MUNICIPAL BOND OUTLOOK
James Dearborn, Head of Municipal Bond Investments and Senior Portfolio Manager
January 2017

Why did municipals bonds sell-off after the election?
The causes of the sharp drop were related to the potential for rising inflation in a pro-growth Trump administration. The Treasury market sold-off after the election and, as municipal bonds generally move in the same direction as Treasuries, muni yields moved dramatically higher. Investor expectations shifted to increased federal spending on defense and infrastructure, combined with tax cuts and reduced regulations that could accelerate economic growth at a time when the labor market is already tight — all potentially leading to higher inflation. Additionally, much of the proposed Trump policy creates a potential for increased federal borrowing, with more Treasury issuance and larger deficits.

While it is possible that this scenario will play out as the market anticipates, there are many factors which may limit the inflationary forces of the proposed policies. Specifically, Republicans in Congress, while nominally sharing the same party with President-elect Trump, may resist elements of the new administration’s proposals that result in expanding the federal deficit. Moreover, the President-elect has proposed changes to existing trade agreements that might result in increased tariffs, which may have a depressive effect on economic conditions. Finally, the general condition of economies in Europe, Asia, Japan and South America is not expected to be driving inflation materially higher in the foreseeable future.

What does President-elect Trump’s potential tax reform mean for municipal bond investors?
Trump’s tax reform plan calls for lower personal income tax rates, possibly reduced from 39.6% to 33%. Note that the value of the municipal bond tax exemption decreases when tax rates fall and, conversely, increases when tax rates rise. Lowering the top marginal federal rate to 33% would marginally reduce the value of municipal bonds.

It is important to remember that the top federal tax rate in 2012 was 35% (and rose to 39.6% in 2013 as a result of the “fiscal cliff” negotiations), not much higher than a potential 33%. On an after-tax yield basis, even at the potentially lower top federal rate, we still believe that municipal bonds are an attractive investment for tax-sensitive investors.
A historical review of municipal yields relative to other fixed income instruments, i.e. Treasuries and corporate bonds, across various federal tax regimes indicates that the level of the top tax bracket does not correlate to relative cheapness or richness of municipal bonds. Thus we do not expect that a potential top federal rate of 33% will materially impair demand or cause a material weakening in municipal bond prices.

**Does the Trump administration's tax reform proposal address the municipal bond interest exemption?**

No. President-elect Trump’s tax proposal is not that specific and makes no mention of the treatment of tax-exempt interest. Tax reform discussions in recent years have included the municipal interest exemption and we expect this topic to be on the table once again. President-elect Trump, in a recent meeting with U.S. mayors, reportedly indicated his support for retaining the municipal bond interest exemption. While this does not represent formal policy of the new administration, we believe it is an important recognition of the role that municipal bonds play in financing critical infrastructure spending.

**How does the large increase in proposed infrastructure spending impact the muni market?**

Like his income tax plan, Trump's infrastructure proposal is short on details. As such, it is difficult to anticipate how his infrastructure plan will impact the municipal market.

It is worth noting that the vast majority of infrastructure spending is financed through traditional tax-exempt bonds issued by state and local governments and their agencies and authorities. Given the importance of municipal bonds in financing infrastructure, changes to the tax code that reduce or eliminate their tax-exemption seem unlikely, as the formidable lobbying efforts of state and local officials will strongly argue that any changes to the treatment of municipal interest would: increase their borrowing costs; reduce their willingness to invest in infrastructure; and ultimately result in higher state and local taxes – exactly the opposite of what the Trump administration is trying to accomplish with its infrastructure efforts.

**How would changes to the tax code be applied – retroactively or prospectively?**

While it is possible that changes to the tax code could limit or end the municipal interest exemption, the question then becomes: “Will the changes be made on a retroactive or prospective basis?” Many members of Congress have spoken out against retroactive changes (essentially changing the rules after the game has begun) that would undercut the value of existing municipal bonds. Given a strong preference for preserving (grandfathering) the municipal interest exemption on existing bonds and making the changes relevant only to newly-issued bonds, we believe outstanding municipal bonds could increase in value should tax code changes be applied on a prospective basis.
Are there other changes that could impact the municipal market?

Yes, Republicans have placed a high priority on repealing the Affordable Care Act (Obamacare). The ACA provided insurance to millions of Americans who were un- or under-insured, and reduced bad debt and charity care at hospitals in those states that implemented the program. The program also brought billions of dollars of additional spending for an increased number of Americans covered under the Medicaid program. At this point, Republicans in Congress are still grappling with what should replace the ACA and when. We will closely monitor this discussion, as changes in the law may have adverse impacts on many not-for-profit hospitals that issue tax-exempt bonds.
Notice to Non-U.S. Investors:
Columbia Management Investment Advisers, LLC ("Columbia Management"), an investment adviser registered with the U.S. Securities and Exchange Commission, currently maintains licenses only in the United States and would need to determine whether there are any licensing or authorization requirements that would need to be addressed prior to offering its investment management services or entering into an investment management contract outside the U.S. Consultants who use this material with non-U.S. investors are responsible for ensuring that such use is in accordance with local laws and regulations.

Notice to Investors in Australia:
Columbia Management does not hold an Australian financial services license and relies on Class Order 03/824 and/or Class Order 03/1100 in marketing and providing financial services to Australian wholesale clients. This material should only be distributed in Australia to “wholesale clients” as defined in Section 761G of the Corporations Act.

Australian clients will not receive the benefits of the Australian law and licensing regime with respect to investment management activities undertaken with Columbia Management Investment Advisers, LLC, but are entitled to and will be treated as having the benefit of the equivalent U.S. law and regime.

Notice to Investors in Canada:
Columbia Management Investment Advisers, LLC (the “Adviser”) is resident outside of Canada and has its head office in the United States. The Adviser is not registered in any category in any jurisdiction in Canada. It may be difficult to enforce legal rights against the Adviser because it is resident outside Canada and all or substantially all of its assets may be situated outside of Canada.

Notice to Investors in China:
This document contains information on Columbia Management’s investment management and investment advisory capabilities but should not be regarded as providing investment advice or market research or a direct solicitation. Columbia Management is not licensed in the People’s Republic of China ("PRC") and may provide investment management services in PRC only to Eligible PRC Investors on a cross-border basis.

The contents of this document have not been reviewed by the China Securities Regulatory Commission or any other relevant regulatory authority in the PRC. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. This document does not constitute any offer of securities, whether by sale or subscription, in the PRC.

Notice to investors in the Netherlands:
As an investment adviser, registered with the U.S. Securities and Exchange Commission, Columbia Management Investment Advisers, LLC is exempt from Section 2:96 of the Act on Financial Supervision based on Section 10, subsection 1 of the Exemption Regulation.

Notice to Investors in the United Arab Emirates:
This document and the information contained herein is for informational purposes only, and does not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. This document has not been approved by the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. The document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). No transaction will be concluded in the UAE. Any enquiries regarding the information contained herein should be made to Columbia Management in the United States.
Notice to Investors in the United Kingdom:
Columbia Management Investment Advisors (CMIA) is not registered with the FCA. This document concerns CMIA and in the UK is directed at and is for distribution only to persons who (a) have professional experience in matters relating to investments and who fall within the description of investment professionals contained in Article 19 of FSMA (Financial Promotion) Order 2005 (the “FP Order”), (b) are persons who are high net worth companies, unincorporated associations, trustees and other persons who fall within the exemption contained at Article 49 of the FP Order, or any other exemption to section 21 of FSMA (all such persons being referred to as “relevant persons” and (c) other UK investors who request investment services directly from CMIA without any solicitation involved by CMIA. Transmission of this document to any other person in the United Kingdom is unauthorised and may contravene FSMA. Any investment or investment activity to which this document relates is available only to relevant persons, and this document should not be relied or acted upon by other persons.

Most if not all of the protections afforded by the UK financial services regulatory system will not apply to investment management activities undertaken with CMIA. Clients will not benefit from any protection afforded by the UK Financial Services Compensation Scheme.

Notice to Investors in Hong Kong:
This document has not been registered by the Registrar of Companies in Hong Kong ("HK"). In addition, this document may not be issued or possessed for the purposes of issue, whether in HK or elsewhere to any person unless such person is outside HK, such person is a “professional investor” within the meaning of the Ordinance or as otherwise may be permitted by the Ordinance. Columbia Management is not licensed in HK.

Notice to Investors in Malaysia:
This document is not reviewed or approved by any regulatory authorities in Malaysia ("MY"). As the Recognition by the Malaysian Securities Commission pursuant to Section 212 of the Malaysian Capital Markets and Services Act 2007 has not been and will not be obtained, any funds mentioned herein are not being and will not be deemed to be issued, made available, offered for subscription or purchase in MY and neither this document nor any document or other material in connection therewith should be distributed, caused to be distributed or circulated in MY, save and except to individuals or other legal entities who fall under Paragraphs 3(a), 4, 5, 6, 10, 13 and 24 of Schedule 6 to the Capital Markets and Services Act 2007.

Notice to Investors in Taiwan:
This document is not reviewed or approved by any regulatory authorities in the R.O.C. This document is made available in the R.O.C. only to banks, bills houses, trust enterprises, financial holding companies and other qualified entities or institutions and other entities and individuals meeting specific criteria (“Other Qualified Investors”) pursuant to the private placement provisions of the R.O.C. Rules Governing Offshore Funds. Persons who come into possession of this document are required by the issuer and its representatives to observe these restrictions. Columbia Management is not licensed in the R.O.C.