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Trump Proposals Could Dent U.S. Muni Bonds, Pressure States.

* Tax rate reductions make muni bond tax-exemption less attractive unless yields rise

* Medicaid funding plan could squeeze state budgets

* Unraveling trade deals may hurt Southeastern states

* Negatives could be offset by big infrastructure boost, repatriating corporate profits

U.S. municipal bonds could lose favor with investors under President-elect Donald Trump's proposals to cut personal income tax rates, thereby reducing the benefit of the bonds' tax exemption, analysts said.

Muni bonds have long been attractive to wealthy Americans who fall into higher tax brackets because income earned on the bonds is exempt from federal income taxes.

"Tax reform is a key risk for munis – and one not reflected in current pricing," Morgan Stanley analysts said in a note after Trump was elected president and Republicans took control of Congress in Tuesday's election.

Muni bonds "could become less attractive from a portfolio perspective given lower tax value and the potential for yields to move higher to compensate for this loss," the note said.

Trump has proposed reducing the top marginal tax rate to 33 percent from the current 39.6 percent.

Under that lower rate, muni bond yields would have to be higher to make their tax exemption as attractive as it is today – by 20 basis points on 10-year debt and 29 basis points on 30-year paper, all else being equal, according to Citi analyst Jack Muller.

That, in turn, would increase the cost of borrowing for the states and cities that issue muni bonds to finance everything from school construction to sewer systems.

Trump's presidency, coupled with Republican control of Congress, could smooth the implementation of an agenda that will have broad ramifications on investor behavior and the public sector.

Many of Trump's proposals are unclear but are expected to solidify in the coming months as he assembles his Cabinet and prepares to take office in January.

In addition to repealing the Affordable Care Act, Trump has called for using federal block grants – instead of the current cost-sharing system with states – to send money to the states for Medicaid, the nation's healthcare program for the poor.

Under that idea, federal funding could drop between 4 and 23 percent over 10 years, Fitch Ratings said on Thursday, citing a Congressional Budget Office review of previous Medicaid block grant proposals.

“Reduced federal Medicaid aid could lead states to tighten overall spending and reduce transfers to local governments,” the credit rating agency said.

However, states could also benefit from the autonomy and flexibility of the block grant structure, Fitch said.

Other pressures could come from Trump’s proposals to withdraw from and renegotiate trade agreements with foreign countries.

“Trump’s trade policy proposals would have significant adverse implications for U.S. investment and growth and push up prices, particularly in the event of foreign counter measures or ‘currency wars,'” Fitch said.

In turn, that could disrupt American manufacturers’ supply chains, which would be challenging for businesses especially in Southeastern states that have recently had job growth in automotive and aerospace industries, Fitch said.

INFRASTRUCTURE, CORPORATE PROFITS COULD HELP

Trump’s proposal to boost infrastructure spending, which he reiterated during his acceptance speech early Wednesday morning, could offset negative implications from other proposals.

His plan calls for $1 trillion of infrastructure investment over 10 years through public-private partnerships and private investments, to be incentivized by $137 billion of tax credits.

The need for spending is certainly acute. The American Society of Civil Engineers estimates the country requires $1.4 trillion of infrastructure spending by 2025.

Issuance of municipal transportation bonds could grow dramatically if Trump’s administration directed federal money through state and local grants or loans, according to Citi. But if the federal government bears the full cost, municipalities would not need to issue debt for the projects.

Institutional investors are also increasingly interested in infrastructure as confidence in the equity markets wanes and investors seek stable, cash-generating investments in the current low interest-rate environment.

Offsetting a possible drop in revenue from infrastructure tax credits is another Trump proposal to let companies repatriate foreign profits at a one-time reduced tax rate of 10 percent, down from the current 35 percent corporate tax rate.

All that money flowing back into the United States “could be a huge tax windfall for states, which would realize one-time tax revenues from any money entering that state, a significant boon for California, New Jersey, New York and Illinois,” Eaton Vance portfolio managers said in a note.

Reuters

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Fri Nov 11, 2016 | 12:00am EST

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