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What Trump Means for Bonds - Taxes

This report is one in a series examining the potential implications of a Trump administration on bond markets. Through the presidential campaign and since the election, President-elect Trump has highlighted policy areas on which his administration will focus. In this series, Ascent will focus on some of the proposed or discussed policies and examine their potential impacts on taxable and tax-exempt bond markets.

Policy:

President-elect Trump has made income tax reform one of the main policy focuses of his presidency. It is widely expected that a Trump administration will streamline corporate and personal income tax rates while significantly lowering taxes for corporations and for many high and middle income individuals and families. Some of the cuts will be offset by limitations on deductions.

Implications:

The current Trump plan would lower corporate income tax rates to 15% and provide an opportunity to repatriate profits held overseas at a reduced 10% rate. Personal income tax rates would be streamlined, from seven marginal tax rates to just three, with the highest marginal rate reduced to 33%. It would also make a variety of adjustments to deductions. Trump's plan would also eliminate the alternative minimum tax for corporations and individuals, as well as repeal the federal estate and gift taxes.

While some of the details of the plan are likely to be revised, we believe that there is a high likelihood that a tax reform law will be passed that follows the basic outline of the current plan. Analyses of the current Trump tax plan suggest that federal revenues would drop by somewhere between $2 trillion and $5 trillion over 10 years. The income boost to corporations and individuals is expected to generate increased economic activity, presumably boosting inflation.

Impacts on Bonds:

Since the election, bond markets have reacted strongly to the expectation that President-elect Trump's tax plan would drive federal deficits higher, increase federal borrowing and stoke inflationary pressures:

- Generally, increasing economic growth drives interest rates higher. To the extent that the Trump tax plan drives increased economic activity and rising interest rates, bond yields would also rise (driving the prices of existing bonds down).
- Corporate earnings would presumably see a boost from lower tax rates. Likewise, corporations with significant offshore earned income would be incentivized to repatriate those funds. The ultimate impacts on corporate bonds will depend on how each company puts these funds to work. Holding cash or paying down debt would likely increase corporate credit quality and boost bond prices. Share buy-backs, dividend increases, increased merger activity or debt issuance could decrease corporate credit quality.
- Conventional wisdom dictates that declining tax rates are negative for municipal bonds, as the tax-exempt yield becomes less attractive at lower marginal income tax rates. However, recent research from Citigroup suggests that there is no correlation between marginal tax rates and municipal bond yields.* Instead, municipal bond performance appears to be related more to their yield levels relative to other fixed-income investments. We believe a better gauge for their relative attractiveness is to monitor municipal yields relative to Treasuries. Historically, nominal municipal bond yields have averaged approximately 80% of Treasury yields. Since the financial crisis, 10-year municipal bond yields have averaged approximately 100% of 10-year Treasury yields and frequently spiked well above 105%, which would suggest they remain relatively attractive considering their tax exempt benefit.*

Ascent's Approach:

While we do believe that tax law changes are coming, we do not believe that they should change investors' long-term strategy or asset allocation. A rising interest rate environment would generally be a positive development for income-oriented investors, who have been yield starved for many years. If tax policy reform drives yields higher, long-term buy-and-hold investors will benefit from rolling interest payments and maturing bond proceeds into new positions at higher yields. Declining bond prices are only a problem for traders; buy-and-hold investors who exercise careful credit selection can feel confident that their bonds will mature at par as scheduled.

* Citi Research, Global Municipals Strategy Focus, "Why is the municipal sell-off NOT justified?" November 16, 2016.

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