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“Trump Effect” on the Municipal Bond Market

2016 might well be remembered as a year full of surprising economic and market extremes.

This past summer, the three major U.S. market indices reached record heights in the same week, the first time that had occurred since 1999. Also last summer, the “Brexit” episode roiled global and U.S. markets, with the Dow Jones Industrial Average experiencing a nearly 900-point decline in two days as the world was taken by surprise with the British vote to depart the European Union.

After market futures fell some 800 points on the Nov. 8 election night, the “Trump Effect” has now pushed U.S. markets to record territory again. The relative strength of the U.S. dollar abroad continues. The 4.9% unemployment rate at the year’s outset is now 4.6%, the lowest since August 2007.

And now the benchmark 10-year Treasury bond yield has jumped from about 1.40% from only a few months ago to 2.50% since the election. Municipal bond yields have moved even higher and are now trading above Treasury yields. For those keeping score, this is a rare occurrence that some see as an attractive opportunity, particularly for long-term investors.

Why has this happened? Treasury bond yields have moved higher in response to the prospects of an expansionary fiscal policy that could include both an increase in spending and tax reform. This could lead to higher inflation, which ultimately is the key driver of interest rates.

Muni yields have moved even higher based largely on two factors:

1) **Angst over tax reform –** Both Trump and the Republican-controlled House have proposed reducing marginal tax rates for individuals and corporations. Any reductions in tax rates, of course, reduce the relative value of tax-free munis. While one might intuitively think muni bonds are owned primarily by the wealthiest to minimize taxes, it turns out in a recent study by Citigroup analyzing tax returns that the majority of those claiming tax-exempt interest fell into the marginal tax rate bracket between 23% and 28%.

Interestingly, the muni market is more concerned about Trump's aggressive proposal to reduce the corporate tax rate from 35% to 15%. This would significantly reduce the tax benefits big institutional investors like banks and insurance companies require to hold tax-free municipal bonds.

2) **Skittish bond fund investors** – Many retail investors get their muni exposure via a muni bond fund. As interest rates increase, the Net Asset Value (NAV) of the muni bond fund declines. In a very predictable response, some of those investors get nervous and sell their fund holdings. This forces those muni funds to sell bonds in an already weak market to meet those redemptions. According to JP Morgan, municipal bond funds experienced over $3 billion in net outflows in the week ending Nov. 11, 2016 – a vicious cycle to say the least.

We saw a similar development happen in 2013. As interest rates spiked in the summer, municipal yields continued to rise through the end of the year, finally culminating in an attractive "cross-over" buying opportunity for even those investors who do not benefit from the tax exemption. Those same investors (pension funds, endowments, etc.) are now looking at the muni bonds as a potential buying opportunity because the absolute yields are relatively high.

If investors are patient and can endure the present pain of lower market values, prospects for taxable and municipal bonds (tax-free) are much more appealing today and in our view may become even more attractive in 2017.

Takeaways

- Keep your account diversified and stay objective when others get emotional or the market is temporarily distorted.
- Stick to your asset allocation goals and consult with your Commerce advisor.
- Retain perspective. Short-term approaches don't usually yield the best investment results.