Trump and State and Local Governments: The Known Unknowns.

Any set of ideas can be separated into known knowns, known unknowns, and unknown unknowns. Leaving the last set aside, one known known that appears virtually certain: that state and local governments are going to have to fight hard for their share of the “policy pie” under the new Trump Administration. Let’s now take a look at some of the key “known unknowns”—factors that are likely to affect valuations and creditworthiness and functioning in the state and local finance sector as the new Administration and Congress sort them out.

1) ARE INTEREST RATES INEVITABLY HEADED HIGHER?

That is the first structural response to the Trump win. But is the inflation that would trigger that trend an inevitable outcome?

Certainly, a much more fiscally stimulative Federal Budget would likely lead to that, but isn’t inevitable—see below. In the meantime, there are a number of potential patterns that could offset the potential for higher inflation or higher long-term rates. These include energy policy that would drive energy costs lower, and more restrictive trade policies that could dampen global demand, and a push toward more rapid increases in Fed short-term rates that could actually slow growth.

Of course, some potential policies could be inflationary – e.g., gutting trade deals and increasing tariffs, and an aggressive push toward more infrastructure spending – but the outcome is far from clear. To assume that any new set of trade policies is inflationary, one also has to assume that they aren’t substantially damaging to global economic activity. We’ll see.

By the way, just as we finished this, the muni market was getting beat up pretty badly on Monday. Is that a response to Trump’s victory, or merely a response to recent heavy supply combined with a down Treasury market and a limited aggregate risk appetite? We vote for the latter.

2) IS A DRAMATICALLY MORE STIMULATIVE FISCAL POLICY INEVITABLE?

Well, maybe, maybe not. It seems that many observers are assuming that a Republican-led House and Senate will automatically accede to Trump’s campaign promises of a combination of lower taxes and aggressive infrastructure spending, and thus a sharply higher Federal deficit.

Color us dubious. Are Republicans all of a sudden ready to enact a combination of significantly lower tax revenues and new spending that isn’t paid for? Are they going to tell their base that all of a sudden, fiscally responsible budgets no longer matter? The answers to this question are, we think, key, because they will strongly help determine the extent to which Trump can spend more (military, infrastructure) and tax less (corporate and individual).

3) WILL THE JOINT COMMITTEE ON TAXATION BE MOVING TO DYNAMIC SCORING?

This is another key in terms of what Trump promises are possible to keep. Under dynamic scoring, the purported economic benefits of a tax law change in terms of stronger economic activity are included in estimating the net cost of any change in the tax code. It is not a given that the Joint Committee on Taxation will move to dynamic scoring, but with Republicans in both houses of Congress functioning as their “bosses,” it’s at least possibility. In terms of a large portion of what Trump has promised and what many Republicans want, this is a very big deal.

4) IS THE TAX EXEMPTION AT RISK?

Some observers seem to be very concerned that the tax exemption is at risk under a Trump Administration. We aren’t so sure.

For any infrastructure expansion program to be successful, it needs to be additive to what already exists, and a move toward tax credits for incremental infrastructure spending will fail if it simply replaces the strongly successful program that already exists through the tax-exempt market.

That said, with Joint Tax staff and other key players likely to have something of a free rein to affect policy over coming months, supporters of the tax exemption will have to be extremely vigilant and involved.

5) WHAT WILL THE STRATEGIES FOR ADDITIONAL INFRASTRUCTURE SPENDING BE?

We already have some idea of what this might look like based upon work by Wilbur Ross and Raymond Navarro, who are apparently advising Trump. Their plan calls for heavy use of public/private partnerships with heavy private sector equity, with a large portion of the cost of that equity offset by tax credits that would sharply reduce the equity exposure and the cost of that exposure.

Theirs is a dynamic scoring framework, which assumes that a large proportion of the cost of the tax credits is offset by increased income taxes resulting from the new economic activity. (Important note: Under fair dynamic scoring, the cost of the tax exemption would be netted this way as well, as would decreased market values if the tax exemption were to be gutted.)

We also note that these two advisors include a heavy dose of energy exploration and development in their definition of new infrastructure.

What will be left out? Probably environmentally-related projects, among others. The selection process for projects that “make the cut” is an issue, as it was under the prior Administration’s plan. The muni market—and Build America Bonds—allowed governments to self-select. The mechanism here isn’t clear. There is much, much more to consider, of course.

6) HOW WOULD SHARPLY LOWER CORPORATE TAX RATES AFFECT THE VALUE OF EXISTING MUNIS?

The format of any such tax cuts matters a lot, but there is the potential for a substantial cut in value. We note that from 2005-2015, according to Fed data, household sector direct holdings of munis are about unchanged, fund holdings are up $263 billion, and bank holdings are up $333 billion (plus direct bank purchases).

Property and casualty insurers’ holdings are only up $17 billion over the period but they would become net sellers at current yield relationships. In our view, a very large cut in corporate tax rates would cause yields relative to taxable to move higher. This is a real risk, we think, because support for lower corporate taxes crosses party lines.

7) HOW WOULD CUTS IN INDIVIDUAL TAX RATES AFFECT THE VALUE OF EXISTING MUNIS?

We are less concerned here, if the top rate were to move to 33%. A large number of current individual owners of munis would still find them attractive at a 33% rate, and the 33% rate, as proposed, kicks in fairly low – ($112,500 for an individual, $225,000 for a couple.) A key variable here is that if the lower corporate rate were not well insulated from use by so-called pass-through corporations, then large numbers of wealthy individuals might get the big cuts in rates.

This will likely be "fixed," though, because if it isn't the drop in income tax revenues would explode.

8) HOW WILL HOSPITALS FARE IF THE ACA IS GUTTED?

This could be the biggest near-term question for the muni market, of course, because many hospitals—and the states and cities they reside in—would face vast cuts in revenues from insured individuals if some fraction of 20 million individuals were removed from the rolls.

Alternatively, what would "repeal and replace" look like? We haven't a clue, but we know we need to watch.

9) WHAT REGULATORY CHANGES COULD ACTUALLY SUPPORT THE FUNCTIONING OF THE MUNI MARKET?

It is very early for this, but changes to regulation, especially including Dodd-Frank, bear close watch.

10) COULD FEDERAL SUPPORT FOR STATE AND LOCAL GOVERNMENT PROGRAMS BE HIT?

It's certainly possible, given the revenue erosion that would result from tax cuts and potentially more spending on the military and (ironically) infrastructure.

11) WHAT KINDS OF POLICY "GLITCHES" WILL THERE BE AND COULD A FIRED-UP POPULACE INCENTED TOWARD MORE ACTIVISM GENERATE ECONOMIC DISRUPTIONS?

As a the new Administration, a fiscally conservative Republican majority in Congress, and a fired-up Democratic minority wielding the filibuster struggle to assert themselves, we believe there is that possibility.

Of course, the above is only a start, but we believe that we have laid out a number of the very important issues that market participants and policymakers will need to track as the new Administration takes hold. Comments welcome.

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