


STANDISH

Tax Sensitive Fixed Income

The American Jobs Act – Less Impact on Municipal Bonds than Meets the Eye

President Obama's jobs bill, The American Jobs Act, which was submitted to Congress on September 12, 2011, contains several provisions that intersect with the municipal bond market. In our opinion, the Act should not affect the orderly trading of municipal bonds in the long run, but may cause some uncertainty in the markets in the near term as the Act is debated.

The bill's funding scheme caps all itemized deductions for high-income taxpayers at a 28% tax rate. This permanently limits to 28% (from the current maximum of 35% or the 39.6% maximum on January 1, 2013 if the Bush tax cuts are not extended) the amount of municipal bond interest income that can be exempted from federal taxes and effectively reduces the after-tax income from municipal bond holdings.

Some market participants fear the enactment of this proposal would lower the demand for municipal bonds and cause tax-exempt interest rates to rise somewhat. Recent history, however, does not support the notion that lower federal tax rates result in declining investor demand. The potential impact on tax-exempt interest rates should be small indeed as municipals continue to offer tax advantages not available in other fixed income instruments.

A centerpiece of the Jobs Act is the creation of an infrastructure bank. As outlined in the bill, the bank would likely provide little competition for financings in the municipal bond market. Taxable loans either directly made or guaranteed by the infrastructure bank would carry higher financing rates than are available from tax-exempt municipals. In addition, the bank appears to be targeted at projects with credit characteristics well below the average for issuers of municipal bonds and are complementary to traditional financings.

Finally the bill proposes to extend the exemption from the alternative minimum tax (AMT) of private activity bonds. We believe, this measure would benefit infrastructure investment issuers whose bonds are currently subject to the AMT.

Tax-Exemption of Municipal Bond Interest Capped at 28% Tax Rate – We've Been Here Before

The historical record shows a very weak link between changes in marginal federal income tax rates and individual demand for municipal bonds. As the chart below shows, during the two years in the late 1980s when the highest federal rate last got down to 28%, individual holdings of municipals, either through direct bonds or through mutual funds, increased by 20%. And five years later, when the highest federal rate was raised to 39.6% as part of deficit reduction, municipal bond holdings by individuals fell by nearly 5% over the next two years. While the earlier period was a different interest rate regime, it seems that the tax rate alone is the not key driver of the demand for municipals.

Year	Highest Marginal Federal Income Tax Rate	Household Sector Muni Holdings (\$B)	Mutual Fund Muni Holdings (\$B)	Total Individual Muni Holdings (\$B)	Percent Change
1986	50.00%	\$410.90	\$67.00	\$477.90	
1987	38.50%	\$516.60	\$74.80	\$591.40	24%
1988	28.00%	\$586.00	\$82.90	\$668.90	13%
1989	28.00%	\$613.30	\$98.60	\$711.90	6%
1990	31.00%	\$647.70	\$112.60	\$760.30	7%
1991	31.00%	\$701.80	\$139.70	\$841.50	11%
1992	31.00%	\$672.20	\$168.40	\$840.60	0%
1993	39.60%	\$640.80	\$211.30	\$852.10	1%
1994	39.60%	\$594.10	\$207.00	\$801.10	-6%

Sources: Tax Policy Center of Urban Institute and Brookings Institution, Federal Reserve

The American Jobs Act

Infrastructure Bank – An Invitation for Speculative Projects and Start-Ups

The Jobs Act also includes provisions for a permanent financing authority with the power to make direct loans or guarantee loans for non-federal transportation, water and energy infrastructure projects. The infrastructure bank could have a meaningful impact: projects of more than \$100 million (\$25 million in rural areas) are targeted, and the total book of loans and guarantees is scheduled in the Act to grow from \$10 billion in 2013 and 2014 to \$50 billion by 2023. However, the municipal bond market, estimated by the Federal Reserve at \$3 trillion, remains the prominent funding source of capital for US infrastructure development.

We believe it is quite unlikely that most high-grade borrowers which predominate in the municipal bond market would tap the bank for financings. In absence of any direct federal subsidy, interest rates on taxable guaranteed loans would be higher than those available from tax-exempt municipal debt. And, according to the Act, interest rates on direct loans must be no lower than yields on comparable Treasury securities.

The infrastructure bank offers generous credit and repayment terms, likely attracting more speculative financings and start-up projects. Each project must only meet the requirement of having a single investment-grade rating. And repayment of principal and interest can be forestalled during a project's first five years.

Extending the AMT Holiday – Good for Bondholders and Issuers

In a clear benefit for some municipal bondholders and issuers, the proposal extends until 2012 the exemption of private-activity interest from the AMT. This exemption was initiated in the first stimulus program, but expired in 2010. Extending the AMT holiday for another two years enables private activity borrowers, such as airports and housing authorities, to finance at lower, fully tax-exempt rates. We expect issuance in sectors subject to the AMT will pause until borrowers have a definitive ruling on their tax status; if enacted, the provision would likely stimulate supply in these sectors by reducing borrowing costs.

*Steven Harvey,
Senior Portfolio Manager*

STANDISH

Tax Sensitive Fixed Income



BNY Mellon Center · 201 Washington Street · Boston, Massachusetts 02108-4408

For additional information please contact Diane Vieira at dvieira@standish.com or (617) 248-6049

This information is not provided as a sales or advertising communication. It does not constitute investment advice. It is not an offer to sell or a solicitation of an offer to buy any security. Past performance is not an indication of future performance. This information is not intended to provide specific advice, recommendations or projected returns of any particular product offered by Standish Mellon Asset Management Company LLC ("Standish"). Some information contained herein has been obtained from third party sources and has not been verified by Standish. Standish makes no representations as to the accuracy or the completeness of any information herein.

The information is not intended and should not be construed as legal or tax advice, parties should consult with qualified investment, legal, and tax professionals

Views expressed are subject to change rapidly as market and economic conditions dictate. Portfolio composition is also subject to change.

This material is not intended as an offer to sell or a solicitation of an offer to buy any security, and it does not constitute investment advice.

BNY Mellon Asset Management is one of the world's leading asset management organizations, encompassing BNY Mellon's affiliated investment management firms and global distribution companies, of which Standish Mellon Asset Management Company LLC and MBSC Securities Corporation are wholly owned subsidiaries. Securities are offered by MBSC Securities Corporation, a registered broker dealer and FINRA member. MBSC also has entered into an agreement pursuant to which it may solicit advisory services provided by Standish Mellon Asset Management Company LLC, a registered investment adviser.

BNY Mellon is the corporate brand for The Bank of New York Mellon Corporation.