Trouble in the Bond Markets? Weighing Policy, Inflation and Rates in the Trump Administration

By Brian Pollak and Howard Cure

"Trumpflation" was introduced to the financial lexicon shortly after the surprise U.S. election results on November 8, 2016. Investopedia describes it as "the inflation that might appear during Donald J. Trump's U.S. presidential administration." It adds, "Though Trumpflation is still only speculative, markets have already signaled they believe Trump will spur inflation." The one thing we can be certain of at this still early juncture is greater uncertainty in the markets than investors are accustomed to. Should our approach to asset allocation, and to bond allocations in particular, change as a result?

We believe that well-researched, investment-grade municipal and corporate bonds remain an important part of a balanced portfolio. Bonds, unlike many other asset classes, are uncorrelated to equities and, in our view, should continue to generate positive returns, net of taxes, inflation and fees over the long term. Here, we focus on the likely impact of President Trump's proposed policies on growth, inflation, and interest rates, and the potential consequences for the municipal bond market.

Let's look at this administration's financial priorities, focusing not on the details (again, too much uncertainty) but on the reasons, in broad strokes, that each policy could prove inflationary and affect municipals. We will also consider some potentially mitigating factors.

It's important to note that a president can only directly affect fiscal policy; the independent Federal Reserve controls monetary policy, which is the more powerful mechanism to regulate inflation through interest rates. While the president has opportunities to appoint the Fed board members, including the chairperson in January 2018, the Fed is likely to continue on its current course of slowly raising interest rates. Fiscal policy can be powerful, however, and can impact both inflation, and state and local government finances.

Infrastructure and Defense Spending

Funding for infrastructure and defense, as promised by President Trump, could come from some combination of increased national debt levels, cuts in other spending programs, public-private partnerships, or one-time gains on revenues from taxes on corporate foreign earnings. To the extent that additional spending is funded with new debt, it would increase the level of new money in the system, which theoretically would push prices up. This infusion of money would affect inflation only temporarily, however, unless the infrastructure spending was put to use on capital projects that had a longer-term impact on economic productivity. For example, a bridge that reduces the average commute in a metropolitan area would drive lasting productivity gains, while repaving a road that was already in good shape would not have a similar multiplier, or longer-term effect.

Tax Reform

The president and Congress have proposed a number of different of tax policies, most of which would reduce the rate of taxes for corporations and individuals, and would broaden the tax base, eliminating various loopholes. Most economists agree that these measures would be positive for growth and also cause some inflationary pressures. But as always, the devil is in the details. Some of the specific tax policies being proposed have less economic consensus regarding their impact on growth and inflation. For instance, the Border Adjustment Tax, which would place a 20% tax on all imports, and a tax subsidy on all exports, is largely seen as inflationary, as consumers would likely incur much of that price increase. There is no consensus on whether this policy would spark meaningful economic growth. At the other end of the spectrum, the proposal to disallow corporations to deduct interest costs would disincentivize companies from taking on high debt loads, potentially reducing corporate leverage, which is deflationary.

Protectionist Trade Policy

Trade policy was an important plank in President Trump's campaign, and he has continued strong protectionist rhetoric since the inauguration. While it remains unclear what, if any, protectionist trade policies will be implemented, we would stress that policies that result in reduction of global trade, such as tariffs and quotas, have a generally negative effect on global growth and increase inflation. This assumes domestic production is more expensive than the goods being imported, as is usually the case in the United States. Consumers are then left purchasing higher priced foreign goods (due to tariffs), or a reduced supply of foreign goods (due to quotas), forcing them to purchase higher cost domestic goods. Historically, free trade policy has been deflationary, as illustrated by the U.S. PCE Durable Goods Price Deflator, which peaked the year NAFTA was struck *(refer to Appendix A)*.

Deregulation

President Trump and his advisors have focused their deregulation rhetoric on the financial services, energy and healthcare industries, aiming to lower the cost of doing business and, in turn, spur growth. The likely effect on inflation is more mixed. For example, energy deregulation would likely result in increased energy supply, which would be deflationary, while financial services deregulation could result in an increase in lending by community banks, which would be inflationary. We'll discuss some of the likely impacts of the repeal and replacement of the Affordable Care Act, or ACA, below.

Animal Spirits

Pro-growth policies can have a significant impact on inflation, as well as on economic and corporate growth. The more confidence people have in future growth, the more they may invest in the economy, creating the potential for a self-fulfilling virtuous cycle. There are some early economic indicators that animal spirits have heightened since November; we have seen spikes in confidence levels among consumers, small businesses and CEOs *(refer to Appendix B)*.

While not every Trump policy will be inflationary, the aggregate is likely to have at least some inflationary impact. But there are other factors, both long- and short-term, that could mitigate these effects. The Federal Reserve has begun its interest rate hiking cycle and its officials have said that they expect to increase rates another two to three times in 2017. Higher interest rates could cool inflation by increasing the cost of debt and slowing both consumer and corporate borrowing, potentially curtailing growth in key sectors of the economy, such as housing. The strong U.S. dollar, which has increased against most other currencies since the election, with many market participants anticipating further strength, is also potentially disinflationary or deflationary. A strong dollar can decrease earnings of U.S.-based multinational companies, hurt U.S. exports and reduce commodity prices, and also hurt emerging market economies.

Longer-term, aging demographics, technological advancements that reduce the need for human labor, and unsustainably high levels of national debt levels relative to GDP are all deflationary forces that could mitigate the effect of Trumpflation and stem increases in interest rates (*refer to Appendix C*).

A New Federal Regime and Its Impact on State and Local Governments

The federal government often implements policies with little regard to the fiscal implications on state and local government finances. The new Republican-led Congress and White House seem to have an ambitious agenda to change many programs; we will focus here on the impact on state and local governments of changes to infrastructure financing, the Affordable Care Act, and tax reform and the credit implications for municipal bond investors.

Infrastructure Spending and Impact on Municipal Bonds and State and Local Finances

The country's infrastructure needs are compelling. The American Society of Civil Engineers estimates that fixing all the roads, bridges, public transit, railroads, energy systems, schools, public parks, ports, airports, waste systems, levees, dams, drinking water facilities, and hazardous waste installations in the 50 states would cost $3.6 trillion, an amount that is roughly equal to the entire outstanding debt in the municipal debt market.[1] (The group also ranks the states with a report card on their infrastructure. No state scores higher than a C+. The country, as a whole, scored a D+.) At present, state and local governments account for nearly three-quarters of public infrastructure spending.

Infrastructure spending may be one of the few areas where President Trump and the Democrats could find common ground. The expectation is for municipal infrastructure bond issuance to remain the primary funding source for capital needs in the United States. Indeed, the public mood appears to favor infrastructure upgrades. In the same election that put President Trump in office, voters approved 80% of bond-issue proposals on ballots nationwide, to the potential cost of $55 billion.

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[1] American Society of Civil Engineers 2013 Report Card for America's Infrastructure.

President Trump has pledged to mobilize up to $1 trillion into upgrading our infrastructure. But that plan might not rely on direct federal funding. To date, the federal government has not been able to agree on the basics: how to pay for the needed infrastructure, how to prioritize our needs, and the most efficient way to design and build projects. President Trump plans to address this by heavily emphasizing private sector participation.

In a Public-Private Partnership, or P3, the private sector provides capital and focuses on the operational and executive aspects of a project, while the government retains administrative and regulatory oversight. This division of roles is supposed to help drive innovation, but any savings that might accrue to the government from a privately financed P3 project must be found in areas other than the financing itself, as government-issued debt is still cheaper than stand-alone project finance. Potential savings could include other project aspects, such as lower costs for employee compensation, and reduced operations and maintenance costs, while avoiding potential political battles such as raising rates and charges during an election year. In short, it is important to recognize that private financing does not constitute a new source of funding. Ultimately, the majority of costs will be borne by the public.

In addition, there is a further incentive for state and local governments to consider semi-privatizing money-making assets – the increasing liabilities derived from pensions and other post-employment benefits. Monetizing these assets and turning them over to corporations can produce a financial windfall and an opportunity to reduce systemic employee liabilities.

A report by Wilbur Ross, the Commerce Secretary nominee, and Peter Navarro, the new director of the National Trade Council, in the run up to the election assumed that, on average, prudent leverage will be about five times equity.[2] Therefore, financing $1 trillion of infrastructure would necessitate an equity investment of $167 billion; obviously a daunting sum. To encourage investors to commit such large amounts and to reduce the cost of the financing, government would provide a tax credit equal to 82% of the equity contribution. The report assumed that these tax credits would be repaid from the incremental tax revenues that result from project construction and that the end result would be revenue-neutral.

The other major tax component to encourage infrastructure investment recommended by Ross and Navarro is for repatriation, where companies would be able to bring overseas earnings back to the U.S. at a reduced tax rate of 10%, rather than the current 35% rate. With the credits, companies could avoid any tax liability by investing the repatriated profits in infrastructure projects.

A possible flaw in this program is that a system of tax credits to encourage private investors to put up money for infrastructure only works for projects that can be monetized easily, such as building a high-traffic highway or bridge that could bear a large enough toll to produce a positive return on capital for the private investor. Investing in routine maintenance projects, no matter

[2] "Trump Versus Clinton on Infrastructure," an analysis by Wilbur Ross, a private equity investor, and Peter Navarro, UC Irvine business professor, October 27, 2016.

how needed, would not be as appealing to investors. The repatriation component is also a one-time cash infusion and not a recurring source of funding.

Another concern, particularly for labor unions, is that the emphasis on P3s will lead to the circumvention of the Davis-Bacon Act.[3] This federal act requires that workers in federal contract constructions be paid at least the locally prevailing wage.

Municipal bond investors may expect:

- More project finance deals that are secured by revenues from a specific project as opposed to an entire enterprise system. The financing, construction and operational risks will be different – and greater – than in traditional enterprise system projects.
- An increase in debt issuance for infrastructure projects if we now have the (public) will and the (government-led) way.
- A privatization or leasing of existing government enterprise systems. These money-making operations could be monetized to help alleviate other long-term operational liabilities of a municipality, such as pension and healthcare benefits.
- Public sector and construction union opposition to P3s based on concerns over maintaining wages and jobs through the Davis-Bacon Act.

Deregulation: the Affordable Care Act (ACA) and Impact on Municipal Bonds and State and Local Finances

The Republican-led Congress is likely to repeal the ACA early in 2017, leaving in place the subsidies on the exchanges and the Medicaid expansion for two or three years. It will need to decide what a replacement bill looks like and when that will go into effect. We should expect uncertainty in the health insurance market for the next couple of years, with hospitals and Medicaid programs particularly exposed.

For all its shortcomings[4], the ACA saved the federal government hundreds of billions of dollars by reducing the growth of Medicare payments to healthcare providers. Repealing the law would eliminate those savings and increase federal spending. The repeal would also result in fewer tax revenues from high-income households, specifically the increased payroll tax and the surcharge on net investment income. The law also imposed annual fees on health insurers and manufacturers of brand-name drugs and medical devices.

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[3] The Davis-Bacon Act: Issues and Legislation Congressional Research Service, March 2004.

[4] Problems ensued as, in many places, not enough healthy people bought plans. This resulted from a weak mandate for all to purchase insurance and left insurers with a disproportionately high risk pool. Also, many individuals complained about too high premiums and designs that forced them to pay thousands of dollars in deductibles. Many insurers rang up losses and, subsequently, withdrew from certain markets resulting in less competition and, ultimately, higher premiums.

The impact on state government finances and healthcare systems following a repeal of the ACA and a potential overhaul to the Medicaid program would be significant. Medicaid accounts for more than half of all federal grants to state and local governments (over $330 billion in 2016), larger than any other program.[5]

While states have considerable latitude over the design of their Medicaid programs, the ACA's proponents did not predict that the Supreme Court would rule in 2012 that it was up to each state whether to expand Medicaid eligibility. Even though the federal government would have helped fund the expansion, 19 states opted not to do so, leaving low-income residents in somewhat of a bind.[6] Congress will need to address these coverage gaps in drafting a new policy.

For many not-for-profit hospitals, the expanded Medicaid program provided meaningful improvement to their overall payor mixes and therefore, profitability. In general, the costs of caring for uninsured patients went down across the country, although this varied considerably by state and by individual hospitals, as millions of uninsured people were covered through Medicaid. While Medicaid is generally considered a hospital's weakest payor, it is better than the payment received from patients without insurance. Hospitals are now bracing for resurgence in uninsured levels and erosion in financial performance. Prior to the ACA, hospitals that served a large number of the uninsured received federal Disproportionate Share Payments, or DSH, from the federal government to cover the associated extra costs. The federal law assumed that Medicaid expansion would be mandatory, and called for a reduction in DSH payments. Now, the hospitals' only hope is that if the ACA is repealed, DSH cuts are also repealed.

There are many questions about what shape GOP healthcare reform would take. One proposal is highlighted in Speaker of House Paul Ryan's plan, which he titled *A Better Way.* This plan delineates reforms including repealing Medicaid expansion, individual employer mandates (requiring insurance to be purchased even by young, healthy individuals and offered by most employers), and taxes introduced by the ACA. It also advocates for transforming Medicaid into a block grant or per capita allotment program. Block grants would mean limiting federal Medicaid funds to a set amount given to the states, rather than the current federal commitment, which is more open-ended.

Republicans have long advocated block grants as a fiscally responsible way to limit federal spending and empower the states, providing them with room to innovate. The per capita allotment program would limit federal spending on each Medicaid enrollee, rather than overall. Unless states are able to bend the cost curve and achieve savings, they would have to either bear more of the responsibility of providing care or choose to offer less generous benefits and/or narrow eligibility.

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[5] *What is the Result of States Not Expanding Medicaid?* Robert Wood Johnson Foundation/Urban Institute.
[6] The states are primarily in the southeast and plains region, and include: VA, NC, SC, GA, FL, AL, MS, TN, TX, OK, MO, KS, NE, SD, WY, ID, UT, WI and ME.

Another program that may be resurrected to help high-risk patients, who were unable to buy insurance in the regular individual markets, is the development of high-risk pools by state. To make the high-risk insurance at least somewhat affordable, states typically had to inject funds. When money fell short, some pools imposed limits on coverage or sign-ups. Certain Republican plans are willing to put in at least $25 billion over 10 years toward the high-risk pools, to cap premiums for enrollees, and to allow as many people to sign up as necessary.

Municipal bond investors may expect:

- A quick repeal of the ACA but questions on when a replacement plan is put into place.
- Future pressure on state budgets around the country.
- The possible reimplementation of statewide risk pools and potential further impact on state finances.
- A negative outlook for the not-for-profit healthcare sector.

Tax Reform and Impact on Municipal Bonds and State and Local Finances

Participants in the municipal market – issuers, investment bankers, and investors – are concerned about the implementation of a variety of tax modifications under consideration by President Trump. During the campaign, Trump didn't propose eliminating any individual deductions but instead proposed an overall deduction cap ($100,000 for individuals and $200,000 for married couples). Congress may take a different approach by entirely eliminating some deductions (such as state and local taxes) and curtailing others (mortgage interest). The more limits to deductions are implemented, the more flexibility there is to lower various tax rate brackets. The general consensus is that corporate tax reform would precede personal income tax reform. However, as almost 60% of the municipal bond market is owned by individuals either directly or through mutual funds[7], personal income tax reform would potentially have a greater impact on this market.

Besides the direct impact on the municipal bond market, it is also important to note any federal changes in income tax deductions and the impact on state and local finances. For example, there have been proposals to eliminate the deductions for state and local taxes, including property and income taxes. This would have a negative impact on states with high income and property tax burdens, while having a limited effect on states that rely more heavily on sales and other taxes such as mineral extraction revenues (a division that falls roughly into, respectively, blue states and red states).

Another proposal is for the Alternative Minimum Tax, or AMT, repeal, which could benefit certain private activity bonds that are subject to that tax. The tax was initially intended to prevent high-

[7] Citi Research Municipals: US Municipals Strategy Focus Q3 2016.

income individuals from using loopholes to avoid having to pay taxes, but it now affects many more taxpayers thanks to the so-called bracket creep, where inflation pushes income into higher tax brackets. Investors who buy private activity bonds subject to the AMT typically pay less for the bonds, raising the interest rates or borrowing costs for issuers.

The threat to municipal bond tax exemption is real. State and local governments were caught flat-footed when the idea was first proposed by the Obama administration in his first term, as part of an attempt to either eliminate or cap various tax deductions and simplify the tax code. It seems to us that there are two possible tax status changes or scenarios:

- Benefit of tax exemption is capped at 28% (or another other amount), and outstanding bonds grandfathered.
- Tax exemption is totally abolished and outstanding bonds are grandfathered.

In both scenarios, maintaining the existing tax benefit for current outstanding municipal bonds helps existing holders while diminishing the cost benefits for future issuance. Changing the value of an investment retroactively would raise concerns over government tax policies and constitute a breach of trust with investors, so we think it unlikely. However, a prospective-only application of this type of provision does not immediately help in the raising of federal revenues and thus lowers its impact in balancing the federal budget or providing flexibility to lower overall federal income tax rates.

The other question is whether lower top marginal tax rates will lead to lower retail demand for municipal bonds. The expectation is *no*, as the average tax rate for municipal bond holders is much lower than the top 39.6% rate and has not fluctuated much over the years.[8]

Build America Bond Program

The Build America Bond, or BAB, program was temporarily implemented in the first term of the Obama administration and may now be resurrected. The idea was that, in addition to continuing the traditional municipal bond tax exemption, taxable BABs would provide another option for state and local governments to expand access to the capital markets. In this program, the federal government paid 35% of the interest on BABs to the municipal entity, equal to the corporate tax rate, to close the yield gap between a higher yield bond and a tax-free municipal bond. The program expanded the buyer base by including non-traditional buyers of bonds, such as pension funds and foreign entities, while lowering borrowing costs though the federal subsidy.

A revived BAB program may come with a smaller federal subsidy equal to the potentially lower corporate tax rate the new administration envisions, ranging from 15%-22%. State and local authorities could choose the infrastructure projects to be funded by either BABs or tax-exempt

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[8] Citigroup Municipal Research: "Global Municipals Strategy Focus, Why is the Municipal Sell-Off Not Justified?" November 16, 2016. Between 1980 and now, the top municipal tax rate for municipals has fluctuated in the range of 28%-70%. Yet, there is no correlation between municipal yields and the top marginal tax rate, as the average tax rate for municipal holders is much lower (likely around 23%-28%) and that has not changed much over the years.

bonds, keeping in mind that there are many restrictions associated with tax-exempt borrowings. It is important to note that, from an issuer's perspective, there was risk in that the original federal subsidy was not guaranteed by the federal government and was, in fact, caught up in a multitude of cuts under sequestration. Also, more corporate or institutional buyers demand certain features that not all issuers are able to provide. One feature is more rigorous disclosure of financial data – a benefit for all holders of municipal debt. The other is liquidity for their investment, which is not available for small entities that are infrequent debt issuers. BABs may also cannibalize tax-exempt issuance and, as a result, lower yield based on lower supply.

Municipal bond investors may expect:

- Significant impacts on state economies if income and property tax deductions are eliminated.
- Continued uncertainty around future tax exemption for municipal debt.
- Potential for a new BAB program and a related effect on supply, buyer base, and bond disclosure, specifically more frequent updates on financial data.

Conclusion

The potential effects of significant policy changes could impact the bond market in myriad ways. For bondholders, the primary concerns are twofold: Policies could have an adverse impact on credit by negatively affecting state and local finances or an adverse impact on interest rates via rising inflation or growth. Municipal bond and U.S. government bond interest rates have already made a significant move higher, rising around 1.00% in yield from July through the end of January 2017. If inflation expectations continue to rise and the Fed hikes interest rates two or three times in 2017, interest rates may rise and bond prices will fall. If we make a fairly draconian assumption that interest rates continue to rise from today's level of 2.50% to 6.25% for a 10-year Treasury five years from now, based on this simple duration calculation above, a hypothetical portfolio of 4.5 year duration bonds would still manage to eke out a small positive gain of a bit under 1%, below inflation expectations, but still positive *(refer to Appendix D).*

So why hold bonds at all if expectations are for higher interest rates? In the example above, each year that interest rates go higher, the hypothetical portfolio would throw off more income as it can reinvest maturing securities in higher yielding bonds, providing more cushion as interest rates increase further. In this era of radical uncertainty, there is a chance that none of the policy prescriptions President Trump has proposed are implemented as expected, that they don't work as planned, or that President Trump focuses more on policies that are negative for growth, like trade protectionism, than the markets currently expect. There is also the risk that exogenous events, including further destabilization of the European Union and, more likely, the Middle East and a further economic slowdown in China eclipse the effects of good fiscal domestic policy.

Finally, longer-term deflationary or disinflationary trends, including aging demographics, technological advancements, and unsustainable national debt levels, could happen faster than most investors expect, keeping the 35-year bull market in bonds charging for the foreseeable future.

A portfolio of well-researched, investment-grade municipal and corporate bonds continues to make sense as an important part of a balanced portfolio. At Evercore Wealth Management, we manage customized bond portfolios through our allocation to our Defensive Asset class. We further advocate broader diversification, allocating to our Credit Strategies Asset class through investments in strategies that take on credit risk, but limit interest rate risk, such as middle market and marketplace lenders whose performance has very little correlation to that of the high-yield credit and equity markets. In our Diversified Market Strategies class, we invest in assets that are uncorrelated to both bonds and stocks, but have a positive expected return over the course of the full market cycle. In our allocation to Illiquid Alternatives, we typically focus on private equity investments that have return streams that have little or nothing to do with traditional stock and bond portfolios (*refer to Appendix E*).

In this era of radical uncertainty, the best portfolio defense is true diversification. Please contact either one of us or your Evercore Wealth Management advisor for further information on our portfolio strategy.

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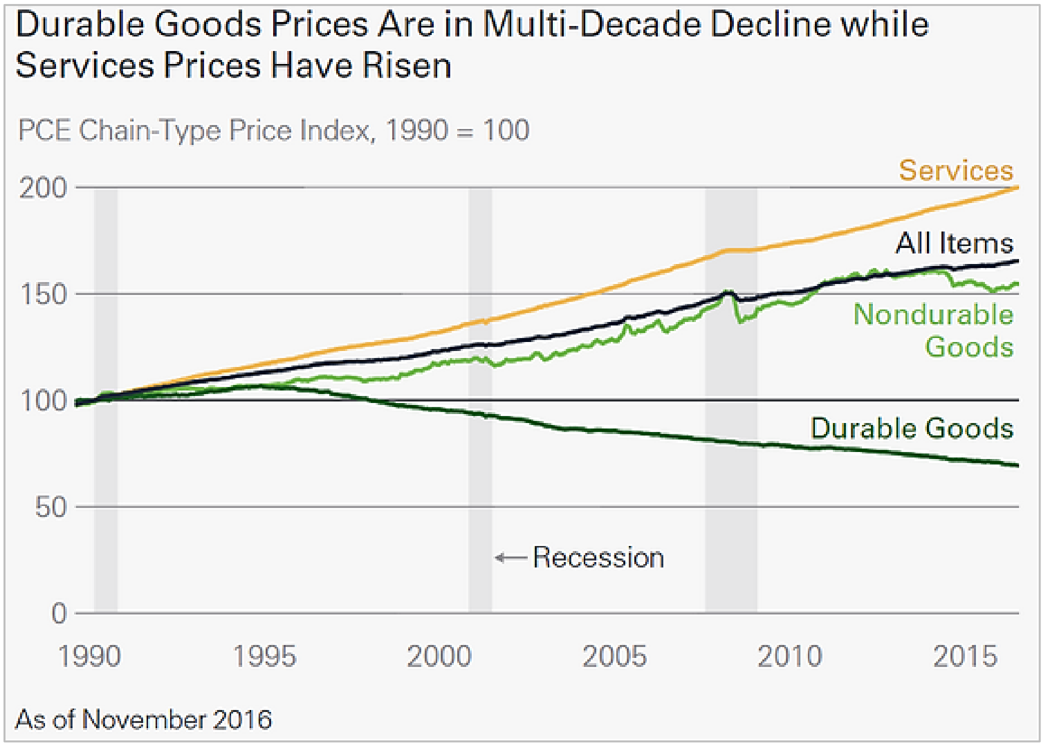
Appendix A: Trump Trade Policy

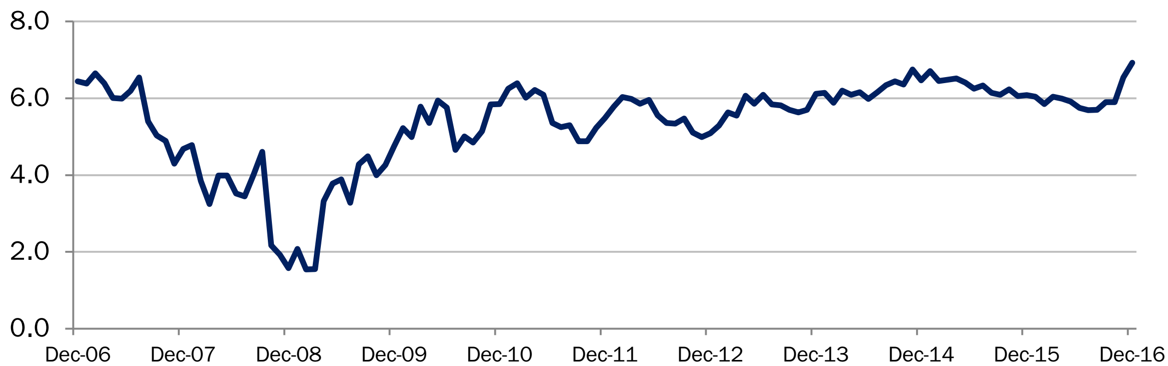


Source: Bureau of Economic Analysis, Haver Analytics

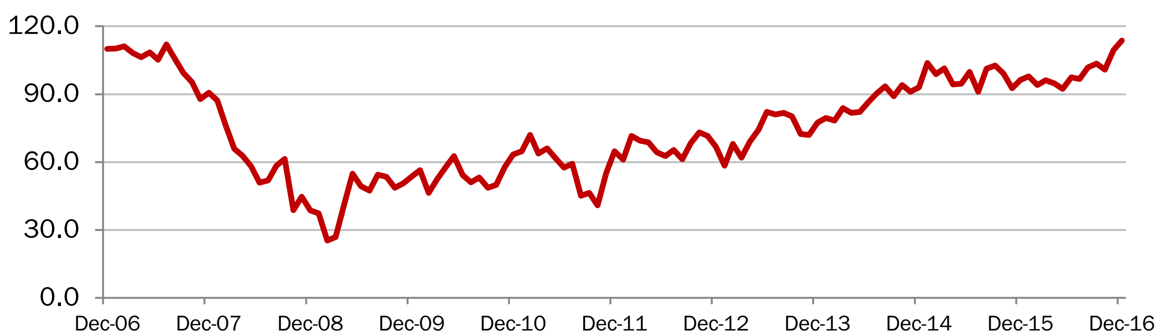
APPENDIX B: ANIMAL SPIRITS

The more confidence people have in future economic growth, the more they will invest in the economy, creating the potential for a self-fulfilling virtuous cycle.

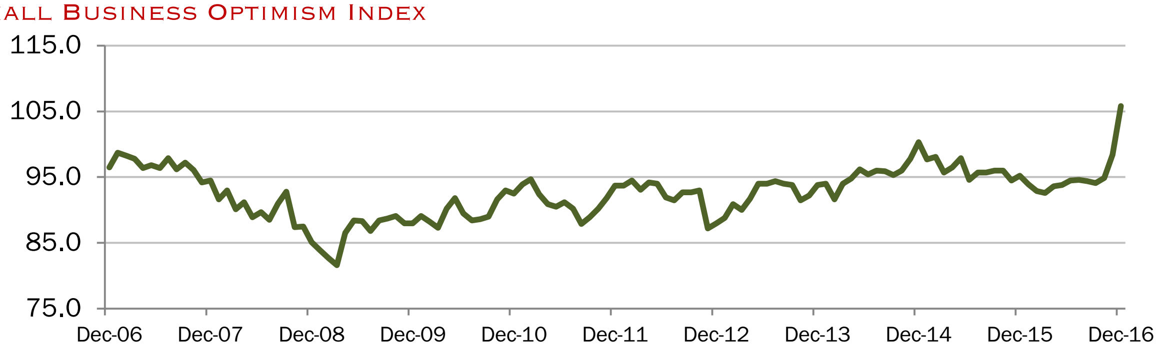
CEO CONFIDENCE INDEX



CONSUMER CONFIDENCE

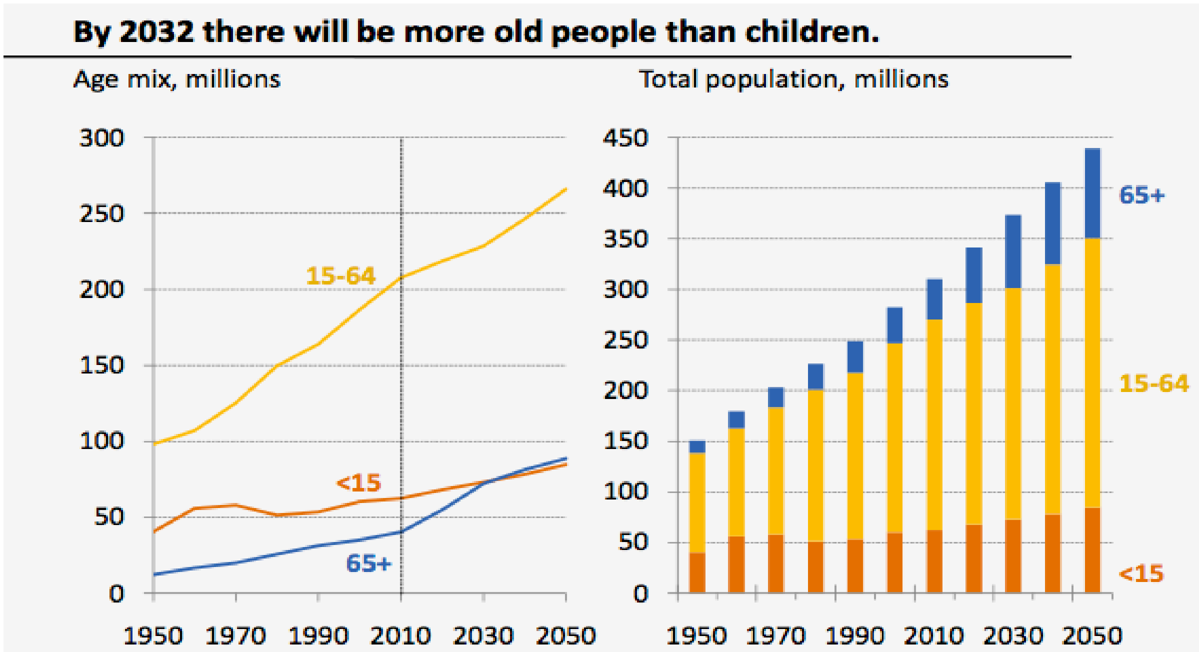


SMALL BUSINESS OPTIMISM INDEX



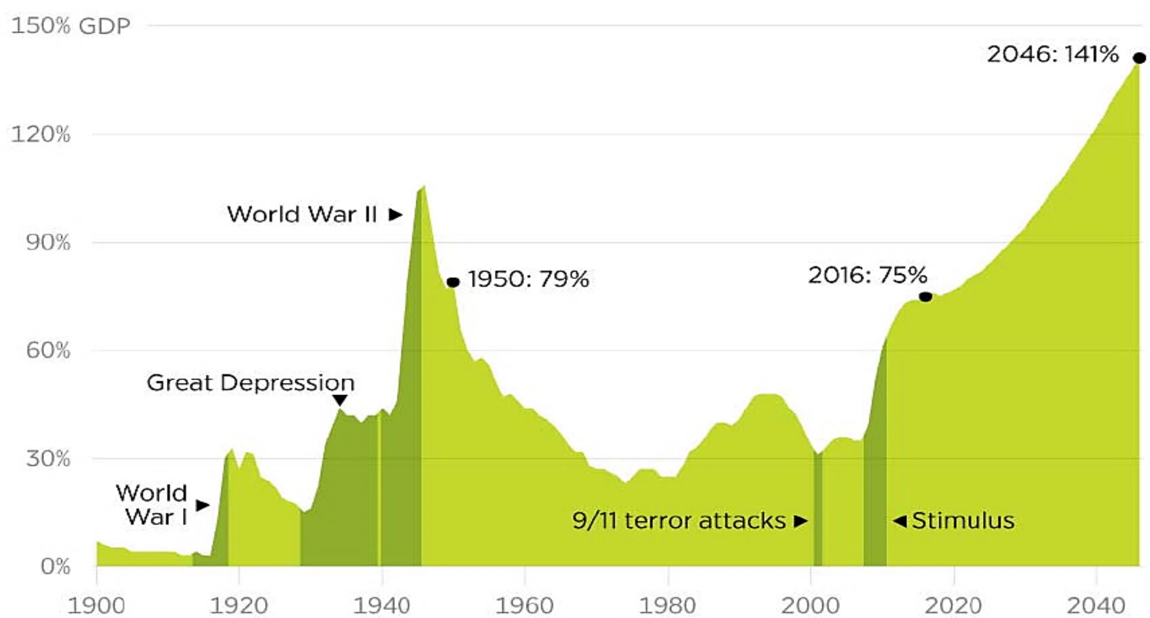
Source: Bloomberg. Data as of December 31, 2016.

Appendix C: Deflationary Factors – Aging Demographics and U.S. Debt



Source: Stanford Center on Longevity. U.S. Census Bureau.

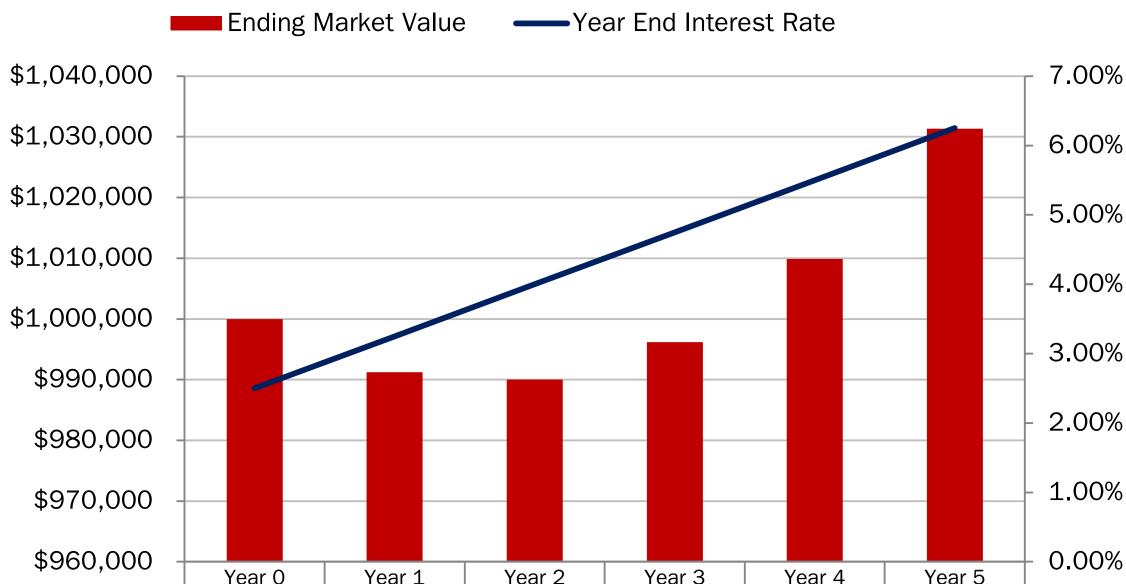
January 1, 1900 Projected through 2040



Source: *Just Markets,* Jeffrey Gundlach, The Heritage Foundation. January 10, 2017.

Appendix D: Fixed Income Stress Test

Stress test on a $1MM portfolio of 4.5 year duration bonds assuming yields rise to 6.25% over a 5 year period.



	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Ending Market Value	$1,000,000	$991,250	$990,011	$996,199	$1,009,896	$1,031,357
Year End Interest Rate	2.50%	3.25%	4.00%	4.75%	5.50%	6.25%

Source: EWM Research

Appendix E: EWM Asset Allocation

Asset Class	Allocation	Sample Assets
Cash	– Managed for anticipated spending needs and future investments	– Cash Management – Money Market Funds
Defensive Assets	– Designed to preserve capital and provide current income	– Taxable Bonds – Municipal Bonds
Credit Strategies	– Developed to enhance total returns through credit risk exposure while minimizing interest rate risk – We retain selected outside managers of liquid alternative fund strategies that invest in a range of non-investment grade credit instruments	– Floating Rate Bonds – High Yield Bonds – Distressed/Stressed Credit – Credit Hedge Funds
Diversified Market Strategies	– Designed to offset risks to which traditional allocations of bonds and diversified stock portfolios are vulnerable – We retain outside managers and select securities that we expect will have low correlations to traditional equities and fixed income investments	– TIPS – Gold and Commodities – Foreign Bonds – Liquid Alternatives – Multi-Strategy Hedge Funds
Growth Assets	– Incorporates all growth-oriented assets – We manage a core mid-large cap portfolio of predominantly U.S. stocks – We additionally retain outside passive and active managers for large cap, small cap, international developed and emerging markets	– Core U.S. Equity – Small Cap U.S. Equity – International Equity – International Small Cap Equity – Emerging Markets Equity – Long/Short Hedge Funds
Illiquid Assets	– Allocated to investments with potential for high-growth returns that are evaluated in the context of risk, tax consequences, liquidity needs and time horizon	– Private Equity – Venture Capital – Illiquid Real Estate Investments

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