12-10-2024

WSJ Print Edition

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What the Trump TaxCutsMeanfor TheDeficitandYour Bond Portfolio

The deficit is likely to rise a lot more, and inflation could prove stubborn, leading to higher interest rates. How investors can protect themselves.

BY AMEY STONE

Tax breaks are nice, but the question of how to pay for them is looming larger among investors now that Donald Trump has been re-elected president. Deficit spending has gone on for years and sparked occasional bouts of hand-wringing, but not real economic or market shocks.

That could change as investors learn more about what a second Trump administration means for the nation's finances. It's too early to tellwith any certaintyhowthingswill playout, but taking campaign promises at face value and noting that Republicans control Congress, investors can take a stab at forecasting the potential economic impact of Trump tax-cut plans and what they might mean for deficits, Federal Reserve interest-rate policy, and bond markets.

Expect "growth, inflation, the Fed cutting less, and upward pressure on bond yields," advises Gene Goldman, chief investment officer at Cetera Financial Group. " The good news is that markets have priced a lot of this in already."

The benchmark 10-year Treasury yield jumped from 4.3% to 4.5% in the 10 days after the election before slipping back to the 4.3% range. It has been rising steadily from a low of 3.6% in mid-September, when the Federal Reserve slashed short-term rates by 0.5%. "There is significant demand forTreasuries at this level, so I don't see the 10-year Treasury yield going much higher," says Goldman. "It is likely cappedat 4.5% to 5%."

Tax-cut conundrum. Trump plans to extend his 2017 package of tax cuts and potentially enact some new ones that would increase the already alarming deficit ($1.8 trillion in the fiscal year ended in September, or 6% of gross domestic product). But it's early to say how much cost-cutting will happen or how much revenue Trump's planned tariffs will generate.

"My base case is that we get tax cuts and some spending cuts, but that in 2025 there isn't too much change in the fiscal situation," says Shannon Saccocia, chief investment officer at Neuberger Berman Private Wealth. "I don't see 2025 as

the year when we have to find religion."

Rather than the deficit, the larger nearterm risk to the bond market is inflation and interest-rate policy. An increase in inflation could prompt the Federal Reserve to hike rates in 2025, rather than cut more, which it is currently positioned to do. Already the Fed is easing less than originally forecast. " The economy is not sending any signals that we need to be in a hurry to lower rates," said Fed Chair Jerome Powell during a speech in Dallas in mid-November.

Higher rates would increase the nation'sinterest expense, whichisestimated to total $882 billion this year, more than spending on the military. Trump is unlikely to get the tax breaks he wants without cutting government spending, and there just aren't a lot of places to cut significantly. The biggest government expense is Social Security, which is considered untouchable.

Buckle up. If the Trump administration tries to overtly force the Fed to lower interest rates, markets can be expected to revolt because the Fed is supposed to be independent and free from political pressure. Powell, whose term ends in May 2026, has already said he will stay at the job, and Trump's advisors have openly discussed appointing a "shadow Fed chair" ahead of that. It's too soon to tell how pitched this battle becomes.

Suffice it to say, investors will have to wait and see but should expect a fair amount of market volatility, and in that context, bonds are a great place to be. Their traditional role is serving as ballast in a portfolio, insulating investors from the wider swings of the stock market. As worrisome as U. S. budget deficits are, Treasuries are still a haven when increasing government debt and authoritarian leadership are global phenomena.

For safety, money-market funds, which recently reached a record $6.7 trillion in assets, are attractive at an average yield of 4.5%, according to Crane Data. Longer-term Treasuries are risky because their prices will fall if yields rise, but if the 10-year gets to 5%, they could be worth buying.

Saccocia favors high-quality corporate debt. These bonds yield on average about 4.5%, a lowyield spread over Treasuries. "Spreads are tight, but corporate balance sheets are strong, and absolute yields are pretty attractive."

Private credit, which is generally available only to accredited investors, is a category that offers attractive yields and can insulate investors from some of the swings of public markets. These investments are floating rate, and the pickup in yield over bank loans ismeaningful, says Saccocia. The Cliffwater Direct Lending Index returned more than 9% a year in the past five years.

Collateralized loan obligations, or CLOs, are securitized bundles of loans that can be bought at a range of credit risk (riskier ones yield more). The triple-A-rated packageofCLOsinthe Janus Henderson **AAA CLO** exchange-traded fund currently yield 6.3%.

A nod to munis. Municipal bonds dipped in pricewhenTrumpwon because of expectations that he will lower taxes, making munis' tax-exempt status less valuable. But they are still attractive, with a roughly 3% yield that translates into a 6% yield on a tax-equivalent basis for investors in a high tax bracket.

"Anytime tax reform or policy changes are discussed, it creates anxiety in the muni market," says Duane McAllister, whoco-leads themuni teamatBairdAsset Management and is a portfolio manager on its highly rated fund, **Baird Strategic Municipal BondInvestor .** "I expect that to be the case aswe head into 2025."

But if muni yields rise, that would be an opportunity, McAllister says. Municipal finances are strong, andstate and local governments generally can't run deficits. "With munis, investors can get 6% or more on a tax-adjusted basis, and that's awfully attractive in today'sworld." B

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