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Now Is the Time to Invest in America

Strategic Investment Opportunities Ahead for Bond Investors

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Accomplishing big things typically requires the collaboration of many. Throughout our nation's history, significant societal advances, whether in the areas of science, medicine, technology, education, business or human rights, have all involved the cooperation of many different talented and committed participants. Building the infrastructure of our country has been no exception. The transcontinental rail system in the mid-19th century and the interstate highway system in the 20th are just two examples of massive endeavors that involved multiple levels of government as well as the private sector. Both infrastructure projects greatly enhanced commerce and the quality of life for all Americans.

Look around the country today and it's easy to see why President Trump has made repairing and rebuilding the nation's infrastructure one of his top priorities. The American Society of Civil Engineers recently completed a comprehensive assessment of the nation's infrastructure and once again assigned a grade of "D+." Their report identified a $2 trillion funding gap over the next 10 years that will need to be filled to meet the repairs and upgrades needed. They concluded that "we must increase investment from all levels of government and the private sector." The same kind of massive collaborative effort that has been required in the past will be needed once again.

One of the key partners involved with the infrastructure financing will be the municipal market. Three quarters of all infrastructure spending in the U.S. occurs at the state and local level. For decades, the municipal market has been a critical source of capital for all types of public projects. 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. The total amount of outstanding taxable debt in the U.S., including the government, corporate and mortgage-backed sectors, is 10X that of the $3.8 trillion in municipal debt. The ability to absorb significant additional debt was demonstrated through the Build America Bond (BAB) program when more than $180B of taxable municipal debt was issued in a 21-month time frame from April 2009–December 2010. In that narrow time frame, the BAB issuance totaled nearly 20% of the $1 trillion infrastructure plan President Trump has proposed to spend over the next 10 years.

Two other very important events occurring in the same time frame as the infrastructure plan are tax reform and monetary policy normalization. It remains uncertain how tax policy changes might affect the municipal market. Given the importance of municipal debt historically in financing state and local projects, eliminating the tax exemption seems a low probability. Even if corporate and/or personal tax rates are reduced, as has been proposed, municipal debt is very likely to remain a core fixed income asset. Individual investors remain the dominant player in the tax-exempt municipal market while institutions control the majority of taxable municipal debt. Should policy changes occur, valuation adjustments between taxable and tax-exempt debt may also change, but the financial strength of the municipal credits will not. Investors who are concerned about the impact of potential tax changes may want to focus their investments on the shorter end of the yield curve, where price fluctuations should be less significant.

Having just raised the fed funds rate by 25 basis points at the mid-March meeting, the Federal Reserve continues on its path toward policy normalization. Currently, there is more than a 50% probability of two more tightening moves in 2017. How this will impact market rates across the yield curve is uncertain, but once again, maintaining a shorter average maturity posture should help insulate portfolios from significant price fluctuations.

The opportunities to "Invest in America" are likely to be plentiful over the next several years. Conservative investors looking for a safe way to help rebuild the nation's infrastructure while earning a competitive return may want to consider investing in the municipal market. Whether borrowing occurs in the taxable or tax-exempt municipal market is less important than finding efficient ways to be involved as an investor. The Baird Funds have both the capacity and desire to invest in the infrastructure rebuilding process for the benefit of our clients. We anxiously await further details from the Trump administration in the coming months.

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