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Trump's Tax Policy Could Reduce Munis' Appeal. Here Are the Hot Spots.

The president-elect campaigned on extending his 2017 tax cuts, which could affect muni tax advantages. But areas like the alternative minimum tax could also suffer. Why the details matter.

Changing tax policy is on the agenda of the incoming Trump administration, and that makes municipal bond investors nervous. Indeed, steady-eddie munis dipped immediately after the election as the prospect that Trump tax cuts from 2017 will be extended—and possibly new cuts added—made muni tax advantages less attractive.

"If it had been a blue wave, munis would have gotten a bid," says Jeff Timlin, portfolio manager for tax-exempt fixed-income strategies at Sage Advisory in Austin, Texas.

Now it has been about a month since the election and muni bonds have regained a spring in their step. The $41 billion iShares National Muni Bond exchange-traded fund, the largest muni index fund, gained a percentage point in November and is up 2.7% year to date. It yields 3.4%, which translates into nearly 6% for high earners.

Munis offer "good, risk-adjusted return," says Paul Karger, who runs TwinFocus Capital Partners, a Boston wealth management firm. That said, he recommends investors stick with shorter maturities to avoid interest-rate risk, and remain mindful of credit risk. "Municipal securities will still provide significant tax benefits for the right investors, even if the Trump administration generally lowers taxes," he says.

Muni portfolio managers are keeping close watch on proposed Trump tax policies. There are several that, if enacted, could reduce demand for munis, although the impact isn't likely to be dramatic.

For example, the alternative-minimum tax is in play. Most high earners were exempted from having to pay the higher AMT rate as a result of changes passed as part of Trump's 2017 package of tax cuts. Those provisions are set to expire at the end of next year. The higher AMT exemption is likely to get extended, but may be part of budget negotiations since lowering it would raise lots of federal revenue. That would hurt munis that are subject to the AMT, says Timlin. "The devil is in the details. We have to pay attention."

Another example: Trump has proposed lowering the corporate income-tax rate, now at 21%, to 15%, which would make munis' tax-exempt yields less attractive for insurance companies and banks, says Lyle Fitterer, who co-leads the municipal sector at Baird Asset Management.

About 25% of munis are held by insurers or banks that pay corporate tax rates, says Fitterer. "They won't be sellers, but won't buy more. On the margin it could have an impact."

Investors are also focusing on changes to state and local tax deductions, known as SALT. The deduction is now capped at $10,000 a year, but it could rise to $20,000 or $40,000. It also could be a bargaining chip for other tax cuts, and remain the same. “You just don’t know,” says Fitterer, who says a higher cap could lower demand for state munis in high-tax states. “The SALT cap may come down to an 11th hour negotiation,” he says.

Most threatening would be a proposal to limit the tax-free nature of munis, which has been floated as a way to raise income. If that were to occur, existing munis would likely be grandfathered in, but that wouldn’t raise much revenue, says Fitterer. It is generally considered unlikely, but could resurface as a proposal.

Karger’s best guess is that changes to the tax code won’t have a major impact on muni demand. “It will be hard to pass tax savings without tax-generating provisions somewhere else,” which means a continuing need for tax-free income for investors in higher tax brackets, he says.

And munis look attractive against Treasuries as worries about the federal deficit grow. Some state budgets are adjusting to the loss of Covid funding, but most are in good shape, says Timlin. His firm’s research shows that since 2012, municipal debt has grown 2.3%, corporate debt 60%, and federal debt 130%. “As concerns about debt levels grow, that looks more like a plus.”

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