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Tax Break's Escape Might Lessen Pressure to Sell: Bloomberg Muni Credit.

For the $3.7 trillion municipal bond market, Washington's political divide may be a good thing.

The coming year's congressional elections weaken chances of a far-reaching tax-code overhaul that would roll back the break for buyers of state and local-government debt, said analysts including Morgan Stanley Wealth Management's John Dillon and Matt Posner, who follows federal policy for Municipal Market Advisors. That may aid a market hit by losses this year as investors pulled out money amid speculation about rising interest rates and mounting distress in governments such as Puerto Rico's.

"The likelihood of any changes to the treatment of the municipal bond tax exemption in 2014 are dim," said Posner, whose firm is based in Concord, Massachusetts. "This Congress is unable to get much done at all."

A change to the century-old tax break to state and local government debt would weaken the value of the securities, which sell for higher prices than other bonds because investors don't have to pay federal taxes on the income. The subsidy also pushes down costs for states and cities, which borrow to pay for roads, schools and other public works.

Little Emerges

The possibility that the tax exemption could be eliminated or curtailed has persisted in Washington since 2010, when the leaders of President Barack Obama's deficit-cutting commission proposed eliminating it as part of a broad package of changes. The following year, Obama sought to curb its value to the wealthiest taxpayers to raise revenue, a proposal that the administration has continued to endorse.

None of the proposals has advanced in Congress. The enmity between the Republican-led House and the Democrat-run Senate made 2013 its least productive first year of any session in three decades, based on the number of laws passed, according to GovTrack, which follows legislation.

Yet the risk that Congress could roll back the exemption unnerved investors. Posner, the bond analyst, said it's one reason that the gap between short- and long-term interest rates in the tax-exempt market is wider than for bonds that don't carry the tax break. That reflects the risk of holding debt that will mature years from now. He said it may also be one reason why investors have been pulling money from municipal bond mutual funds, which lost $26 billion from March through September, according to Federal Reserve data.

"Just the uncertainty has to make for some selling pressure," Posner said.

Fresh Love

Spurred by such selling, muni performance is set to trail stocks, commodities, Treasuries and corporate bonds this year, according to data compiled by Bloomberg and Bank of America Merrill Lynch. Munis have declined 0.9 percent, after adjusting for the volatility in trading, the numbers show.

The diminished chance that Congress may succeed in rewriting the tax code may help municipal bonds. David Litvack, head of tax-exempt bond research at U.S. Trust, a New York-based unit of Bank of America Corp., said the advantages of municipal bonds may become more apparent as investors file their taxes for 2013, when the top tax bracket rose.

“We don’t see much incentive in an election year for politicians to compromise,” Litvack said. “Barring an unexpected sweep by the Democrats in the House of Representatives so that they would get a majority, we don’t see the same thing happening for the next two years as well.”

Danger Diminished

There are other obstacles. Senate Finance Committee Chairman Max Baucus, who has led efforts to change the tax code, is becoming ambassador to China. His counterpart in the House, Ways and Means Committee Chairman Dave Camp of Michigan must step down in 2014 because of Republicans’ six-year term limit for committee leaders. The budget agreement signed by Obama, which fixes spending targets through fiscal 2015, has also removed pressure to deal with spending.

John Dillon, head of muni strategy at Morgan Stanley Wealth Management in Purchase, New York, said the market’s dominant concern is the threat of rising interest rates, which would reduce the value of outstanding bonds. Still, he said, the diminished risk to the tax exemption should help demand.

“It don’t think the threat goes away, but it’s mitigated for 2014,” he said.

In trading yesterday, the interest rate on AAA 10-year local securities was 2.93 percent, little changed from Dec. 27, according to Bloomberg data. The ratio of the yield of munis to U.S. Treasuries of comparable maturity, a measure of relative value, was about 98.6 percent, near the lowest since June. It compares with a five-year average of 102 percent. The smaller the number, the more expensive munis are compared with federal securities.

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