Convexity Maven

A Commentary by Harley Bassman

May 19, 2020

"State of Mind"

Call me crazy, but I have always liked paying income taxes; the more the better. Why ? Notwithstanding various (legal) tax mitigation strategies, taxes paid have some rough correlation to income, so I am happy to have them both rise.

I suppose this may explain why my wife and I chose to move from New York City to Laguna Beach five years ago as it was the only way to increase our marginal state tax rate from 12.7% to 13.3%....and did I mention the additional 1.0% mental health tax added last year ?

Thus, filed under the heading of high-class problems, I was a bit bothered with the passage of the Tax Cuts and Jobs Act (TCJA) in late 2017 which greatly reduced the deduction for State and Local Taxes (SALT).

And it has been a painful irony that mortgage REITs and MLPs, two of the asset classes that benefited from the TCJA, imploded in March; so perhaps the third time will be a charm as I consider an investment in tax-free Municipal bonds.

I say a pox on both their houses with respect to the juvenile bickering between MSNBC and Fox. That said, there is often a (small) kernel of truth underlying the much larger topics that are soon twisted beyond recognition.

Proponents keen to eliminate the SALT deduction posit that the Federal Government has no business subsidizing states whose greater services are supported by a higher tax rate. One could argue that residents of these states vote for such policies by who they elect.

Subject to a few Schedule A limitations, a resident's Federal tax bill is reduced by their state tax times their Federal tax rate. Thus, the IRS is effectively paying a portion of your state tax bill via reduced revenues to the Federal Government.

In a vacuum, this is not a bad concept; except for the small detail that we are a Republic with a Federal system of Government. While state law is disparate, the Federal Government offers a unified system of taxes and benefits for everyone.

"From each according to his abilities, to each according to his needs", or so said Karl Marx about communism. He would surely appreciate the incongruity found in the -shale table- that details how Federal taxes are collected and redistributed.

FEDERAL TAX DOLLARS RECEIVED PER TAX DOLLARS PAID PER STATE

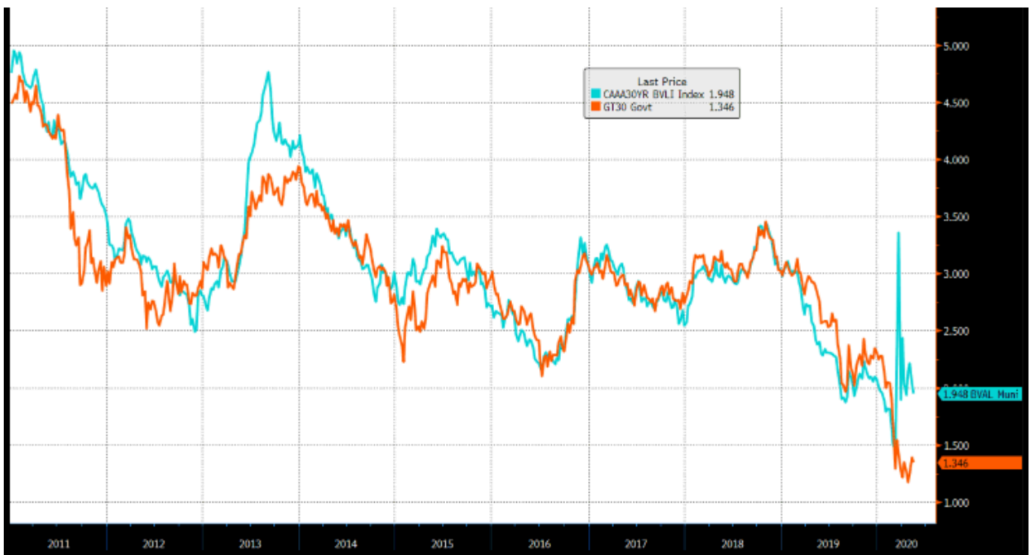
NEW JERSEY	0.61	RHODE ISLAND	1.00	S. CAROLINA	1.35
NEVADA	0.65	GEORGIA	1.01	OKLAHOMA	1.36
CONNECTICUT	0.69	INDIANA	1.05	ARKANSAS	1.41
NEW HAMPSHIRE	0.71	OHIO	1.05	MAINE	1.41
MINNESOTA	0.72	PENNSYLVANIA	1.07	HAWAII	1.44
ILLINOIS	0.75	UTAH	1.07	MONTANA	1.47
DELAWARE	0.77	N. CAROLINA	1.08	KENTUCKY	1.51
CALIFORNIA	0.78	VERMONT	1.08	VIRGINIA	1.51
NEW YORK	0.79	IOWA	1.10	S. DAKOTA	1.53
COLORADO	0.81	NEBRASKA	1.10	ALABAMA	1.66
MASSACHUSETTS	0.82	WYOMING	1.11	N. DAKOTA	1.68
WISCONSIN	0.86	KANSAS	1.12	W. VIRGINIA	1.76
WASHINGTON	0.88	ARIZONA	1.19	LOUISIANNA	1.78
MICHIGAN	0.92	IDAHO	1.21	ALASKA	1.84
TEXAS	0.94	TENNESSEE	1.27	MISSISSIPPI	2.02
FLORIDA	0.97	MARYLAND	1.30	NEW MEXICO	2.03
OREGON	0.98	MISSOURI	1.32		

You might notice that states with higher income tax rates often transfer much more to Washington D.C. than they receive back in benefits.

With this in mind, one might surmise that the unlimited SALT exemption was a quid pro quo between the 'net givers' and 'net takers', designed at a time when compromise was not a dirty word. Perhaps I am speaking my book, but it does seem like the sort of solution King Solomon might have devised.

When the President spoke of "American carnage" three years ago, I suspect he did not anticipate COVID-19. So too did I not consider that tax-advantaged, high grade Municipal bonds would completely disconnect from benchmark rates.

The -hauyne line- is the yield for the Bloomberg Index of Moody/S&P, AAA-rated, 30yr callable Municipal bonds. (Please hold your mortgage rating comments.) The -crocoite line- is the yield of the US Treasury 30-year bond.



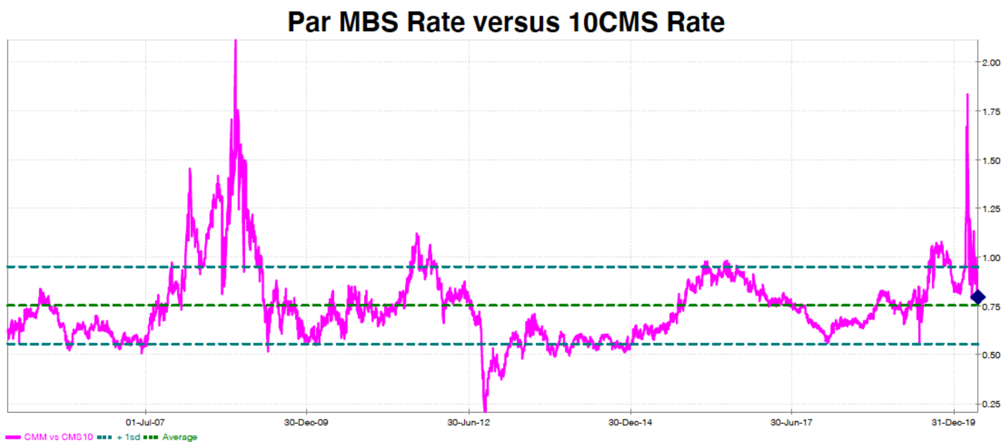
Source: The Bloomberg

For clarity, this is not quite an apples-to-apples comparison since the Muni's tend to be structured as thirty-year final maturity bonds that can be "called" after ten years. Thus, they tend to rally like a ten-year and decline like a thirty-year, similar to a mortgage bond.

To stay on topic, I am going to wave my hand and skip the muddy swamp of Option Adjusted Spreads, and simply direct your attention to the lock-step fit of these two lines, except for the small panic during the "taper tantrum" in 2013, which was quickly resolved.

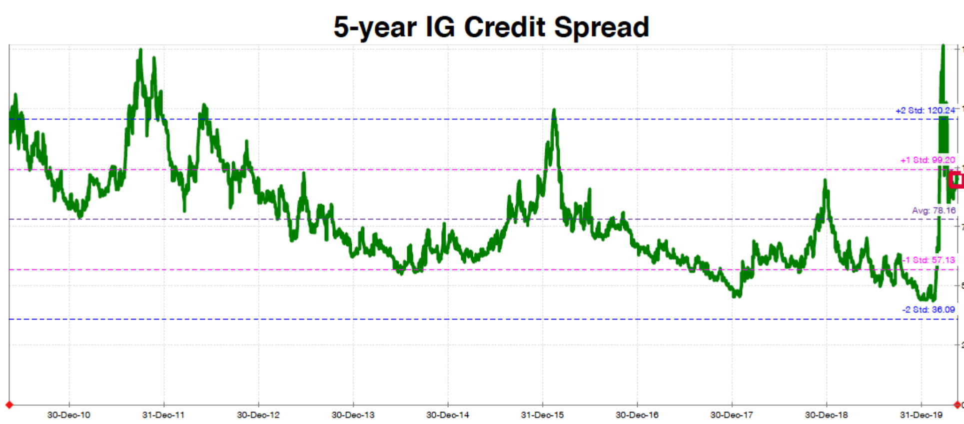
As last measured, the Muni Index had a Federal tax-free yield of 1.95% versus its Tsy-30yr benchmark of 1.35%, a spread of 60bps. This is fully two standard deviations above its decade average of about 8bps.

Many asset classes have recovered from March's pandemic panic, especially those that earned support from the Federal Reserve (FED). Helped by a $200bn FED bazooka, the -greigite line- spread between MBS bonds and the Sw10yr rate has compressed to near its "forever" average of 75bps.



Unless noted, Source is Credit Suisse LOCUS

In a similar fashion, the Index for -odinite line- Investment Grade (IG) retraced to within 17bps of its ten-year average when the FED hinted at a backstop.

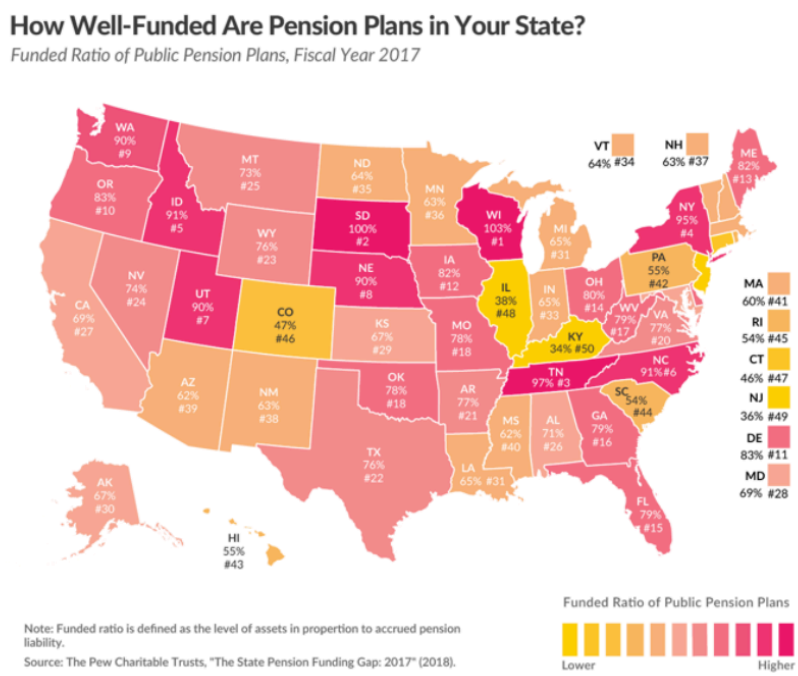


The most likely reason Muni bonds have not reverted to spread, despite the FED indicating it might aim the money cannon in its direction, is the comment Senate Majority Leader Mitch McConnell made on April 23rd: *"I would certainly be in favor of allowing states to use the bankruptcy route…we're not interested in solving their pension problems for them…we're not interested in rescuing them from bad decisions they've made in the past."*

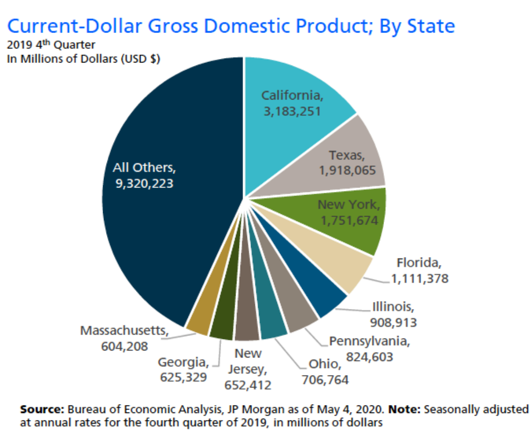
I must admit I respect such Chutzpah said with a straight face. Depending upon the measure used, Kentucky is one of the top five "takers" of net Federal dollars. No matter; let's keep our focus on investing and avert our gaze from the swamp.

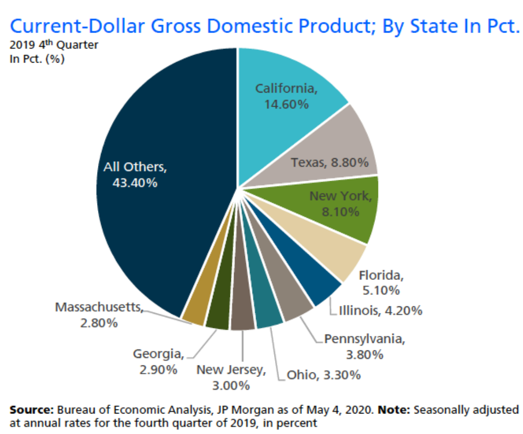
Allowing for a smidgen of hypocrisy, Senator McConnell is correct that pension obligations can pose a serious threat to state finances, and perhaps so much that it may impair the ability to fulfill debt obligations. One need look no further than Detroit or Puerto Rico to appreciate these risks.

The -rainbow picture- below details the pension funding for various states. What is interesting is that there is little correlation between funding level and tax rates.



Let's consider opportunities in Muni bonds issued by states whose pensions are roughly 80% funded AND have a large enough float so their bonds are not "museum pieces"; I will also include California for the obvious reasons.





Below is a sampling of bonds (not funds) that have traded recently. The bonds from Georgia, Ohio, and Florida are rated AAA, while the NY bond is AAA / AA+. The California bond, rated AA-, is a large general obligation issue.

State / Rank / Rating CUSIP	Call / Maty	Issue Date	Issue Px / Yld	Spd / Bench	Cuurent Px / Yld	Spd / Bench	Wider since Issue
GA #16 AAA 373385CU5	01-Jul-28 01-Jul-35	19-Jun-18	107.311 3.14%	0.11% 3.03%	119.02 1.51%	0.86% 0.65%	0.75%
OH #14 AAA 172311PM8	01-Dec-29 01-Dec-37	11-Nov-19	113.974 2.42%	0.05% 2.37%	118.16 1.91%	1.26% 0.65%	1.21%
FL #15 AAA 34153QLV6	01-Jun-27 01-Jun-38	7-Dec-17	98.75 3.08%	0.32% 2.76%	106.38 2.02%	1.37% 0.65%	1.05%
CA #27 AA- 13063DPV4	01-Oct-29 01-Oct-44	2-Sep-19	115.55 2.26%	0.30% 1.96%	113.50 2.38%	1.73% 0.65%	1.43%
NY #4 AAA / AA+ 64971W5D8	01-Feb-27 01-Feb-45	10-Apr-17	98.5 3.71%	0.72% 2.99%	104.45 2.89%	2.24% 0.65%	1.52%

A few comments not offered in the table above:

1) These bonds are trading one to six points lower than last January, despite the yield on the Tsy30yr declining by 70bps;
2) A taxable-equivalent yield of 2.50% to 4.80% (higher if you live in-state);
3) Compare to an implied taxable 5-year IG index yield of roughly 1.35%.

Apple's recently issued 30-year bond yields 2.60%, about flat to Georgia (tax-equivalent). While it is a near certainty that Georgia will pay off its obligations (just raise taxes), the same cannot be said about Apple. Recall that Motorola, Nokia, and Blackberry at one point also offered a "must have" phone.

Let's rip away the veneer and recognize when something is the "wrong price". I suppose a Tsy5yr at 0.31% could be reasonable relative to short-term deflation and the realization that a V-shape recovery is a pipe dream (even in CA where pipes can be fully inhaled); but a Tsy30yr at 1.35% seems a bit nutty. If not, then the market is taking McConnell at his word, and states may default.

Buying single name bonds is not for everyone, so be careful. I like that they have a "final maturity", unlike funds that are perpetual; but they can be hard to sell.

One final note: While I prefer to avoid politics in my Commentaries, perhaps you noticed that Kentucky is #50 in pension funding at just 34%....just saying.

Harley S. Bassman
May 19, 2020

Your comments are always welcome at: harley@bassman.net
If you would like to be added to my distribution, just ping me.

For reference literature on the financial markets - particularly about options and derivatives - I will immodestly direct you to my educational archive at:

http://www.convexitymaven.com/themavensclassroom.html

If you still have kids in the house, please take a vacation that is more interesting than the Four Seasons, Costa Rica – life is not a dress rehearsal. Turn off the Crackberry (did I just date myself ?) and explore with the family. You don't need to break the bank, rent an RV and see the U.S. We traveled with our four kids on five incredible RV trips.

http://bassman.net

If you are an institutional investor, I can highly recommend:
Hunter Davis at BNP and Jordan Brink at Morgan Stanley

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