Bond Case Briefs

Municipal Finance Law Since 1971

Municipal Bonds Will Survive Tax Reform.

Like the schools and bridges and levees they make possible, municipal bonds are built of strong stuff. They're facing more tough tests, but I expect this indomitable financial sector to prevail once again. Not everyone agrees, but my contrarian message is to keep calm and trust your tax-exempts.

Recall that a 10% drop in muni-bond prices after Donald Trump's election did not persist. The downturn rested on speculation that Congress would quickly pass massive income tax rate cuts, which would undercut the value of municipals to affluent retirees who count on every dollar of after-tax income.

As usual with munis, the knee-jerkers blew it. Tax reform wasn't quick, and the segment rebounded, aided by the tight supply of new issues and decent economic growth that did not ignite interest rates or inflation. Municipals outgained Treasuries for 2017 and returned about the same as high-grade corporate bonds. After investors pocketed what they saved by not paying Uncle Sam, tax-exempts had a considerable bottom-line edge.

So, then, what is clouding the outlook for the muni market now? It's this: Americans are facing a realignment of the relationship between the U.S. Treasury and the states and localities. No one in Congress aims to topple the tax-exempt bond market. Cities and states run by Republicans and Democrats alike sell road and school bonds. But some of the so-called tax reforms that seemed on the cusp of approval as we went to press may have unexpected consequences. Assuming legislation is enacted by the time you read this (or soon thereafter), what might limited deductibility of state and local income and property taxes mean to the muni market? Or, what if millions of taxpayers suddenly take the standard deduction rather than deduct mortgage interest?

Whatever your opinion of (and tolerance for) local taxation, gazillions of dollars of tax-free bonds from all over America are backed by general tax revenues. As Washington rescinds some of its help bearing those burdens, you can bet on a surge in appeals of assessments and pressure to cut local property taxes. Real estate values could suffer, along with state and local coffers. Many cities, counties, hospitals and school districts might then struggle to raise cash when they need it, and ratings agencies would be poised to downgrade issuer after issuer. For investors, that is bearish.

There are some other technical hazards, but even if tax reform manages to simplify the system, it's likely that the judging and pricing of individual bonds will become more complex and unpredictable. How, then, can I square such worries with my conviction that tax-exempt bonds will parry yet another challenge? Here's my reasoning:

I expect way fewer new bond issues. And that's despite the fact that investor demand is already overwhelming the volume of available bonds. Further shortages would prop up prices and offset some of the above risks.

Munis have many fans. I won't say tax-free bonds have a cult following among investors, but readers sometimes tell me they so deeply hate to pay taxes that they don't care if the after-tax yield on a taxable alternative would be to their advantage. Jim Colby, VanEck Funds' municipal bond chief, says he’s heard the same thing “right from investors’ mouths.”

Chicken Littles are rarely right. Everyone who has in recent years emphatically declared that municipal bonds are headed for an existential crisis has turned out to be wrong, not counting the dire warnings about Puerto Rico. More broadly, advocates of a tax cut tend to exaggerate its benefits for economic growth and for investor optimism generally, and opponents overestimate its drawbacks. But until and unless there’s a recession–which would be a serious matter for the soundness of municipal debt–keep calm and carry on.

Kiplinger’s Personal Finance

by Jeffrey R. Kosnett, Senior Editor

January 8, 2018