Investment White Paper | August 2017

President Trump and the Muni Market

Status quo is good for municipals – for now

Duane McAllister, CFA
Managing Director, Senior Portfolio Manager

Baird Funds

Investors in the municipal market were understandably anxious after the election of Donald Trump last November. His pro-growth policies of less regulation, reforming healthcare, a huge infrastructure spending plan, and a massive tax cut were expected to lead to an economic "Trump bump." Interest rates were supposed to move higher and lower tax rates would reduce the demand for tax-free income. This significant post-election sentiment shift led to heavy selling in the municipal market. The "get me out" crowd overwhelmed the smaller "buy the dip" group, leading to $14.7B of net redemptions from municipal funds in the fourth quarter of 2016, according to Lipper. Fast forward to mid-2017 and it's now clear that those who maintained their municipal allocation, or even better, bought tax-exempt debt on the market weakness, were rewarded with strong relative performance in the first half of 2017. The Bloomberg Barclays Municipal Bond Index outperformed the U.S. Aggregate Index by 130 bps YTD through June 30th (3.57% vs. 2.27%).

President Trump is behind schedule on the passage of his pro-growth policy agenda. Views as to where the blame lies for this will vary depending upon one's political leanings, but there is no arguing over the lack of significant progress so far. A beneficiary of this policy stalemate has been the municipal market where, at least so far, maintaining the status quo has been good.

Below is an overview of the status of three key policy items and the impact on municipals:

Health care reform - stalled

Healthcare reform is currently stalled in Congress with uncertain near-term prospects for passage. While the challenges facing the current healthcare market have been widely reported, the fundamentals of the market from a municipal investor's perspective have been good. The Affordable Care Act (ACA) led to an increase in the number of insured patients, which helped reduce indigent care expenses at hospitals and boosted operating margins. As a result, the credit trend of not-for-profit hospitals since the passage of ACA has been positive. The hospital sector has been one of the best performing of all municipal sectors in recent years, according to Bloomberg Barclays Indices. That said, even without future reform, revenue gains going forward are likely to be challenging, and healthcare providers will need to remain focused on controlling costs and identifying operating efficiencies. This was evident in the outline of the Senate healthcare plan which would have gradually slowed the rate of increase in Federal Medicaid dollars to the states. For now, the ACA and the 3.8% Medicare surtax that accompanies it remain intact, providing important revenue to the healthcare system. Perhaps under-appreciated by investors is the fact that municipal income is not only exempt from federal income taxes (and state taxes in some cases), but it also exempt from the Medicare surtax, enhancing the value of municipals for some investors.

Tax reform – "less and later"

The decision to address health care reform as the first big agenda item following the election necessarily delayed the focus on tax reform and other key policy initiatives. Reportedly, however, top Republican leaders and key Trump Administration officials have been working behind the scenes on a tax reform plan. To date no significant details have been released. What we do know is that the House Budget Committee, which has been involved in the discussions, recently passed a budget plan that authorizes only revenue-neutral tax changes. If this holds, even with the benefit of dynamic scoring, it will limit the extent to which taxes may be cut. This does not mean that pro-growth tax reform cannot still occur; it can. Even with the goal of revenue neutrality, a focus on corporate tax cuts offset by limiting or eliminating other deductions could still provide a boost for businesses. Practically speaking, however, this development minimizes concern in the municipal market over major tax changes. The "less and later" tax changes that municipal investors now expect increases the likelihood that tax-free bonds remain a core allocation for investors.

Infrastructure plan – financing, but no funding

Both Republicans and Democrats agree with President Trump that more money is needed for the nation's infrastructure. Finding consensus on anything beyond this, however, has proven to be difficult, and few details have emerged regarding President Trump's infrastructure plan. A combination of public and private capital will likely be needed to finance the myriad of projects anticipated, with much of the financing potentially occurring in the municipal market – both taxable and tax-exempt. Yet, the funding sources for debt repayment remain uncertain. Some believe the federal government should provide the majority of the funding, ignoring the budget deficit implications. Others think the cost should be borne primarily by state and local governments where higher fuel taxes and/or the tolling of federal highways, among other ideas, are not surprisingly unpopular options. Without new funding sources identified in advance, state and local governments are understandably reluctant to borrow. Many municipalities already face rising pension and healthcare costs that warrant caution and fiscal prudence; adding on speculative debt is not a high priority. As a result, the Bond Buyer reports that the amount of new municipal supply remains relatively light – off 13% year over year. In fact, the net outstanding supply of municipal debt has been relatively stagnant since the Great Recession.

Conclusion

The lack of progress on President Trump's major agenda items has, so far, proven to be beneficial to the municipal market. A lack of borrowing to fund infrastructure and fading concerns over an overhaul of healthcare and taxes has led to the outperformance of municipals relative to the comparable Bloomberg Barclays taxable index cited above. At this point, a significant change in the political environment in Washington seems unlikely and should continue to provide a favorable backdrop for the municipal market in the second half of 2017. Yet the status quo may not be good for the market long-term. Without modifications in healthcare, for example, costs may become prohibitive, causing insurers to back away from the market, and fewer individuals to be able to afford coverage – both trends that are currently evident. Eventually, these deleterious trends are likely to negatively impact financial conditions for healthcare providers as well. Regarding the U.S. tax code, there is broad agreement that the current system is onerous and inefficient. Improvements are needed to enhance economic growth and productivity. Finally, delaying necessary infrastructure spending only leads to higher costs later on. The bottom line is that a solid municipal market requires a stable economy and healthy municipalities. So while the short-term benefits for municipal investors have been welcome and may continue, eventually policy makers will need to find a way to address the big needs this country faces, for the benefit of all citizens and investors.

Duane McAllister is managing director and senior portfolio manager, Baird Advisors.