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The Muni Market Turns Toward Washington.

With \$3.8 trillion in bonds from more than 50,000 issuers, the municipal market is remarkably large and diverse. But right now, the vast muni universe is focused on one city, Washington.

Numerous proposals of the Trump administration and the Republican-controlled Congress could rattle the market if enacted.

President Trump's call for \$1 trillion in infrastructure spending could swell the nation's municipal bond supply, for example, while the possibility of lower corporate tax rates could reduce the appetites of banks and insurers, which now own about 30 percent of muni bonds.

What's more, if personal income tax rates went down (another possibility in Washington these days), demand for muni bonds could drop because the tax-sheltering features of the bonds could be less enticing. Even more troubling for the market, the tax exemption of interest income — the very foundation of municipal bonds — is always part of discussions about changing the tax code.

The muni bond market initially reacted negatively to these possibilities. The iShares National Muni Bond ETF fell 4.2 percent from the presidential election until Dec. 2. That was a rough stretch for all kinds of bonds, as interest rates climbed and the Federal Reserve indicated it was on the cusp of more aggressive rate increases, though the muni slide was more pronounced. The iShares Core U.S. Aggregate Bond ETF, which tracks the high-grade taxable market, lost only 2.75 percent in the same period.

But the market may have overreacted, said John V. Miller, co-head of fixed income at Nuveen Asset Management. "There is a perception that every one of the policies being discussed will be passed and passed in short order and all will be deeply harmful to municipal bond investors," he said. The reality is different. "I expect there will be a delay, and even if some of the proposals get through, they aren't all unequivocally negative," Mr. Miller said.

Indeed, after the initial shock wore off, the Bloomberg Barclays Municipal Bond index gained 3.2 percent from its December low through the end of the first quarter, while an index of taxable bonds rose 1.3 percent. "It's not 100 percent clear it is going to be a rocky year," said Cormac Cullen, co-manager of Fidelity Municipal Income Fund.

Professional municipal bond investors are generally sanguine that while policy changes may cause some near-term volatility, they are not an existential threat. Depending on how negotiations in Washington play out, there could even be some good news for munis.

For example, the precarious condition of the compromised Oroville Dam during California's heavy rainfall this winter once again put the spotlight on the need for major infrastructure investments. The early estimates to repair the damaged spillway for the tallest dam in the United States are as high as \$200 million. While Oroville is an extreme case, there is no shortage of other dams, bridges, roads and transit systems across the country in need of serious care.

The \$1 trillion for infrastructure the president proposed may not roil muni bonds too greatly because the outlay would probably be spread out over a decade, making it more digestible for the \$3.8 trillion market. Moreover, all or a portion of the money may be earmarked for funding private-public partnerships, which could resemble something along the lines of the taxable Build America Bonds that were issued as part of the 2009 stimulus. In that case, the supply of traditional tax-exempt munis would not swell. "You can't presume all the spending would be for projects financed with tax-exempt money," Mr. Miller said.

Nor is a reduction in the corporate tax rate all bad news. Peter Hayes, head of the municipal bond group at BlackRock, believes that a new rate would not be low enough to cause insurers and banks to high-tail it out of municipal bonds. "What we could see is that they let their municipal portfolios mature and, over time, shift money into other assets," he said. Yet, Mr. Hayes said, "There's also the possibility that the ability of corporations to deduct corporate bond interest goes away." That would lead to less issuance of corporate bonds — and that could increase demand for muni bonds.

A reduction in personal income tax rates is also not expected to be a seismic event. One possibility is that the top rate would fall from 39.6 percent to 33 percent. That's a lot less than the fall from 50 percent to 28 percent under the Reagan tax cuts, which the municipal market survived. Moreover, it is not as if any state with a high income tax rate is talking about cuts. And right now, a 10-year high-grade municipal bond has the same 2.5 percent yield as a taxable 10-year Treasury note. That works out to a 3.73 percent taxable equivalent yield for someone in a 33-percent federal income tax bracket

As for eliminating the exemption for interest income, changing it would affect thousands of municipalities that rely on muni bonds to finance their public works. For that reason alone, it is widely seen as unlikely to happen.

What has a much higher probability of affecting muni bonds this year is rising interest rates, though even here, the damage may not be great. While a sharp rate spike would cause bond prices to suffer bigger losses, Christopher Ryon, municipal bond manager at Thornburg Investment Management, noted that "we are not in a situation where rates are going to take off." (Bond prices and bond yields move in opposite directions. Total return is the sum of the yield and the price change.) With expectations for rates that are higher but not too high, "you will be getting more income, which is why you own municipals," Mr. Ryon said.

And that rate rise is making municipal bonds a better value. "Before the election, you were not getting paid to take risk," Mr. Ryon said, citing the fact that the inflation-adjusted yield for a 10-year municipal bond was below zero. Today it is back at 0.65 percent. That is still below the longer-term norm of two percentage points, but it is moving in the right direction.

Nonetheless, rising rates merit some attention. Gary Schatsky, a financial adviser based in New York City, is sticking with short-term municipal bonds maturing in three years or less. The yields are small (around 1 percent before factoring in the tax break), but you aren't exposed to much price movement as rates rise, or if policy changes materialize.

Another way to eke out more yield is to look for portfolios that emphasize bonds rated A (often called single-A) over AA and AAA bonds. A single-A bond is still considered high quality, just a little less than AA and AAA. The 3 percent yield for a 10-year A-rated bond is about a half a percentage point more than the yield for AAA bonds.

Funds and ETFs that track a municipal index hold less than 20 percent in single-A bonds. Actively managed high-quality funds including Fidelity Municipal Income and T. Rowe Price Summit

Municipal Income now invest more than 30 percent in single-A issues.

“Single-A bonds offer good risk-reward,” said Kevin Ramundo, co-manager of Fidelity Municipal Income. That’s a balancing act that will be ever more valuable this year as policy makers bear down.

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