
Citigroup, Barclays Warn of Muni Bond Selloff If GOP Wins Big.

- **But analysts see it unlikely Republicans will gain in election**
- **If they do, it could trigger repeat of post-Trump market rout**

The municipal-bond market has pre-election jitters.

That's understandable: President Donald Trump's surprise victory in 2016 drove state and local government debt to its biggest monthly loss since the 2008 credit crisis on speculation that his fiscal policies would fuel an increase in inflation. Both Barclays Plc and Citigroup Inc. strategists warned clients in notes this week that if Republicans buck forecasts and win big, it could cause another sell-off, just as the bond market is steadying from the one that erupted earlier this month.

Barclays strategists say that if the GOP maintains control of the House and Senate, yields could increase significantly in what could be "a rather dramatic move" due to the risk of lawmakers enacting more tax cuts. A Republican majority could be especially bad for debt issued by hospitals, given the potential for lawmakers to try to repeal the Affordable Care Act again, they said.

"In essence, this would be a repeat of the late-2016 sell-off, but on a smaller scale," wrote Barclays analysts led by Mikhail Foux.

After the 2016 election, state and local debt posted a loss of 3.7 percent in November, the biggest since September 2008, according to Bloomberg Barclays indexes. There hasn't been as bad a loss since.

Citigroup analysts led by Vikram Rai said most forecasters expect Democrats to win control of the House and Republicans to hold the Senate, a scenario that would pose no significant risks to municipal bonds given that the opposing sides would be unlikely to agree on big policy changes. Barclays said its baseline scenario is for a similar outcome, which it says would likely cause yields to decline slightly.

But Citigroup analysts said that if Republicans retain a "decent" majority in the House, that may lead investors to anticipate another round of tax cuts, which would diminish demand for tax-exempt bonds.

"That could spook investors into selling tax-exempts. And this kind of selling could not come at a worse time since the Treasury sell-off and the ensuing mutual fund outflows have already depressed annual returns," they wrote.

Representative Kevin Brady, the chairman of the House tax-writing committee, said Tuesday that Republicans will advance a 10-percent tax cut aimed at middle-income earners if they retain control. Changes to the tax code are viewed as a threat to the state and local government debt market because lower tax rates — such as the corporate rate cut last year — can translate into less demand for the tax-exempt income that the debt provides. There's also the risk that lawmakers could seek to tax income on municipal bonds to offset the cost of other cuts.

Some investors with election worries might be selling their holdings, given that mutual funds have seen cash pulled out for four weeks straight. Given the risk of an unexpected outcome on Nov. 6, Barclays said “it makes sense to lighten up” on state and local debt.

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