Municipal Market Braces for Wave of Debt Amid Trump Selloff.

The global bond rout couldn't have come at a worse time for the U.S. municipal market.

State and local government bonds dropped by the most in more than three years since the Nov. 8 election amid speculation that President-elect Donald Trump's plan to slash taxes and unleash a new wave of spending will spur inflation and weaken demand for the tax-exempt securities. That's coming just as municipalities are forecast to keep selling new debt at a swift pace after voters approved at least $55 billion of borrowing at the polls, threatening to put further pressure on prices.

"You have all these factors in play at a time when more supply is going to be trying to come to the market," said Peter Hayes, who oversees $120 billion as BlackRock Inc.'s head of munis. "That typically is not very good," he said. "I suspect demand next year is not going to be as strong."

The election fallout is threatening to wipe out gains posted in the municipal market this year as the Federal Reserve held off on raising interest rates. Since last week's election results, the securities have lost 2 percent, cutting this year's return to 1.1 percent, according to Bloomberg Barclays municipal index. The yields on benchmark 10-year debt soared Monday by 0.2 percentage point to 2.13 percent, the highest since December, before steadying early Tuesday. It was the biggest one day jump since June 2013.

Trump's tax plans pose a unique risk to the $3.8 trillion municipal market, which is dominated by investors seeking returns that are exempt from federal income taxes. That benefit makes the securities less valuable when levies are lowered.

With Congress also in Republican control, Trump has made reducing taxes one of his first priorities. He has backed cutting rates across the board, including on wealthy households that are key buyers of municipal bonds.

"Any or all of these tax policy changes, if implemented, would likely raise issuers' borrowing costs and depress market prices of existing coupon munis as investors no longer seek out the exemptions offered by munis," Peter Block, managing director for credit strategy at Ramirez & Co., wrote in a note last week.

Any sweeping overhaul could also result in the elimination — or reduction — of the tax-exemption on municipal bonds, if lawmakers close loopholes to offset cuts elsewhere. The leaders of President Barack Obama's deficit-reduction commission recommended taxing the income on municipal bonds in 2010, though the proposal never made headway in Congress.

"It may find itself in jeopardy if and when loopholes start to close," Vikram Rai, head of municipal strategy at Citigroup Inc., said in a note last week.

Besides, more bonds may be on the way if Trump follows through on proposals to pump as much as $1 trillion into crumbling roads and bridges. While the construction would give a boost to local economies, it's not clear how much — if any — of that would come from borrowing by states and localities, as was done under part of Obama's stimulus program.

"It remains to be seen if states primarily are going to have to pick up some of the tab for infrastructure, or it's going to be a partnership or it's going to be more private sector involvement," said Block of Ramirez. "The details are too thin."

Some of the pressure on the municipal market could be eased if rising interest rates cause local governments to put the brakes on borrowing. This week, for example, Chicago's school district postponed a $426 million sale due to market conditions, with plans to potentially revive it next year.

The selloff in the bond market "could be a buying opportunity," said Dawn Mangerson, a managing director at McDonnell Investment Management, which oversees about $7.6 billion of tax-exempt debt. "Even if they put through some type of reform, the attractiveness of munis is still going to be there."

As the growing economy lifts their tax collections, localities have been moving forward with plans to improve their fraying infrastructure, with many rushing to borrow before the Fed raises interest rates as soon as next month.

Issuers have sold about $390 billion in bonds this year, marking the fastest pace since 2010. Citigroup forecasts that sales may reach $430 billion, while Ramirez projects about $450 billion.

"It looked like based on this year, next year was certainly setting up to be another big year of issuance," said BlackRock's Hayes. "The offset to that is when interest rates go up, you'll actually see less issuance. Borrowers are more averse, they may wait."

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