Bond Case Briefs

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Reports Of Municipal Bonds' Demise Have Been Greatly Exaggerated.

Top earners have traditionally been attracted to municipal bonds for their tax-exempt status at the federal and often state and local levels. In the wake of President Donald Trump's stunning upset victory, however, muni investors were forced to readjust their expectations of fiscal policy going forward. Because Trump had campaigned on deep cuts to corporate and personal income taxes, equities soared while munis sold off, ending a near-record 54 weeks of net inflows. This appears to have been premature, for a couple of reasons.

Tax Reform Unlikely To Happen Anytime Soon

Trump and congressional Republicans are currently butting heads on how best to handle tax reform, with many lawmakers saying it's unlikely they'll get around to it during the new president's first 100 days, and possibly his first 200 days.

According to House Speaker Paul Ryan, Congress will focus instead on replacing the Affordable Care Act (ACA) and funding Trump's $1 trillion infrastructure spending package before it worries about taxes. With an estimated 30 million Americans enrolled on Obamacare exchanges, finding a suitable replacement is of high importance and might take some time. The same goes with negotiating a costly infrastructure deal, which several fiscally conservative lawmakers are hesitant to support.

Besides, we all know how fast Congress operates, even on a good day. Former President Barack Obama took office in January 2009, and even with a Democratic majority in the House and Senate, his signature health care law didn't reach his desk until March the following year.

All of this is to say that it might be premature to start dumping your munis, or withhold an investment in munis, purely on the notion that income taxes are about to get a haircut. We're probably looking at many more months of Obama-era tax rates, including the 3.8 percent Obamacare surcharge on investment income. Other investors have realized this as well, which is why we're seeing positive net inflows back into muni bond funds.

If enacted as conceived, Trump's tax reform plan would indeed be the most significant in decades, simplifying the number of tax brackets from seven to three, lowering the top rate from 39.6 percent to 33 percent and eliminating personal exemptions and filing status options.

One of the unintended consequences of this is that income taxes could actually go up for certain middle-income filers. According to an analysis of Trump's proposal by the independent Tax Policy Center, as many as 8 million American families, including a majority of single-parent households and large families, could end up paying more than they do now (emphasis mine):

> Increasing the standard deduction would significantly reduce the number of filers who itemize. We estimate that 27 million (60 percent) of the 45 million filers who would otherwise itemize in 2017 would opt for the standard deduction. **Repealing personal**

exemptions and the head of household filing status, however, would cause many large families and single parents to face tax increases.

But What About Rising Interest Rates?

In December, the Federal Reserve lifted interest rates for only the second time in nearly a decade, and many expect to see up to three additional increases this year. It's important to be aware that when rates rise, bond prices fall because if newly issued bonds carry a higher yield, the value of existing bonds with lower rates declines. This is why I believe investors should take advantage of short- and intermediate-term munis, which are less sensitive to rate increases than longer-term bonds, whose maturities are further out.

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