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Municipal Bonds Have a Lot Riding on Race for the White House.

Will Hillary Clinton pump money into infrastructure as president? Will GOP presidential front-runner Donald Trump? Is the tax-exempt status of municipal bonds under a new Congress in jeopardy?

Those are all pressing postelection questions that could shape the outlook for municipal bonds.

Municipal bonds—typically used to fund infrastructure products, including bridges, tunnels and sewers—were the best performing fixed-income assets in 2015, posting a 3.3% return, even as the Federal Reserve raised interest rates for the first time in nearly a decade in December.

But as the race for the White House heats up, questions abound for the muni market.

Munis stand to outperform other fixed-income categories again in 2016, said Peter Hayes, head of the municipal bonds group, and Sean Carney, head of municipal strategy at BlackRock BLK, -0.25% in a research note first issued in January and backed in an early-March update.

That's good news for wealthy investors who tend to scoop up these bonds for their tax advantages—for qualifying filers, munis are exempt from certain state and local taxes. Modest inflation could help, too, increasing the allure of tax-exempt munis relative to their taxable federal-issued and corporate-issued brethren, all things being equal. Rising inflation can erode spending power on your bond's income over time.

However, for state and local governments, political uncertainty could sideline muni issuance. And for income-focused investors who need these tax-exempt bonds to lower their tax bills, limited supply may frustrate.

Against that shifting political and regulatory backdrop, here are some key election-related factors to keep an eye on:

Clouds for that rainy-day fund?
For states and municipalities, the political climate, for instance the likelihood for easier taxing capabilities, typically impacts decision-making on capital projects that are penciled in for several years out from an election, said Justin Marlowe, public finance professor at the University of Washington's Evans School of Public Policy and Governance. The presidential election isn't likely to sway decision-making on bond issues spanning even two to five years from an election year. Those plans are already baked in, he argues.

But issuers do care now about the future cost of capital, and they may be inclined to try to lock in bond offerings sooner versus later, Marlowe said.

Private-public blend?
On the national landscape comes the potential for new or expanding infrastructure financing tools. They made their way into the Obama administration and could have legs for the future, says

Marlowe. One such program, Build America Bonds (BABs) were created to supplement state and local government's capacity to access conventional corporate debt markets for public infrastructure instead of issuing traditional tax-exempt debt. Will they stay around? Clinton, for one, has called for the creation of a national infrastructure funding bank to help pay for transportation projects. Muni-market trade publication "The Bond Buyer" has declared Ohio Republican presidential candidate Gov. John Kasich and Democratic Sen. Bernie Sanders as the friendliest candidates for infrastructure funding. All told, analysts think that private-public financing options could gain increasing attention, which could limit the number of more traditional bonds coming to market.

Obamacare

Candidates including Trump and his Republican presidential rival Sen. Ted Cruz have threatened to scrap Obamacare. "Easier said than done," said Marilyn Cohen, chief executive officer of bond-focused Envision Capital Management. "But it is true that the challenge of funding Obamacare has impacted the fiscal profile of issuers including medium and small hospitals and so this is a national issue that trickles down to the states and locals."

The economy, stupid

Whether talking about bond issuance or job creation, the economy is a major differentiator in this and any election. Think China and global trade issues can't touch munis? Think again. "State economies are deeply dependent on exports in ways that wasn't really the case 10 years ago," said Marlowe, who points to Washington state's export-led production of software, aircraft, and more. "Even if local economy fundamentals are solid, the tie-up with Asian markets could have a 2% to 4% impact on local tax collection in Washington state, for example," said Marlowe, whose University of Washington posting affords him this vantage point. It is also true that state-specific issues, including the budget and economic toll of unfunded pension liabilities in Illinois, can ramp up attention on state and local elections in determining the winners and the losers in the muni-bond market.

The next administration and congressional makeup could have a thing or two to say about the complexity of e-commerce taxation after Amazon.com AMZN, +0.00% has blown up the model, according to Marlowe. States, including Michigan, Colorado and Alabama, are trying to circumvent high-court rulings on cross-state taxation. Sales tax can be one of the major revenue streams that finances public debt, including muni bonds. "This is a macro trend that alone is a huge source of uncertainty and certain to feature in a new congress," Marlowe said.

Also, Sanders and other lawmakers have questioned the fairness of tax exemption for muni holders. It is a "trial balloon" floated from time to time in Congress and elsewhere that has so far been mostly hot air. A study commissioned by the International City/County Management Association and the Government Finance Officers Association, argues that because investors don't have to pay an income tax on their interest earnings from the bonds, governments can pay off their bonds at a lower interest rate than they would otherwise. In other words, muni bond issuers can compete with the often higher yields on corporates or Treasury bonds. The tax-free status of municipal bonds saved governments an estimated $714 billion in extra interest payments from 2000 to 2014, according to the report. Without the benefit, a typical bond issue would cost $80 to $210 in added interest per each $1,000 of borrowed money.

Loss of the exemption "could crush the states' [post tax-benefit] competitive yields compared to corporate bonds," says Envision's Cohen. "You could have governors storming the White House and that may keep this topic a non-starter. Washington will have bigger problems than it."

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