Investment Insights

Municipal bond market watch Q&A

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We spoke with Senior Client Portfolio Manager, Stephanie Larosiliere, about the potential impact of US fiscal policy and rising global demand for municipals on the US municipal market.

The Trump Administration has discussed a number of initiatives that could impact the US municipal market – some potentially adversely. At the top of the list are tax reform and major increases in infrastructure spending. Concern over the impact of these policies – especially changes in tax exemptions enjoyed by US municipal investors – has caused some volatility in municipal bonds since the US election. However, while policy uncertainty remains, Invesco's municipal bond team believes the US municipal market may offer opportunity in 2017.

Q: How has the municipal market responded since the election and what are you watching for in terms of catalysts that might impact the market in the next few months?
Retail municipal investors reacted to the US presidential election with strong selling pressure. Concerns that the Trump administration would potentially lower income tax rates, cap municipal tax exemptions or eliminate the Alternative Minimum Tax (AMT) raised concerns that municipal bonds would drop in value. However, the investor exodus from the asset class has subsided this year and flows have turned modestly positive. At the current level of yields,[1] we believe the municipal market offers opportunity. Supporting our positive outlook are this year's supply expectations. We expect $350–370 billion in new issuance in 2017, around $70–90 billion less than in 2016 and $30–50 billion less than in 2015.[2] If we experience slight to moderate economic growth, as is our base case, fundamentals among municipal issuers should continue to improve. We believe this backdrop sets the stage for the municipal asset class to perform well this year, assuming there are no major negative surprises on the tax reform front.

Q: The Trump administration has suggested that tax reform is a policy priority. While there is still much uncertainty, what is your baseline outlook for how tax policy will play out?
We believe there is a high probability that federal income tax rates, particularly at the highest tax brackets, will be adjusted down. However, we do not believe they will be cut as aggressively – for example, to 33% – as has been discussed in the media. Nor do we foresee a significant impact on the municipal market. When President George W. Bush cut tax rates in 2001 and 2003 there was no discernable impact on the municipal market.[3] This is likely because the average tax rate of municipal bond holders was between 23%–28%, and this has not changed very much since the late 1980s.[4] Unless tax cuts are more aggressive than the often discussed "33%," we believe the final details on the tax plan will likely be met with muted response in the municipal market.

Q: Do you believe the tax-exempt status of municipal bonds is threatened?
We do not believe there is a true threat to the tax exemption of municipal bonds. During the Obama administration, this issue was raised regularly, either in the form of a 28% cap on the federal income tax rate or the elimination of the tax exemption altogether. During those years, the conversation never made it past the initial stages for two main reasons: (1) It became clear that the majority of municipal bond holders were not ultra-high earners as generally thought but comprised more middle income investors; (2) A cap on the exemption of tax-exempt interest would increase the borrowing costs for state and local governments. It was recognized that higher borrowing rates could result in less spending on infrastructure and fewer jobs, which could ultimately slow economic growth, place state and local finances under pressure and hinder needed infrastructure improvement. As a result, this proposal was met with strong bipartisan and municipality opposition. We believe similar proposals today would face similar resistance.

Q: What are the municipal bond team's views on President Trump's proposed infrastructure plan?
According to the American Society of Civil Engineers, the US needs massive investment in all essential infrastructure, from bridges and airports to dams and railways.[5] Much of the economic boom that the US experienced over the last 50 years was due to its network of highways, which made it easy to ship goods. It is believed that if American infrastructure remains in a state of disrepair, it will not only be dangerous, but could also hurt the economy in the long-run.

For these reasons, we believe infrastructure was one of the only policies that President Trump discussed in detail on his campaign trail. His original plan called for $1 trillion in infrastructure expenditure over a 10-year period.[6] While there are still very few details available on the plan, we envision that at least $25–50 billion per year would be funded through the tax-exempt municipal bond market. We believe the municipal market could readily absorb this level of supply, especially if it were issued at a measured pace. This is because infrastructure bonds are the "building blocks" of the municipal market – they appeal to both retail and institutional investors.

Q: Non-US demand for municipals has increased recently. What are the municipal bond team's thoughts on this new source of demand and how does it impact the municipal market?
Negative interest rate policies introduced by the European Central Bank and the Bank of Japan have led to increased global interest in the US municipal bond market. Although the US municipal asset class has historically been the investment of choice for US retail investors, in the last year, yield-starved non-US investors have flocked to investment grade US municipal bonds.[7] They have likely been drawn to the asset class by its history of low volatility[8] and near-zero default rates,[9] the potential for diversification and attractive yields. Unlike US investors, non-US investors are not eligible to take advantage of the federal tax-exemption that municipals are known for. Nonetheless, these investors have piled into the $3.8 trillion market.[10] At the end of 2015, foreign investors held around $90 billion in US municipal bonds, up from $72 billion in 2010.[11]

Municipal bonds have likely been attractive to non-US investors because they are a pure play on the US economy. They held up well as oil spiked and Brexit and other geopolitical events surprised markets. Municipal bonds issued by hospitals, universities, water, sewer and electric power authorities, bridges, tunnels, airports, senior living facilities and public transportation are truly tied to the performance of the US economy. Because these sectors have not historically been tied to the performance of US stocks, investment in the municipal asset class has allowed non-US investors to invest in the US economy without exposure to US equity market risk. If this new source of demand continues at the pace of the last two years, we believe it could provide support to the municipal market going forward and potentially help smooth volatility tied to US retail investment cycles.

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1 Source: Barclays, as of Feb. 28, 2017
2 Source: Bond Buyer, as of Jan. 31, 2017
3 Source: Citigroup, as of Nov. 16, 2016
4 Source: Brandeis/MIT Study by Bergstresser and Cohen, as of July 2015
5 Source: American Society of Civil Engineers, as of March 2013 (most recent data available)
6 Source: Trump/Pence, "Thank You Tour", Des Moines, Iowa, Dec. 8, 2016
7 Source: Reuters, "U.S. municipal market sales reach 6-year high in 2016", Dec. 30, 2016
8 Source: Bloomberg Barclays Municipal High Yield Index for the 10-year period ending Dec. 31, 2016. Volatility is measured by standard deviation.
9 Source: Moody's "US Municipal Bond Defaults and Recoveries, 1970-2015" as of May 2016
10 Source: SIFMA, Feb. 1, 2017
11 Source: Federal Reserve Z1 Report, Dec. 8, 2016

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