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Barron's: Munis' Tax-Exempt Status Could Be at Risk. What It Means for Investors

Heads up, municipal bond investors: Amid all the Trump 2.0 policy proposals, there is one you should be aware of: The potential for munis to lose their tax-exempt status. "Eliminate Exclusion of Interest on State and Local Bonds" is listed on page 9 of a 50-page House Budget Committee document prepared in January that lists some 200 ways the government could raise extra funds to offset the impact of extending the 2017 Trump tax cuts.

That doesn't mean it's going to happen, or is even likely, but uncertainty around the budget process has been enough to dent the muni market and worry investors, as well as state and local government officials who rely on the bonds to fund their infrastructure projects.

"The muni market abhors uncertainty," says Dan Close, head of municipals at Nuveen. Excess supply has been an issue, but tax policy uncertainty has played a part, he says.

Muni fund managers say members of Congress understand the value of the tax exemption when it comes to funding projects in their districts, making removal of the exemption unlikely. While the House budget document estimates that eliminating the exemption would add $250 billion to federal coffers over 10 years, the Public Finance Network says it would cost cities and states $824 billion in higher borrowing costs. Those costs would be passed onto households as a $6,555 tax increase over the next decade, the network projects.

Yet sometimes bad policy moves get through Congress, says Craig Brandon, who co-heads the muni investment team at Morgan Stanley Investment Management. "Budgets happen in the middle of the night, when no one has slept and they've been drinking coffee for 24 hours," he says. "Things you normally wouldn't do can happen just because you need to get a budget deal done."

Given that, it's worth considering some scenarios for how changes to the muni exemption could impact investors.

If a change were retroactive so it applied to existing bonds—considered highly unlikely—muni yields would jump to near taxable peers, says Jason Appleson head of PGIM Fixed Income's municipal bond team. There's now about a 1.25-percentage-point spread between taxable munis and tax-free munis, which, assuming a 10-year duration, means a theoretical 12.5% decline in value for the tax-free munis, since bond prices move inversely to yields. "A full repeal would destroy a lot of household wealth," he says.

It's more likely—though still considered quite unlikely—that tax-exempt status would be grandfathered in for existing munis. In that case, scarcity value could lead to a rise in demand, but legacy tax-free muni yields wouldn't have much room to fall, says Wesly Pate, senior portfolio manager at Income Research + Management. Most yields are already at a level where only individuals in the highest tax brackets derive an after-tax return benefit.

"There's a floor on how low muni yields could go," says Pate. "Investors probably shouldn't expect a

meaningful rally in the muni market if that was to occur.”

There is a scenario where a limited repeal of tax exemption could lead to gains for holders of some grandfathered tax-free munis—in the hospital and higher-education sectors, for example. Those bonds have already taken a hit and could benefit from scarcity value, says Nuveen’s Close. Overall, he says, the threat to the muni exemption “doesn’t materially change how one ought to be investing in municipals, but everyone is taking it very seriously.”

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