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[How the Buyside Is Handling Trump's Shift from Healthcare to Tax Reform.]

Municipal portfolio managers are sticking with their health care strategies after the failure of the American Health Care Act last Friday, saying they expect the Trump administration to continue its quest to undo Obamacare.

With tax reform replacing health care on the front burner, they predicted the prospect of lower rates or a change in the muni tax exemption will have a greater impact on overall market demand and other technicals than on their individual strategies.

"On any given day, we are and will remain open to sourcing value across the hospital sector – or any other major municipal sector for that matter – as long as the end product in our portfolios is properly diversified and all credits have been thoroughly reviewed," Jonathan Law, a portfolio manager at investment and financial services firm Advisors Asset Management, said on Wednesday.

Law, who has been pro-health care sector since prior to President Obama's Affordable Care Act becoming law in 2010, said his exposure was steady through the first quarter of 2017 and he doesn't expect to do anything different in light of the AHCA defeat.

His firm is responsible for $1.1 billion of client assets under management, of which $370 million consists of municipal assets, as of Dec. 31, 2016.

He said he will keep his sights set on larger, nonprofit systems with multiple hospitals in multiple states, organizations with leading market share, and/or well-diversified revenues that aren't overly reliant on Federal funding.

"The sound and rational municipal investor was generally unaffected by the proposal and the failure of the American Health Care Act," Law said. "Compared to the rest of the market, the health-care sector did not trade out of the ordinary at any point during the lifespan of this bill."

Law said it is also unlikely that health care bonds will rally and spreads significantly tighten following the AHCA's demise.

Dawn Mangerson, who co-manages municipal portfolios with Jim Grabovac at McDonnell Investment Management, said the team continues to like the hospital sector, in which it was recently overweight.

McDonnell oversees $11.5 billion in client assets, 63% of which are tax-exempt municipal assets, including separately-managed accounts and two sub-advised municipal mutual funds, as of Dec. 31, 2016.

"We were looking for an opportunity to take advantage of spread widening – which we did see – but there was not enough supply" in the first quarter, Mangerson said on Tuesday.

She and Grabovac will be looking for more opportunities from the sector as the second quarter rolls in next week.

While portfolio managers are seeing little impact from the failure of the AHCA, the event is triggering more of a reaction in the overall municipal market, municipal experts said this week.

Price, performance, and value are just some of the market technicals being influenced – or expected to be impacted – by the non-vote of AHCA, according to municipal experts this week.

For instance, municipal bonds already outperformed along the curve, following U.S. Treasuries to "decidedly higher levels" last week, Jeffrey Lipton, managing director and head of municipal research and strategy at Oppenheimer & Co. wrote in a March 27 report.

Municipal yields finished unchanged on March 24 – the day the AHCA vote was removed from the previous day, which Lipton said indicated "support for haven assets evident early this week."

The 10-year and 30-year Municipal Market Data triple-A benchmark yields declined by 12 and 11 basis points, respectively, Lipton pointed out, while comparable maturity U.S Treasury yields declined by seven and eight basis points, respectively.

Other impacts from the defeat of the AHCA are being seen in municipal volume and flows, managers and analysts said.

"With municipal yields off their highs of the quarter and supply limited on year-over-year basis, it wouldn't be a surprise to see issuers returning to the market with more new money and refunding deals during the second quarter," Law of AAM said.

The volatility and uncertainty surrounding the new administration "and its ability to pursue a successful fiscal stimulus policy with tax-reform at the core would likely create a more uneven trajectory of muni bond mutual fund flows," according to Lipton's report.

For example, he said, flows turned positive after three consecutive weeks of outflows, according to Lipper Inc.

Meanwhile, some managers agreed that the impact from the passage of the AHCA would have put the municipal health care sector in critical condition.

"The potential to restrict Medicaid funding would have been a negative for the hospital sector," Grabovac said.

Secondarily, it would have also been a negative for states, which would have been responsible for picking up the slack in a market where states and hospitals make up a quarter of the debt.

He said the market is "breathing a little easier" in the wake of AHCA's failure. "To have dodged that bullet is a credit positive," especially for smaller, rural hospitals, Grabovac added.

Managers like Lipton said the negative consequences could have included significantly reduced funding for Medicaid beneficiaries, a more restrictive deployment of subsidies, and elimination of the newly applied taxes under ObamaCare, as well as associated budgetary implications.

Alan Schankel, managing director of research at Janney Capital Markets, said it would have triggered investor concerns about the healthcare sector, since fewer customers covered by insurance in coming years would have reduced hospital revenues.

“The state sector would also have been pressured by the conversion of federal Medicaid matching funds into block grants, which would have reduced federal payments to states over time,” Schankel added.

The bill’s failure serves as an example of “rhetoric meeting reality,” according to Grabovac.

“The failure of the AHCA to even come to a vote in the house is really significant and a significant indication of how difficult the legislative road is going forward,” he said.

Schankel said although the ACA “emerged from the Congressional process intact, uncertainty remains, with the potential for Congress to revisit in future.”

Lipton said the “much-heralded, yet perhaps ill-conceived” AHCA would have been the fulfillment of one of the “hallmark promises” of President Trump’s campaign.

“Given the events of last week, we would expect market performance to be more sensitive to potential disruptive forces regarding the President’s agenda,” Lipton said. “Undoubtedly, there is likely to be an extended post mortem of the AHCA.”

Now that health care is taking a backseat, managers say the focus on tax reform under the Trump administration creates some challenges and uncertainty for the municipal market. But like the failure of the AHCA, it will not damage or alter their investment strategies or goals.

“The House failure to pass the AHCA does not render tax-reform improbable,” Lipton wrote in his report.

“It does, however, make it more difficult with potential delays, especially given the observation that the Republicans have competing ideological agendas within their own party, and we have to wonder how easily they can come together on other policy legislation.”

Lipton predicted tax reform will be a fourth quarter event – or possibly a 2018 first quarter occurrence – with the Border Adjustment Tax a widely-debated issue, and infrastructure spending and deregulation also crucial topics.

“We remain skeptical over just how much GDP growth can actually offset the Republican tax cuts,” Lipton wrote, adding that there is a potential impact on economic growth from tighter Fed policy and a stronger dollar.

Lipton predicts three increases to short-term rates this year, with June and December being appropriate dates.

“If Congress demonstrates continued divergent views that inhibit the Administration’s agenda, there could very well be a recalibration of economic growth and inflationary performance expectations,” he added.

Lipton said as the market moves into the tax-reform phase of fiscal policy, he expects the relative value ratios to remain “generally rangebound.”

On March 24, the Bloomberg Valuation 10 and 30-year ratios stood at 95.56% and 102.86%, respectively.

“While we remain cautious of the potential effects these various tax proposals could have on the municipal market, the concrete issues at hand that we prepare and adjust our investment strategy around continue to be rising interest rates and inflation,” Law said.

He seeks a defensive duration versus his benchmark, above average coupon bonds, and properly diversifying across various sectors, states, as well as parts of the yield curve to manage his composite portfolios through a rising rate environment – despite the potential tax proposals.

Tax reform is not as complex as health care economics, according to Grabovac, who believes any potential tax changes will involve smaller reductions in rates compared to some of the more significant cuts that have been floated as ideas.

“There were concerns that if a significant change in marginal rates were implemented that could reduce demand from insurance companies and banks, which are 30% of the market,” Grabovac said.

“To the extent those changes are very likely to be moderated significantly that has removed some potential concern,” he added.

In fact, the failure of the AHCA could end up sparking increased appetite for municipals, portfolio managers and analysts predicted.

“Perhaps we may see a change in sentiment now that health care reform has been tabled and chances of Republican consensus have now been diminished,” Lipton’s report said, suggesting the possibility of a “more enduring appetite” for less risky assets.

“Other than an immediate selloff following the election, the market has held in extraordinary well, and there has been no significant lessening of the demand,” Grabovac said.

Similarly, there is less concern if individual tax cuts are likely to be moderate and take longer to implement “rather than more quickly and at an extreme fashion,” according to Grabovac.

“I think the big issue of potentially the border tax and deductibility of interest are extreme changes to the tax system and probably will have a difficult time getting resolution even within the Replication party – if they chose to take a path other than through reconciliation,” Grabovac said.

He said tax reform issues highlight the difficult political balance that Congress and the Trump administration face. He said it will likely be “much more difficult to accomplish the fiscal initiatives than the market anticipated.”

The Bond Buyer

By Christine Albano

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