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Tax-Exempt Bonds Already Pinched by Proposed Trump Tax Cuts.

Investors pulled another $2 billion from U.S. municipal bond funds in the latest week, underscoring fears that potential sweeping tax changes under President-elect Donald Trump and a Republican Congress will undermine the tax-exempt debt market.

Trump's plans to cut taxes and increase fiscal spending have already boosted inflation expectations. As a result fixed-income markets, already weighed down by forecasts for tighter U.S. monetary policy, have see prices slump while stocks have reached record highs.

Since the Nov. 8 election, munis suffered more than any other fixed-income sector with a negative total return of 3.229 percent, according to Bank of America Merrill Lynch indices.

Trump wants to reduce the current seven tax brackets to three: 12 percent, 25 percent and 33 percent. This mirrors a June tax proposal by U.S. House Republicans but the House proposal would also allow taxpayers to deduct 50 percent of their capital gains, dividends and interest income, shrinking overall taxes even further.

"It just seems that municipals would have to readjust in terms of yield, a little bit higher yield, to bring itself back into parity proportionately with other asset classes to remain competitive," said Jim Colby, chief municipal strategist at VanEck.

Tax-exempt bonds, which outperformed other fixed-income assets in 2015, are on track to have the only negative return, albeit a small one, for all of 2016.

As of last Wednesday, munis returned a negative 0.078 percent versus positive returns of 0.551 percent for Treasuries and 5.158 percent for corporate bonds, BAML reported.

The corporate tax rate, as envisioned by Trump, would fall to 15 percent from 35 percent, making muni bonds less attractive for tax-exempt debt buyers like banks and property and casualty insurance companies.

Wealthy investors subject to federal income tax rates currently as high as 39.6 percent are traditional buyers of tax-free bonds sold by states, cities, schools, nonprofits and other issuers.

Investors are fleeing from muni bond funds. The net outflows have grown for six straight weeks to $13.5 billion since the U.S. election, according to Thomson Reuters Lipper service. The muni market is $3.7 trillion overall and until recently was the beneficiary of 54 straight weeks of fund net inflows.

DO TAX RATES MATTER TO MUNIS?

While there is talk of a tax reform bill moving through the House relatively quickly, past history indicates a vote by the August recess, setting up a Senate vote in the fall and potential signing by Trump before year-end. If progress stalls, tax reform could lay dormant during 2018's election year.

Some question the tax impact on the municipal bond market though.

Philip Fischer, municipal research strategist at BAML, said tax rates are no longer the driving force behind muni purchases and that tax-sheltered investment vehicles have replaced competition from other fixed-income assets.

“What is going on is that munis have to yield enough so they are competitive with other tax sheltered instruments like 401k’s,” he said.

The tax-exempt market should have some time to adjust before the first major U.S. tax changes materialize since 1986’s massive reform law.

“We really believe if it really does happen it’s more of a 2018 event not a 2017,” said Dan Heckman, national investment consultant at US Bank.

Meanwhile, muni issuers are facing higher borrowing costs than just six months ago.

A rise in yields on Municipal Market Data’s benchmark triple-A scale from record lows reached this summer accelerated after the election.

The yield on top-rated 30-year bonds ended Friday at 3.11 percent, which is 118 basis points up from its 1.93 percent low. For 10-year bonds, Friday’s 2.39 percent yield was 110 basis points over the all-time low of 1.29 percent.

Issuers took advantage of historic low rates to refund old debt and sell new bonds, pushing 2016 issuance to $423.5 billion as of Friday, just short of 2010’s record $430.35 billion supply, according to Thomson Reuters data.

“We could envision a market totaling $350 billion (in 2017), about $100 billion less than this year, but this of course depends heavily on how the proposals play out,” Natalie Cohen, a senior analyst at Wells Fargo, said in a December report on potential tax changes.

Refundings of existing bonds, which accounted for about 61 percent of 2016 issuance, would not screech to a halt given the impending 10-year call on hefty amounts of debt issued in 2007, she added.

Reuters

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