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Buy Side

Why the Buy Side Has Pre-Election Jitters

By Christine Albano
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A Donald Trump victory in Tuesday's presidential election might rock municipal bonds by triggering volatility in broader financial markets, as investors weigh concerns over the Republican candidate's attitudes on debt.

Beyond that, it's hard to predict how the election outcome might affect the municipal market, buy-side analysts and investors said. Both Trump and Democratic nominee Hillary Clinton have said they want to step up investment in infrastructure, which would boost munis. At the same time, neither candidate has specified how their tax reform proposals would affect the municipal tax exemption that has traditionally encouraged investment.

"The primary election impact on the municipal market is the likelihood of increased federal support for infrastructure investment," said Alan Schankel, municipal strategist at Janney Capital Markets. "Treasury and other markets will see initial volatility if [Trump] is elected, at least until there is more clarity about his specific policy proposals and objectives."

Trump in May suggested a partial default on U.S. outstanding sovereign debt obligations in order to renegotiate with current holders at a discount if interest rates increased. That and his four corporate filings of Chapter 11 bankruptcy raised concerns over his debt management skills.

Trump's comments on refinancing or renegotiating debt have been "a bit opaque," even after he retracted the earlier statements, Schankel said.

"His choice for Treasury secretary will be closely watched for signs of policy direction," Schankel said. He added that he sees no direct impact on municipal bonds from concerns over Trump's debt positions, saying munis will generally move in the same direction as Treasuries.

The election's "greatest impact to munis would occur if their exemption is capped, or worse, eliminated," David Litvack, managing director and head of tax-exempt research at U.S. Trust, Bank of America Private Wealth Management, said in a report.

"It is also important to note that comprehensive tax reform requires an extraordinary amount of political consensus and is very difficult to achieve," Litvack said. The last structural change that affected the tax treatment of municipal bonds was the Tax Reform Act of 1986.

"Limiting or eliminating tax preferences is very controversial, and numerous special interests have powerful lobbying efforts to preserve them," Livack said.

While Clinton and Trump's tax reform proposals differ, changes in the code can undermine the value of municipal bonds, said Michael Pietronico, chief executive officer of Miller Tabak Asset Management.

"Both Hillary Clinton and Donald Trump have tax plans, which if implemented in full, would be negative for municipal bond valuations," Litvack said in his September report.

A victory by Clinton may eventually mean an increase in the marginal tax rates for those who earn over $250,000 and a resulting increase in municipal demand, while a Trump win could lead to lower marginal tax rates, curtailing demand, muni market participants said.

"My initial thoughts are that Clinton wins and it's a net positive for munis on the demand side," said Peter Block, managing director at Ramirez & Co., in an Oct. 26 interview. "Her proposal to increase marginal tax rates on taxable incomes above $250,000 will be a driver of demand," he said. "Clinton will not kill the muni tax exemption, as she supports infrastructure."

Clinton's proposal includes a new tax bracket for income over $5 million with a 43.6% marginal rate, up from the current top rate of 39.6%, as well as maintaining the 3.8% investment surtax.

"She would also cap the benefit of itemized deductions and certain exclusions, like tax-exempt interest, at 28%, so if her entire plan were implemented, it would be negative for municipal bond pricing," Litvack said.

Trump's tax plan, by comparison, reduces the current seven tax brackets down to three, with a top marginal rate of 33%. He also wants to caps itemized deductions at $100,000 and $200,000 for couples.

"Regardless of who is elected, the municipal market can expect to experience some repercussions from a new administration," Rick Calhoun, first vice president of Crews & Associates, told The Bond Buyer in an Oct. 26 interview.

Under a Trump win, the market will see a "lighter regulator touch and possibly even a smaller regulatory bureaucracy," Calhoun said. "This could impact new municipal disclosure rules and other current issues," Calhoun suggested. "If Republican campaign promises to lower marginal tax rates are honored, municipal demand could be reduced regardless of what happens to interest rates."

If Clinton is declared president, Calhoun said there will be renewed attempts to end tax-exempt financing in a quest to increase federal revenue. "There may also be a regulatory push to curtail municipal trading by some of the biggest banks, which would certainly hurt liquidity in the municipal market," Calhoun said.

Dick Larkin, director of municipal credit analysis at Stoever Glass & Co. in Boca Raton, Fla., said municipals' tax-exemption "is at real risk."

"Mr. Trump wants to cut taxes and needs portals in order to do that," he explained. "Secretary Clinton has made it clear that she looks to raise taxes from the wealthy, and probably looks at muni tax-exemption as a mere loophole."

John Donaldson, director of fixed income at The Haverford Trust Company, believes the municipal market is not in jeopardy from either candidate.

"We continue to believe that fears of elimination of tax-exempt are overstated," Donaldson, who leads the fixed income team, recommends fixed income strategies, and oversees the investment portfolios for the Radnor, Pa.-based wealth management firm, said.

"It is never a zero risk, but is very, very unlikely," Donaldson, a vice president at the firm, said.

"There remains a broad consensus for the public policy goal that state and local governments should benefit from lower cost financing," Donaldson added. "We do not see a change in that consensus in any outcome."

Rather than concern over elimination of tax-exemption, he said, the more "remarkable" aspect of the election is that state and local voters will "most certainly approve" a record dollar amount of bond financing.

Chief among the ramifications of that, Donaldson said, is that approvals would create stimulus spending at the state and local levels independent of any action at the federal level.

"All of that spending would be sourced from new-money bonds, not the refundings that continue to drive supply in a low interest-rate world," Donaldson said. "The spending from these bonds could well be more targeted and less wasteful than whatever comes from Washington, regardless of who wins the election."

When it comes to regulatory reform, meanwhile, participants, like Donaldson, are on board with increased enforcement by the Securities and Exchange Commission.

This includes continuing efforts to tighten the definition of so-called "political subdivisions" eligible to issue tax-exempt bonds, he said.

"We favor any changes that improve the overall quality and transparency of the municipal bond market," Donaldson said. "We hope that any change in administration does not result in cutbacks to the SEC budget that would impair the improved enforcement."

On the other hand, federal infrastructure investment is a key factor in the outcome of the election, according to other buy-side analysts.

"Although Donald Trump's top number for federal infrastructure investment was larger, Hillary Clinton's policy proposals are more specific, including $250 billion of direct federal investment and $25 billion to fund an infrastructure bank over five years," Janney's Schankel said.

Clinton's proposal for the infrastructure bank includes renewal and expansion of the Build America Bonds program.

Still, passage of tax exemption or tax reform measures is uncertain no matter which candidate takes the White House, Jim Robinson, chief executive officer of Robinson Capital, pointed out in an interview on Monday.

"The disappointment for me is we are probably looking at four more years like the last eight," said the founder and chief investment officer of the Gross Pointe, Mich.-based asset management firm, which oversees $500 million of tax-exempt investments, including separately-managed accounts, mutual funds, and a combination of other investments.

Litvack noted that tax laws are passed by Congress, not the president.

"Therefore, the presidential candidates' plans are far from 'done deals,' but rather should be considered starting points for negotiations," Litvack said.

"We believe the probability of significant tax reform is greatest if one party sweeps the elections, taking over the Presidency and majorities in both chambers of Congress," Litvack continued. "If, however, the current environment of divided government continues, we believe it is more likely that no changes or only minor changes in tax policy will occur."

Robinson said Trump's plan to lower taxes "could get some agreement if the Republicans retain the House and the Senate – but that could be a negative for the municipal market. If you lower marginal tax rates it makes tax-exemption advantage less appealing."

Robinson said if Clinton's tax hike proposal for high income earners is passed, that could boost demand among the most dominant players in the municipal market.

Others said there may be little short-term impact from the election outcome on the municipal market and beyond – but much reservation, skepticism, and doubt.

"Given the difficulty in predicting election outcomes, in Congress as well as the Presidency, we believe it would be premature, at this time, to make any changes in allocations to municipal bonds based on potential changes in tax policy," Litvack said.

"I think that most will agree that this is the most confusing presidential election in our lifetime," Calhoun of Crews & Associates added. "Traders and municipal participants all feel a degree of uncertainty and, as we all know, the market doesn't like uncertainty."