Tax-Free Bonds: Making Sense of the Post– Election Slump

Hamilton-Bates

Market Update

December 13, 2016

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The 'surprise' win and concerns about the president-elect's tax and fiscal policies have pressured the municipal market in recent weeks. But investor assessments appear overly pessimistic.

After a strong run for much of 2016, the municipal bond market has encountered some headwinds in recent weeks. The year started well, and the market still was able to weather an increase in interest rates from their July lows through mid-October. But things changed in the wake of the November 8th election of Donald Trump as U.S. president, and Republican majorities in both houses of the U.S. Congress. The shift in investor sentiment was evident in mutual fund flow data from Lipper: Muni funds' streak of 54 weeks of positive inflows ended in mid-October, and flows turned sharply negative since the election.

Municipal bond investors are dealing with number of concerns related to anticipated policy under the newly elected U.S. president. Among them:

- -Potential changes to U.S. tax rates that may make tax-equivalent yields less attractive
- –The effect on muni-bond supply ahead of the December rate hike
- -The effect of planned increases in infrastructure spending
- -The potential for U.S. stimulus to lift interest rates, hurting longer-duration bonds

Tax-Rate Changes

Trump has floated across-the-board tax cuts for individual filers, including a reduction in the top marginal tax rate, from 39.6% to 33%. Although his Secretary of Treasury nominee has already said cuts in rates would be offset by cuts in deductions, this concern still weighs on investors. However, in the past, when prior Presidents were elected on a platform of tax-cuts (Bush 2000), the municipal market held up well.

Municipal bonds should remain attractive even if tax rates are lowered under a Trump administration. As the table (created by bond manager Lord Abbett) below shows, **the nominal yields available on 10-year maturities of 'AAA' rated munis, as well as the Bloomberg Barclays Municipal Bond Index ('AA' rated), are higher than the yield on 10-year U.S. Treasury securities—even before any tax effect**. The tax-equivalent yields on each index were higher, at each of the 43.4% top current bracket (which includes the 3.8% Medicare tax) and the 33% top rate floated by Trump's team. Even for investors in the 28% tax bracket, municipal bonds offered attractive taxable equivalent yields versus comparable maturity Treasuries.

		Taxable Equivalent Yield at Tax Rate		
	Yield (11/30/2016)	43.4%	33.0%	28.0%
10-Year U.S. Treasury	2.38%			
10-Year MMD AAA Municipal Index	2.52%	4.45%	3.76%	3.50%
Bloomberg Barclays Municipal Bond Index (10-Year)	2.79%	4.92%	4.16%	3.88%

Tax-Free bonds remain attractive, especially with nominal yields already above Treasury bonds. Bonds in general have been oversold in the wake of the Election, and the entire credit complex is due for a rally.

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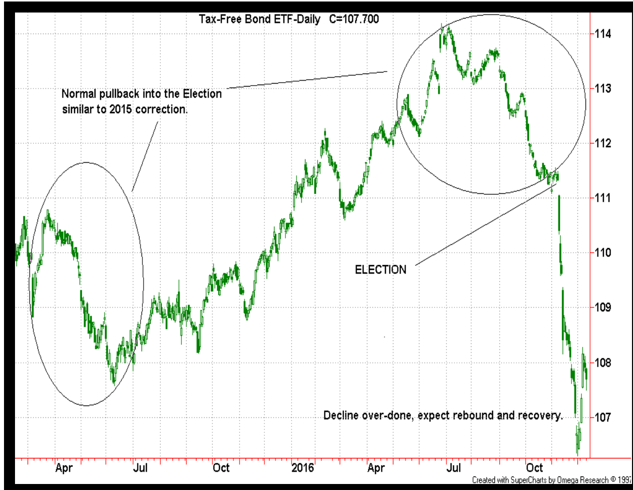
Market Charts—Election Jolts Credit Markets & Interest Rate Expectations



Municipal Bond ETF (MUB)
Bonds had been drifting back into the Election, with the decline roughly similar to the pullback seen in mid-2015. The Election results triggered a mass hysteria for investors, as there was a near panic in selling pressure that has left most sectors of the credit market deeply oversold. In the short to intermediate-term (two weeks to two months), we'd look for a technical rebound rally from deeply oversold conditions.

Long-Term Trend in Rates Still Down But...
The long-term trend of falling rates has supported the financial markets for decades. The chart above is of the 10-year Treasury Yield. The 10-year Treasury yield went from 8% in 2000 down to 1.3% in July of this year.

The downtrend in yields and uptrend in bond prices is still technically intact; but that trend is being tested. First, there is a potential technical double bottom pattern forming, and a push much further upward in yields could break the multi-decade down trend in yields. There is still a bit more room before the trend is 'broken' however, yields would have to rise above 2.75-2.80% from the 2.49% level currently. On a bullish note, a move up to 2.75% that fails to move higher could be a strong buy signal for the debt sector. Prior moves to the top-end of the range in past rate hike fears only proved to be excellent buying opportunities.

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