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[Why a Democratic Wave Could Be Good for Muni Investors.]

Muni investors should be rooting for a Blue Wave.

The midterm elections are around the corner, and the stakes are high. The market's consensus — as seen on prediction markets on Hypermind — is that the Republicans will keep the Senate, but lose the House to Democrats.

That might be good news for buyers of state and local debt, according to the muni research team at investment bank Barclays .

If Democrats gain control of one or both chambers, "we think that muni yields would likely decline slightly, outperforming Treasuries, as concerns about new tax reforms would be largely put to rest for now," Barclays researchers led by Mikhail Foux wrote in a note dated Oct. 23. A "Blue Wave" is their baseline scenario.

But the alternative — a "Red Wall," if Republicans keep control of both chambers — would send yields "significantly" higher, they wrote.

"Given that this outcome has largely not been priced in, we envision a rather dramatic move, with health-care credits likely underperforming. In essence, this would be a repeat of the late-2016 sell-off, but on a smaller scale."

That would likely result in an expansion of the president's policy agenda, including more restrictive moves in trade with China, Europe and other trading partners, as well as immigration at U.S. borders, they wrote. And Republicans may try for a second round of tax cuts, to push the buoyant economy beyond the 2020 presidential election. But, the researchers wrote, "the legislative path to pass another round of tax cuts could be tenuous."

With a wide band between those potential outcomes, they recommend easing up on munis going into next month, especially in health care, and hedging with Treasuries.

As for the various races for governor seats, the Barclays strategists see Democrats adding three, with eight others so far too close to call. But any effect will be minimal, they say: "Given that most states are in relatively good financial shape, we do not believe that most of these races will have any meaningful effect on credit spreads."

General obligation bonds in Illinois and Connecticut "might have room to tighten," they say.

With the third quarter's strong economic growth boosting tax revenues, U.S. state budgets are actually in decent shape, according to a new report by S&P Global Ratings.Trade tensions with China won't hurt the overall U.S. economy too much, but that's not true for some states and regions, they said. S&P Global also says that it will be watching for a slowdown in housing permits.

"The positive tone should persist at least through the next six months-to-one year," S&P Global Ratings analysts led by Gabriel Petek said in the report. But, they wrote, some of the gains, and the resulting increase in tax receipts, may be the product of a bunch of one offs that are not sustainable — like the federal tax cuts combined with higher federal spending. That effect will likely fade in the coming months, they said.

S&P's economists revised their projection for real GDP growth in 2018, expecting a 2.9% increase instead of the 3% they forecast in June due to the trade dispute with China and the economic activity lost in the wake of Hurricane Florence. Hurricane Michael could weigh on GDP growth in the final quarter this year, they wrote.

S&P Global expects economic growth to slow to 2.3% in 2019 and 1.7% in 2020; as the expansion drags, a "renewed fiscal strain" will start to show across states.

"The currently more favorable macroeconomic backdrop presents a window of opportunity for state and local governments to consolidate," according to S&P Global, "more than it does a new baseline."

Barron's

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