Bond Case Briefs

Municipal Finance Law Since 1971

Is This Obscure Bond Key to Rebuilding America's Crumbling Infrastructure?

The bond market has room for taxable muni bonds and investing in public-private partnerships

When the American Society of Civil Engineers slapped a "D+" grade on the nation's infrastructure in a report that identified a $2 trillion funding gap for repairs and upgrades over the next 10 years, the municipal bond market knew it had a fix.

It just had to retrain investors on how they typically think about munis.

No single source, or even a select few, can carry the financing burden necessary to build bridges, roads, dams, railroad tracks and more, but bond-market participants insist there's a lightly used investment that should get a lot more attention as part of a buffet of financing approaches to fix the nation's bones: taxable municipal bonds.

Those words rarely go together. After all, a muni bond's tax-exempt status is typically its calling card, appealing to higher-net-worth investors.

But not all munis have this traditional feature.

For the issuer, taxable munis are sometimes attached to projects that include private partnerships (think stadiums or investor-led housing developments and, in the current climate for many states, taxable issuance to help underfunded pension systems). For the investor, taxable munis tend to outyield their tax-exempt counterparts because they don't carry as much tax savings (some may still be exempt from certain state income taxes).

They instead entice investors with higher yields (and higher risk) comparably, while still carrying the relative security of government backing, and they could be part of a bond mix in a mutual fund.

Within the huge $3.8 trillion muni-bond market, there are about 10 times more tax-exempt bonds outstanding than taxable muni bonds. But according to some bond managers, taxable munis may be underappreciated.

To meet infrastructure demands, "there is capacity to increase issuance in the tax-exempt market, where 90% of municipal borrowing occurs, but even greater capacity exists in the taxable municipal market," said Duane McCallister, senior portfolio manager at Baird.

"Academic studies show that for every $1 spent on infrastructure, local government gets back $2-$4 over time," he said.

President Donald Trump has pledged $1 trillion in infrastructure spending, a proposal that will likely call for public and private funds. So far, the administration is touting tax credits to private investment as an infrastructure financing incentive. On the other side Sen. Chuck Schumer of New York, the Senate's top Democrat, has pitched direct federal investment.

Details remain thin—although Trump this week said he's open to a higher gasoline tax pegged to highway funding—as the administration works to first push a tax overhaul and revive a health-care revamp. By the president's timeline, he'll repair the nation's "badly depleted infrastructure…soon," he said in a mid-April speech in Wisconsin.

Taxable munis' biggest push into the limelight came with the 2009-2010 Build America Bonds program under the Obama administration, part of a $787 billion economic stimulus bill. After two years, it was left to expire. The outstanding bonds are still knocking around, including in the Nuveen Build America Bond fund NBB, +0.14% and the BlackRock Taxable Municipal Bond Trust BBN, -0.22%

The program's short run "was successful," said McCallister. "It opened the muni market to a broader audience. Institutional investors were looking to buy a large quantity of high-quality munis, and they could."

Jonathan Mondillo, portfolio manager of fixed-income funds at Alpine Funds, agrees that BABs may be back as Trump pushes for infrastructure spending, although they'll likely return under a different name as "all things President Obama seem to be on the chopping block, whether good for bad."

Standard & Poor's took up the topic of infrastructure funding brainstorming earlier this year when it laid out the case for allowing companies to repatriate the more than $2 trillion parked overseas on a tax-free basis if they committed 15% of that cash to investments in interest-bearing infrastructure bonds that would be issued by state and local governments.

Bob DiMella, co-head of municipal managers at MacKay Shields, said that so-called Public-Private Partnerships (P3) projects, a popular infrastructure financing structure outside of the U.S., will gain momentum stateside. They'll likely be combined with tax credit incentives.

"While P3 financing may displace some traditional tax-exempt issuance, we believe that the acceptance of P3 projects will be a net positive for additional two-way flow in the municipal market," DiMella said. "P3 projects should introduce a multitude of new entrants including private equity, developers and nontraditional buyers to the municipal market."

"We expect that these entities will be enticed by municipal financing attributes including attractive yields (for both borrower and lender), exposure to long duration, low correlation [to stocks and other bond types], cash flow stability and low default rates," he said.

Fear of the new supply expected to come with the infrastructure push, as well as worries that proposals for lower income-tax brackets would cut demand for tax-favorable munis, sent prices lower in the wake of the election. They've since stabilized as many fund managers smelled a buying opportunity.

DiMella, as part of a late-April Morningstar Investment Conference panel, stressed that the risk of lost tax advantages has seldom hurt the muni market for any sustainable period. The iShares S&P National AMT-Free Municipal Bond Fund MUB, +0.08% was little changed near $109 in Tuesday trading, about where it stood when the administration in April amped up its tax-reform talk.

Muni-market watchers have also stressed that Trump tax-reform proposals could support muni demand, which could help soak up infrastructure-linked bonds. For instance, the some $140 billion in outstanding municipal bonds that are subject to the alternative minimum tax, or AMT, which could go away under current proposals, are likely to trade better than non-AMT peers. Investors residing in high-tax states could have even greater need to manage their tax bills by picking munis should the deductibility of state and local taxes from federal income tax be eliminated, as proposed in the administration's tax plan.

DiMella said he has confidence that Treasury Secretary Steven Mnuchin and top White House economic adviser Gary Cohn understand how the muni bond market could fit into an infrastructure plan, but that the odds of that plan moving forward in full yet this year remains a political long shot.

As for investors, there may be too many unknowns for now, but its clear investors are paying attention.

"For the equity or fixed-income market to try get ahead of Washington policy is a little premature," said Mondillo. "I want to sit back and see the whites of their eyes with policy [on infrastructure and taxes] and not get caught over or under allocating in one or both."

MarketWatch

By RACHE KONING BEALS

Published: May 3, 2017 8:15 a.m. ET