York Profiles

May 2019

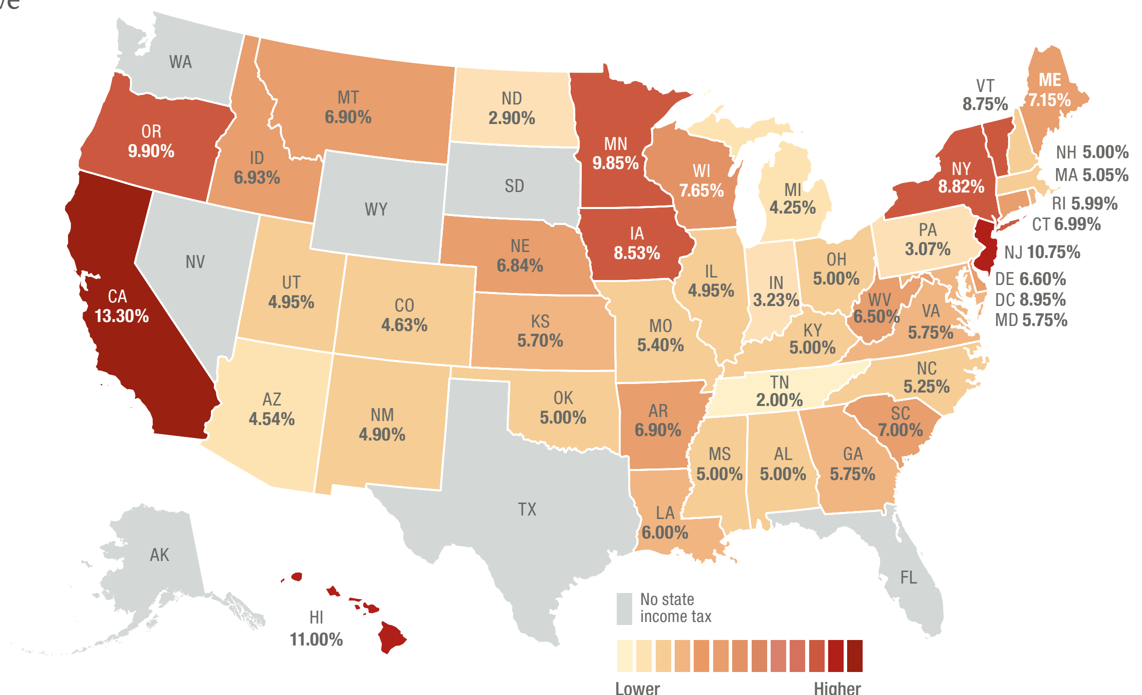
Overview

As noted in our 2019 municipal market insights, we believe the uncertain economic and geopolitical landscape will create attractive investment opportunities for municipal investors who are well-positioned to tactically adjust portfolio exposures. We believe that this approach provides better total return opportunities than strategies anchored to more traditionally passive investment approaches.

For some time, we have been of the opinion that municipal bonds from states with high-income tax rates would outperform those from states with marginal to zero income tax. As federal rates have been modestly reduced, we expect municipal investors to become more keenly aware of the benefit of double exemption, particularly when factoring in state and local tax deductions (SALT), which are now capped at $10,000. This will become even more evident as taxpayers recognize how much they are paying in taxes during future tax seasons. Importantly, we also believe that demand for bonds in high-income tax states will be even greater for those fiscally responsible state and local issuers that have maintained strong credit ratings. As active managers, we have sought to identify credits poised to outperform based on population growth momentum and underlying economic stability.

Figure 1: Overview of State Income Tax Rates

Top State Individual Income Tax Rates, 2019



Source: Tax Foundation, March 2019. Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.

NEW YORK LIFE INVESTMENTS

As we've closely followed the effects of tax reform, we believe California and New York issued bonds represent increasingly attractive segments of the municipal market. As this paper seeks to explain, the benefit these bonds can provide to in-state residents is clear, especially given one's ability to achieve broad diversification across the various sectors of the municipal bond market. In addition, we believe it's also beneficial for residents outside of these states to emphasize exposures in these specialty states within a national municipal portfolio, as high-tax states' bonds could outperform due to greater market demand.

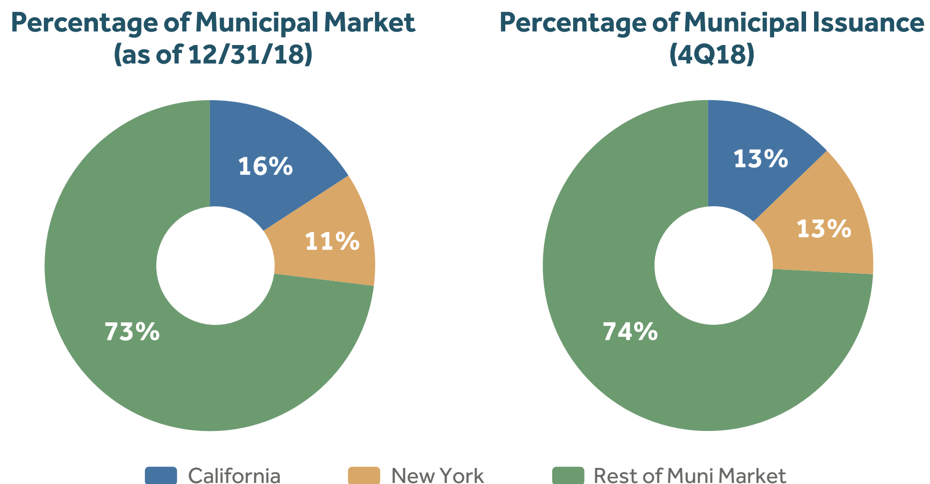
California and New York: Achieving Diversification in High-Tax States

Within the municipal market, some states possess a unique set of characteristics, where "state-focused" municipal investment strategies present a compelling opportunity for many residents of those states. This would include states with strong credit fundamentals, diverse issuance, and strong demand stemming from high-income tax rates. We believe New York and California fit that profile better than any other state, especially with respect to tax rates and wealth levels.

In addition to the obvious value provided by income exempt from both federal and state taxes, California and New York residents benefit from their ability to achieve broad diversification given the significant size of their respective municipal markets. California and New York are the two largest issuers in the market. Together, they represent approximately 27% of the outstanding municipal supply. In any given period, the two states are likely to drive new issuance as well. This has continued to be the case more recently, as California and New York placed first and second, respectively, based on issuance volume at the end of 2018.

Figure 2: New York and California Comprise Meaningful Portions of the Municipal Market

Source: SIFMA Municipal Bond Credit Report, February 2019.



MacKay Municipal Managers has said in recent years that we believe high-tax states outperform with a preference for those that are financially well-positioned and have demonstrated fiscal responsibility. In addition to broad opportunity sets, we believe both states present attractive fundamentals that can further support their municipal credit profile. The State of California has enjoyed a strong and expanding economy since the recession, and now stands as the fifth largest economy in the world, and the largest in the United States. Since the recession, the state has filled its coffers, including the rainy day fund. To continue Governor Brown's legacy, first-term Governor Newsom's budget proposal focuses on putting additional funds away in the rainy day fund lifting the fund to new heights, and paying down debts and pension liabilities.

We believe the State of New York continues to have a favorable credit profile as well. Leadership under Governor Cuomo has addressed a number of issues at the state level, and has also provided support for many county and local governments that experienced levels of distress following the economic crisis. In recent years, New York has consistently passed balanced budgets on time, an event that was no guarantee under previous administrations. New York represents the third largest state economy in the U.S., also benefitting from high per capita income and low unemployment versus many other states. As a result of recent fiscal progress and economic growth, fundamentals are compelling with strong reserves and a strong 94% funded state pension system, one of the highest in the nation. As a high-tax state that is deeply affected by the $10,000 limit on SALT deductions implemented with the 2017 Tax Cuts and Job Act (TCJA), New York State taxpayers benefit from the tax exemption of municipal bonds.

Figure 3: Attractive State Profiles

	New York	California
Issuance (% of market)[1]	The second largest issuer in the market with $408.2B outstanding, representing 11.30% of the market	The largest issuer in the market with $573.9B outstanding, representing 15.89% of the market
Diversification (# of issuers)[2]	**~3,600 issuers** ■ 62 counties ■ 62 cities ■ 932 towns ■ Approximately 728 school districts	**~8,900 issuers** ■ 58 counties ■ 482 municipalities ■ 1,025 school districts
Credit profile[3]	**General Obligation (GO) Ratings Aa1/AA+/AA+** ■ 3rd Largest economy in US; $1.68T Gross State Product ■ High per capita income and low unemployment ■ 94% funded pension system ■ Strong liquidity and cash balances from monetary settlements ■ Strong push for infrastructure development ■ On-time budgets and multi-year financial plan	**General Obligation (GO) Ratings Aa3/AA-/AA-** ■ Largest economy in the US; 5th largest economy in the world ■ $142B budget for FY 2019-2020—Personal Income Taxes is the largest revenue source (70.5% of total revenues) ■ High per capita income and low unemployment—boosted by tech and health care sectors ■ 67% funded pension system ■ Strong and increasing liquidity and reserves ■ On-time budgets and multi-year financial plan
Top Marginal Tax Rate[4] (Combined Federal and State)	49.62%	54.1%
Tax Equivalent Rate (Based on 3% or 4% tax free)	**3.0%:** 5.95% **4.0%:** 7.94%	**3.0%:** 6.54% **4.0%:** 8.71%
Client Municipal Allocation (Base Case, Starting Point for FA)	For the average moderate investor, a 55% allocation to a New York-specific portfolio may be considered, complemented by a 45% combination of National Investment-Grade and High-Yield Municipal exposure.	For the suitable average moderate investor, a 55% allocation to a California-specific portfolio complemented by a 45% combination of National Investment-Grade and High-Yield Municipal exposure.

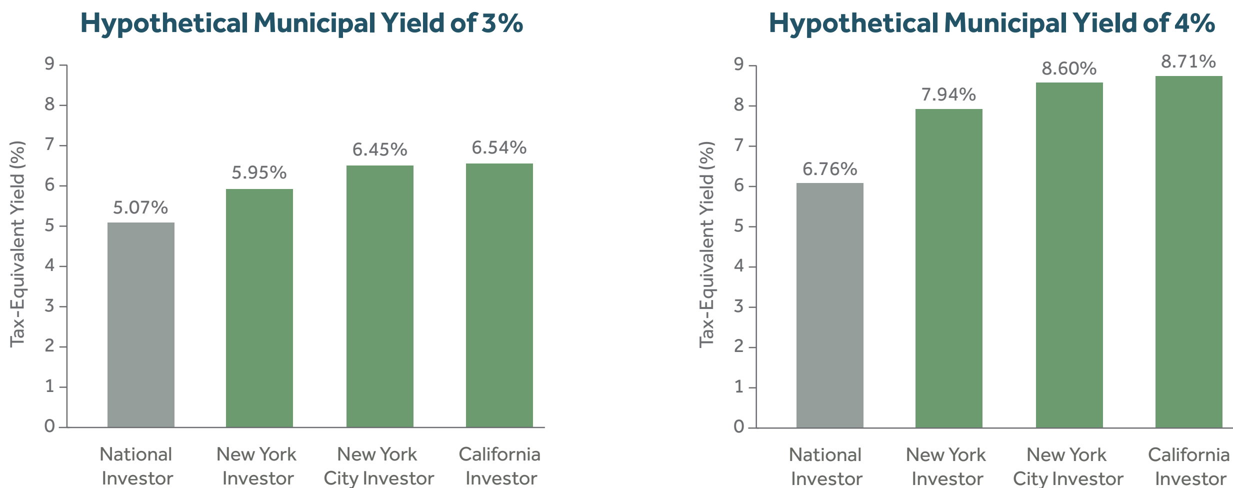
1. Source: SIMFA, Municipal Bond Credit Report, February 2019

2. Source: Electronic Municipal Market Access (EMMA), January 2019

3. Source: GO Ratings: SIMFA, Municipal Bond Credit Report, February 2019. Source: Pension funding stats: Bloomberg, 2017. Source: all other statistics: National Association of State Budget Officers, www.nasbo.org

4. The tax-equivalent assumes a tax rate used for New York taxable investors of 49.62%, which represents the blended income tax rate based on the 3.8% net investment income tax, the New York State personal income tax of 8.82%, and the federal tax rate of 37.0%. This does not factor in state and local income tax deductions. The tax-equivalent assumes a tax rate used for California taxable investors of 54.1%, which represents the blended income tax rate based on the 3.8% net investment income tax, the California State personal income tax of 13.3%, and the federal tax rate of 37.0%. This does not factor in state and local income tax deductions.

Figure 4: Tax-Equivalent Yield Increases Meaningfully within the Context of High-Tax States*



* Tax Equivalent Yield calculations are based on the blended rates derived from a top federal income tax rate of 37%, the 3.8% net investment income tax, top state income tax rates of 8.82% and 13.30% in New York and California, respectively, and an additional city tax of 3.88% for New York City. This does not factor in state and local income tax deductions.

Tax Reform Will Continue to Bring Increased Demand for Municipal Bonds from High-Tax States

As the effects of the TCJA tax reform are felt in subsequent tax filings, we believe this will spark continued incremental demand for municipal bonds from investors in high-tax states. In our view, lower federal tax rates will cause residents of high-tax states to seek more tax-free income at the local level and will, therefore, increase their preference for in-state municipal bonds. At the same time, the tax law limits on SALT deductions will further reinforce these residents' demand for tax-free income at the state level. Although SALT deductions weren't fully eliminated, municipal bonds from such states should still benefit from increased demand, as their tax-exempt characteristics have become incrementally more valuable. The prospects for increased demand present a positive technical factor, given the structural dynamics of the municipal market.

As a result of the TCJA tax reform, taxpayers who itemize may no longer deduct the full amount of their state and local income taxes (SALT) from their federal returns. Tax reform has now capped the itemized deduction amount for SALT at $10,000 per return for single filers, head of household filers, and married taxpayers filing jointly. Residents of high-tax states, such as California and New York, are expected to feel the most pain from the new law.

How much pain? $323 billion worth on a national level, according to a report just released by the House Ways and Means Committee. Nearly 11 million tax filers, including almost eight million married couples filing jointly, are taking the hit. That's almost $30,000 in lost deductions per return.

As a result of new limits on SALT deductions, it is estimated that

11 million tax payers

will lose out on

$323 billion

worth of deductions

This is not just affecting the highest earners. The 2017 median California household income of approximately $70,000 faces a 9.3% state tax rate, while the median New York household income of approximately $62,000 faces a 6.33% state tax rate (not including New York City tax when applicable). Just a few thousand dollars of taxable investment income could push even these median taxpayers in both states above the $10,000 SALT limitation.

State vs. National — Considering a Municipal Bond Allocation

When we think about opportunities in the municipal market, especially given the potential effects of tax reform, we believe there are important takeaways for municipal investors to consider as they look to capitalize on these opportunities, while managing risks in an evolving and complex market.

In states like California and New York, we believe high-income earners will benefit from investing the majority of their municipal assets within their respective states. Although federal tax rates were slightly reduced, tax liabilities for investors in high-tax states may elevate further, especially when factoring in the cap on SALT deductions. In addition to the incremental benefits of the state income tax exemption, the breadth and depth of these two markets allow investors to achieve broad diversification not available in many other states.

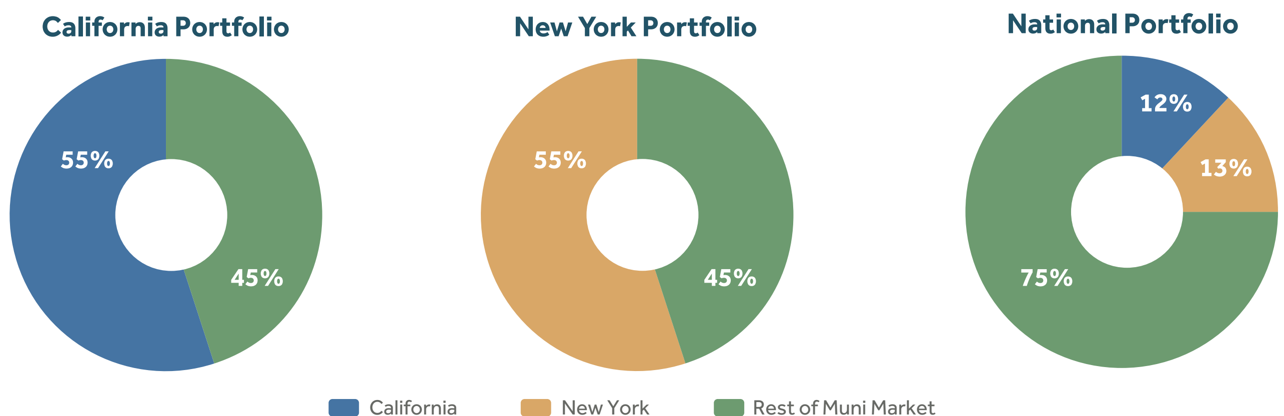
Improving fundamentals and strong economic momentum further support these credits as well. For many of the same reasons, we believe municipal investors residing outside of California and New York will also benefit from an increased emphasis on credits from these states. Although the incremental value provided by the state tax exemption wouldn't apply, investors building a national portfolio can benefit from the attractive credit profiles and strong economic fundamentals that we have discussed.

As residents of these states are likely to gravitate towards municipal bond opportunities following tax reform, the potential for spread compression makes bonds incrementally more attractive to investors residing in other states as well.

While it may seem counterintuitive for New York or California residents to have exposure to municipal bonds outside of their respective state, especially in light of the points highlighted in this paper, complementing the portfolios with a smaller allocation to municipals on a "national level" should be considered. Opportunistic exposure outside of these states is still attractive, as such exposure provides an additional layer of diversification and expands the ability to capitalize on mispricings throughout the rest of the market. At the same time, the focus should remain on credits that can provide income exempt from both federal and state income taxes.

Figure 5: Allocation Recommendations — Specialty State and National Portfolio Perspectives

Assumes Moderate Investment Profile



Conclusion

When one evaluates California and New York in terms of credit profile, diverse issuance, and strong demand stemming from high-income tax, it's clear to see why the municipal investment opportunity within these states has been compelling for some time. With the passage of the Tax Cuts and Jobs Act in 2017, we believe the modest reduction of federal rates, combined with the SALT deduction cap of $10,000, will result in even greater demand for these bonds, leading to their outperformance. We believe residents of certain high-tax states, California and New York for example, should consider a material exposure to bonds issued in their respective state, complemented by a national approach seeking to capture opportunities across the balance of the municipal market. In doing so, MacKay Municipal Managers believes an active, relative-value, and total-return-oriented approach that seeks to capitalize on market inefficiencies lends itself well to the current municipal market.

Before you invest

Mutual funds are subject to market risk and will fluctuate in value.

A portion of a municipal fund's income may be subject to state and local taxes or the Alternative Minimum Tax. Funds that invest in bonds are subject to interest rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner. High-yield securities (commonly referred to as "junk bonds") are generally considered speculative because they present a greater risk of loss than higher-quality debt securities and may be subject to greater price volatility. High-yield municipal bonds may be subject to increased liquidity risk, as compared to other high-yield debt securities.

Municipal securities risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities. Such uncertainties could cause increased volatility in the municipal securities market and could negatively impact the Fund's net asset value and/or the distributions paid by the Fund. Securities purchased by the Fund that are liquid at the time of purchase may subsequently become illiquid due to events relating to the issuer of the securities, market events, economic conditions, or investor perceptions.

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