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[U.S. Tax Cuts Could Drive Key Buyers Away From Muni-Bond Market.]

- 'Most realistic near-term threat to the market,' says analyst
- Banks, insurers have swelled holdings of tax-exempt debt

President Donald Trump's push to cut corporate taxes threatens to undermine a key pillar of the $3.8 trillion municipal-debt market.

Banks and insurance companies emerged as major buyers of U.S. state and local government bonds over the last seven years by adding $415 billion to their holdings, leaving them with their largest share of the market since the late 1980s, according to Federal Reserve Board data.

While the details, timing and scope of Trump's plans haven't taken shape, he's made it a priority to lower corporate tax rates — a step that would weaken demand for municipals, which are a draw because the interest payments are tax exempt.

"The corporate tax cut is probably the most realistic near-term threat to the market," said Mikhail Foux, head of municipal strategy at Barclays Plc.

The rollback could cause the price of municipal bonds to underperform other assets and increase costs to governments that rely on them to finance public works. Such concerns, though, have largely taken a back seat since Trump's election, with state and local debt outperforming Treasuries amid speculation that his tax and spending plans will stoke the economy and further increase interest rates.

The ability of Trump to act swiftly on his agenda, however, been cast into doubt by the failure of his effort to repeal the Affordable Care Act, and his mixed signals on tax reform are vexing Republican hopes of achieving consensus. The House Republican blueprint endorsed by Speaker Paul Ryan envisions a 20 percent "border-adjusted" corporate tax rate that applies to domestic sales and imports, while exempting exports. Trump has floated a corporate tax rate as low as 15 percent, without specifying how — or if — the cost of doing so would be offset by other changes.

So far, no action has been taken in Congress. Representative Kevin Brady of Texas, a Ryan ally who chairs the tax-writing Ways and Means Committee, reiterated on Thursday his commitment to action on a bill this spring, while key Senate Republicans, including Finance Committee Chairman Orrin Hatch, have questioned on the prospects of passing permanent tax changes without Democratic support.

Any cut to the tax rate could sap demand for tax-exempt securities from businesses. While highly rated 10-year municipals would still provide a better after-tax yield than comparable corporate debt if the rate were cut to 25 percent, that wouldn't be the case if it were reduced to 20 percent, according to Matt Caggiano, who helps oversee more than $9 billion of municipals from insurance companies at Deutsche Bank AG.

For banks, their “sweet spot” are bonds due in 15 to 20 years, which otherwise have “no natural buyers” since retail investors prefer shorter maturities, said Foux, the Barclays analyst. Should banks scale back their purchases, that part of the curve would be most affected.

Insurers also gravitate toward longer-dated bonds. Property and casualty insurers have already started selling some securities and letting others mature without replacing them, said Foux and Caggiano.

Some municipal bonds are already trading above comparable Treasuries, despite the tax breaks. During the broad fixed-income selloff that followed Trump’s election, the yields on 10-year benchmark tax-exempt debt jumped to as high as 108 percent of Treasuries, indicating that the price of municipals was cheap by comparison. While that has since declined, benchmark municipal bonds maturing in 13 years or more still yield more than U.S. government debt, according to data compiled by Bloomberg.

“Buying 15-year triple-A munis at almost 110 percent of Treasuries seem like a pretty good deal unless you believe taxes are going to zero,” said James Iselin, head of the municipal fixed income team in New York at Neuberger Berman, which oversees about $10 billion in munis.

For investors concerned about the uncertainty ahead, seven- to 15-year maturities are attractive, said Deutsche’s Caggiano. Iselin also advises steering clear of lower-rated municipals, which may be hit hardest if tax changes spur investors to yank money from mutual funds.

“If there’s tax reform that has a real negative consequence on muni buying behavior, the greatest pain is going to be felt on the more duration you have and potentially the lower quality stuff that you have,” Iselin said. “This is the time to be a little bit more cautious until we have more clarity.”

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