Presidential elections showcase numerous policy change proposals that have little impact on the municipal bond market. Issuance, mutual fund flows and municipal/Treasury yield ratios have historically not reacted to political rhetoric. A Merrill Lynch study going back twenty years and covering five elections corroborates, finding no clear trend in municipal market activity during the periods leading up to a presidential election.¹ In this market update we take a brief look at front runner Democratic candidate Hillary Clinton’s and presumptive Republican nominee Donald Trump’s campaign proposals that could have contrasting implications for the municipal bond market, post-election.

History Shows Little Correlation Between Muni/Treasury Yield Ratios and Presidential Elections

¹ Source: Bank of America Merrill Lynch report March 2016

Source: Standish, Thomas Reuters as of April 30, 2016
Tax Reform: Status of Municipal Bond Tax Exemption

Clinton: No Proposals Targeting Muni Tax exemption

Trump: No Proposals Targeting Muni Tax exemption

For over a century dating back to 1913, tax exempt bonds have served as a vital low-cost financing tool for state and local governments to fund critical infrastructure and other capital projects. According to a recent Bond Buyer article the municipal bond tax exemption has led to lower borrowing costs with savings to state and local government issuers of more than $700 billion for debt service expenses from 2000 to 2014. Past political proposals calling for removal or curtailment of the tax exemption have been a cause for anxiety; we have seen no evidence to suggest plausible threat. To our knowledge, neither Hillary Clinton nor Donald Trump has focused on the tax exempt status of municipal bonds in their tax plans. There has been growing recognition of the value of municipal bonds, as evidenced by recent support from Congress via legislation H.R. 2209 to include liquid investment-grade municipals as High Quality Liquid Assets (HQLA) under bank liquidity rules. We believe future political attempts to change the tax exempt status of municipal bonds would need to be part of a major tax reform package, and would face rigorous debate in an already fractured Congress.

Tax Reform: Federal Tax Rates

Clinton: Raise Tax Rates for Highest Earners

Trump: Lower Top Individual Tax Rates

History has shown little correlation between municipal bond valuations and federal tax rate changes. Both Clinton and Trump campaign agendas have included proposals to change top income earner tax rates which may have contrasting implications for municipal bonds' tax benefit, if enacted. Clinton's tax proposal seeks to raise tax rates for the highest earners with a 4% surcharge on adjusted gross income (AGI) over $5 million and a 30% minimum tax on adjusted gross incomes (AGI) over $1 million. Additionally the tax proposal retains the Affordable Care Act (ACA) 3.8% net investment surtax of which municipal bond interest is exempt. This means that the wealthiest Americans would bear a federal tax liability as high as 47.4%, a 9% increase from the current maximum level. We believe the potential impact on demand for municipal bonds would be positive at the margin, but immaterial for overall demand.

Trump's plan proposes lower individual tax rates which would lessen the tax benefit for municipal bonds, leading to a potential reduction of overall municipal bond demand. Trump is also calling for a simpler tax code with a reduction to four from seven federal tax brackets to 0%, 10%, 20% and 25%, plus would repeal the ACA 3.8% surtax on net investment income. Demand for municipal bonds is not limited to just the wealthy. According to IRS data approximately 45% of tax returns that reported tax-exempt interest had adjusted-gross incomes of less than $200,000; taxpayers aged 65 and over also represented around 50% of tax returns that included tax exempt interests. Both Clinton and Trump plans incorporate the Obama administration's budget proposal of limiting itemized deductions, which might include tax exempt interest and could have negative implications on demand for municipal bonds if ever enacted.
Healthcare:
Clinton: Defend Affordable Care Act (ACA) - Obamacare
Trump: Repeal Affordable Care Act (ACA) – Obamacare

The municipal bond market has responded favorably in our view to the enactment of the Patient Protection and Affordable Care Act (ACA), which was signed into law in 2010. Hospital bond prices have been supported by strong overall demand, resulting in lower borrowing costs with credit spreads at multi-year lows. In the near term, the ACA has driven a broad decline of the uninsured population, fueling reductions in bad debt expense and buoying fundamental credit metrics for many issuers among the not-for-profit hospital sector. We believe the long-term impact of the ACA is more uncertain; we expect Medicare rate increases in the future will be strained as the federal government faces increased costs for ACA-related subsidies. Medicare reimbursement can comprise 40% to 45% of a hospital’s revenues. Clinton has been a clear proponent of the ACA, while Trump’s platform calls for a full repeal of the ACA. We would expect a negative impact on municipal bond hospital credits if there were a Republican victory in the White House, coupled with control of both houses of Congress.

Energy/Climate Change - Clean Power Plan (CPP):
Clinton: Defend Clean Power Plan (CPP); Combat Climate Change
Trump: Calls for Abolishing EPA Which Enforces Clean Power Plan (CPP)

The public power industry, including municipal utility agencies which operate power plants, appears headed toward a transitional period. Improving efficiencies and rising demand for renewable energy sources – i.e. wind, hydroelectric, solar - coupled with stringent regulatory changes aimed at reducing carbon emissions are key market drivers. The U.S. Clean Power Plan (CPP) final rules were issued in August 2015, setting a goal for national electricity sector carbon emission reductions at an estimated 32 percent below 2005 levels by year 2030. Clinton has been a proponent of the CPP and combatting climate change, while Trump has called for abolishment of the EPA which enforces the CPP. Regardless of the election outcome, we expect continued regulations aimed at reducing carbon emissions and forcing expensive transmission upgrades, to remain a headwind for the public power sector.

In the long run, those issuers most likely to suffer from higher costs to meet CPP regulations are public utilities that are heavily reliant on carbon-intensive coal for energy generation and also

Muni Green Bonds Top $7.9B, Up 24% Since December 2015

Regardless of the election outcome, we expect continued regulations aimed at reducing carbon emissions and forcing expensive transmission upgrades, to remain a headwind for the public power sector.

![Graph of Muni Green Bonds](source: Bank of America Merrill Lynch as of April 22, 2016)

*Standish annualized projection 2016
reside in states subject to sizeable mandated carbon-reduction goals. A key fundamental positive for most issuers in the public power sector is independent rate setting authority which allows for effective implementation of consumer rate increases to help offset rising cost trends. Regardless of the election outcome, we expect to see continued supply growth of green bonds, which are issued to fund environmentally friendly initiatives such as renewable energy, clean water and clean transportation capital projects. Since December 2015, the municipal green bond market has increased by 24% and currently stands near $7.9 billion. Carbon emission regulatory requirements as well as other initiatives to combat climate change are here to stay. While the recent granting of a stay on the CPP by the U.S. Supreme Court has delayed implementation, we expect cost pressures over the long-term of moving toward cleaner energy will continue to pressure many public power issuers.

**Infrastructure Spending:**

Clinton: Proposed Five-year $275 Billion Infrastructure Plan; Reenact Build America Program

Trump: Proponent for Infrastructure Investment

There is much evidence that the U.S. faces an infrastructure crisis causing economic headwinds and alarming public health and safety risks due to aging roads, schools, bridges, and water systems. Infrastructure funding levels when measured as a percentage of GDP have reached their lowest level since WWII. Historically the U.S. has relied heavily on state and local governments via the municipal bond market to fund approximately 80% of the nation's public infrastructure, according to the Congressional Budget Office. The American Society of Civil Engineers estimates that $3.6 trillion of infrastructure investment from 2013 to 2020 is needed to get the U.S. up to standard. Since the financial crisis, the municipal market has witnessed declining state and local municipal bond issuance, and hence infrastructure investment. A reversal of this trend with more serious investment and commitment to maintenance and development of U.S. infrastructure would help support business growth, create jobs, provide a healthier and safer community environment, and ultimately promote stronger productivity and economic competitiveness.

During their campaign's, both Clinton and Trump have been vocal proponents of increasing infrastructure investment. Clinton's proposals are enthusiastic but lack the commitment to have a real impact. She proposed to boost infrastructure federal spending by $275 billion over the next five years as well as create a $25 billion infrastructure bank to support critical projects. She has been in support of a reauthorization of the Build America Bonds (BABs) program to further stimulate infrastructure investment. The BAB program which was in effect during 2009-2010 was fraught with controversy and raised only $181 billion. Trump has been vocal about the need to invest in U.S. infrastructure but has made no specific proposal that we know of. He was quoted during a December 2015 Republican presidential debate when asked about his views on the Iraq war; “... we could have spent that $4 trillion in the United States to fix our roads, our bridges and all of the other problems, our airports and all of the other problems we have, we would have been a lot better off — I can tell you that right now.” Regardless of the election outcome, we believe that state and local governments are likely to continue to drive the majority of infrastructure investment, with municipal bonds serving as the primary financing vehicle. In our opinion it is critical that the new President supports the well-functioning municipal bond market for the benefit of our consumers and economy.
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