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WSJ: Municipal Bonds Markets Fear Trump Tax Cuts Could Clip Momentum

The tax debate comes as the munis landscape looks bright

The Trump administration's efforts to cut taxes are threatening to upend the U.S. $4 trillion municipal bond market.

The potential change comes as local governments are increasingly relying on munis to finance public works. Municipal bonds issuance is growing, after a post-pandemic lull. Investors, in turn, have sought the low-risk securities to buffer their fixed-income portfolios while reducing their tax load.

"We truly benefit from a strong and sort of voracious market wanting to invest in safe, liquid and nearly riskless assets," said Emily Brock, a lobbyist for the Government Finance Officers Association, a national organization of state and municipal finance officials.

The momentum in munis could now wane, as lawmakers look for ways to increase federal revenues and offset wide tax cuts proposed by President Trump. Tax exemptions that for generations have made municipal bonds attractive could be eliminated, pushing investors to demand higher payouts to finance infrastructure including schools, sewage systems, roads, airports and more.

"Far and away, the biggest risk [for munis] is a change in the tax system this year," said Matt Fabian, partner at research firm Municipal Market Analytics.

The tax debate comes as the munis landscape looks bright. Local budgets are healthy after states and municipalities used part of Covid-related federal transfers to beef-up their rainy day funds, while volatile markets bolster demand from investors for this type of low-risk assets.

"We are very comfortable right now that the municipal bond market is starting [2025] from a position of strength," said Matthew Norton, chief investment officer of municipal bonds at AllianceBernstein. Norton said AB research shows that munis finance around 75% of the U.S.'s infrastructure.

Municipal bonds typically offer lower yields than other fixed-income options, including Treasurys. The ICE US Municipal Securities Index effective yield was 3.4% on Feb. 13, compared to 4.5% on the ICE BofA U.S. Treasury Index.

It is the tax advantage that makes them attractive, particularly to high-income individuals and institutional investors.

The Securities Industry and Financial Markets Association estimates there were $4.2 trillion outstanding munis in the third quarter of 2024, 3% more than a year earlier. According to SIFMA, $36.3 billion in munis were issued last month, the highest January issuance in records going back to 1980.

Using SIFMA data, the National Association of Bond Lawyers estimates that the vast majority, or around $3.5 trillion of outstanding munis, are tax-exempt.

The concerns about exemptions stem from discussions regarding the Tax Cuts and Jobs Act approved in 2017 with Republican support. Some cuts expire by year end and are widely expected to be extended or even deepened. But given the growing federal budget deficit, lawmakers face pressure to find alternative revenue sources.

Nixing tax exemptions on interest earned by municipal bondholders has been mentioned by the House Ways and Means Committee as a way to save $250 billion over 10 years. Local authorities are trying to dissuade lawmakers from doing so, arguing it would do more harm than good.

“There is a good chance, maybe 50% chance, that the Republicans remove the tax exemption entirely…to pay for extension of the TCJA,” Fabian said, referring to the 2017 Tax Cuts and Jobs Act.

The critical role munis play in reducing local governments’ reliance on federal handouts, however, makes some investors believe that the tax exemptions will survive.

Dan Close, head of municipals at Nuveen, said he is monitoring developments in Washington. “We are always concerned every time there is discussion about tax exemptions,” he said. But Close is confident that incentives will survive. He expects issuance to be around $500 billion this year —about the same as in 2024— with returns also unchanged. He isn’t changing strategy or holding cash.

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