
Will Trump's Lower Income Tax Rates Really Hurt Muni Bonds?

There was some paranoia a couple years back surrounding the muni market. Those fears are cropping up again, but infrastructure momentum could make munis a safe bet.

It feels like deja vu all over again in the municipal bond market.

All the chatter of how President-elect Trump's lower income tax rates may hurt munis reminds us of the Meredith Whitney scare back in 2011.

She went on CBS's 60 Minutes program and claimed that more than 100 American cities could go bankrupt.

Oops.

O.K., we'll give her Puerto Rico and Detroit, but other than that, the muni market basically has been just fine.

Until recently. Remember, the income on a municipal bond is generally tax-free. As a result, lower income tax rates decrease a muni's attractiveness, at least on the tax front. So there are a bunch of naysayers, channeling their inner Meredith Whitney and claiming the sky may fall again in the muni world.

"And just the potential for lower tax rates immediately hit the bond market and brought municipal bond returns [yields] up and values [prices] down," says Bernie Kent, tax expert and Chairman, Schechter Investment Advisors, in Birmingham, Mich. (Remember, a bond's price moves in the opposite direction of its yield.)

But let's not panic.

We don't know when (or even if) tax rates will officially change, and history has shown it can take a while.

"Don't forget that both Reagan and Bush took a full year to get a tax cut in place," reminds Jim Robinson, bond expert and founder of Robinson Capital in Grosse Pointe, Mich.

Plus, there are some other variables to consider.

Granted, Lower Rates Could Make a Difference

The top federal tax rate for those making $500,000 or more, realistically could be over 44% these days. The top federal tax rate is currently 39.6%. Then you have to throw in the 3.8% Obamacare surtax and this pesky stealth surtax on high net worth individuals, says Kent. Without getting into the weeds of the calculation (it's called the Pease tax), you could find yourself taxed at 44%.

So if the top bracket drops to 33%, as both Trump and Paul Ryan suggest, the tax benefits of a municipal bond decrease.

A quick calculation shows you why.

In really simple terms, divide the municipal bond rate by (1 minus your tax rate).

Let's say the muni is yielding 5% and your tax rate is 40%. So the equation looks like this: 5/(1-0.40) = 8.3%.

Consider that your cut-off when choosing between a corporate bond and a municipal one. If you find a corporate bond yielding more than 8.3% (good luck with that), take it, because you may be better off with that bond even if you have to pay taxes on the income.

But let's say your rate drops to 33%, 7.46% becomes your cut-off. Granted it's lower, but it's still tough to beat in the corporate world.

The decision is never based on just one factor, though. Don't forget about the quality of the bond, the duration, fees etc., says Kent.

But Trump Is a Big Infrastructure Guy

So he's not going to want to kill the funding.

Remember, muni bonds are debt obligations issued by states, cities, counties and other governmental entities to raise money for schools, highways, hospitals or other public projects.

So when you buy a muni, you're essentially lending money to the project in return for your money back and some additional interest. And as we mentioned, a bigger perk is that the income is often federal and state tax free.

And while we don't have details, Trump may promote policies that actually help these bonds, says Mark Luscombe, principal analyst at Wolters Kluwer, a tax and accounting services company.

We know that some Trump's infrastructure proposals may include tax incentives to create private-public partnerships for infrastructure. He also has signaled that he'd consider Build America Bonds.

And We Know There Will Be Interest Rate Increases

But even that is hedged into the calculation, says Robinson.

Short-term debt is already the optimal choice compared to longer-term bonds, because no one really knows what the interest-rate future looks like either.

There is Talk of Decreasing the Tax on Interest Income

One potential tax change that could benefit corporate bonds is if the tax on interest income is reduced. Bonds pay interest to their holders (usually) semi-annually. Currently that interest is taxed at the ordinary income rates, which could be as high as 44%, as we mentioned above.

"There is talk of implementing a cap at 16.5%," says Robinson, (which is basically 50% of the highest proposed rate of 33%).

"If that happens, we'll see a rally in corporate bonds as opposed to munis getting beaten up," Robinson adds.

So What Should You Do?

Rates have gone up and down over the years and munis have managed to beat out their taxable counterparts. And even with all this noise, the relationship between munis and corporates is about the same as it was 12 months ago, notes Robinson.

If you are a high-net worth individual, you probably still will need municipal bonds in your portfolio regardless of what happens.

And many will argue that now’s a good time to buy them. Especially with variables like market volatility and the Fed and Trump presidency.

To boot, municipalities may have to increase their yields to keep investors coming, which will only help investors.

So don’t overreact like the market did. Just take advantage of it.

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