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These Bonds Could Benefit From a Democratic Sweep.

Hint: They tend to attract more buyers when taxes rise.

The results of the 2020 election could have a dramatic impact on the municipal bond market.

If Joe Biden wins the presidency and if the Democrats take control of the Senate, marginal tax rates for the wealthiest Americans could rise, increasing demand for munis, whose interest payments are exempt from federal income taxes and from state taxes for residents of the issuing state.

Under Biden's tax plan, individual taxpayers earning more than $400,000 annually would be taxed at 39.6%, up from 37% currently, and subject to an additional 12.4% Social Security tax on wages split equally with their employer. If they itemize deductions (which Biden's plan caps at 28%) and live in a high-tax state like California, their total tax burden would be close to 60%, providing them a tax-equivalent yield of 5.625% on a California muni yielding 2.25%.

A Democratic sweep could also help shore up the finances of state and local governments, which would support muni credits. Congress then would be more likely to pass an economic aid package that would provide billions of dollars for state and local governments, which has been a key sticking point in recent stimulus negotiations between Republicans and Democrats. Those talks have so far failed to develop a compromise plan. Moreover, If the pandemic worsens, as it's expected to, the financial needs of state and local governments will increase.

James DiChiaro, senior portfolio manager at Insight Investment, said financial markets are now pricing in a higher probability of a Democratic sweep and probability of stimulus, which is why interest rates have been rising in the past week. The 10-year Treasury yield on Friday topped 0.85% in intraday trading on Friday, its level since June.

"Solid fund flows [for muni bonds] through the fall" also suggest that investors expect a blue wave in the upcoming election, said Rabasco. He explained that higher tax rates for wealthier individuals coupled with higher tax rates on corporations — Biden plans to raise corporate tax rates from 21% to 28% — also boost support for muni bonds.

Corporations, saddled with higher tax rates could also be attracted to the tax-exempt income that muni bonds provide. Banks and property and casualty insurers especially would tend to be attracted to munis, according to AllianceBernstein.

Even if there is no Democratic sweep in the upcoming election and the federal government remains divided, demand for munis will still be strong because the limits on state and local tax (SALT) deductions will remain. Those limits, set by the 2017 tax overhaul, "drove a lot of demand in the marketplace," said Rabasco, adding that there has been "solid fund flows" for munis through the fall.

He expects state and local governments will adopt austerity measures and debt financing if there is no strong federal support for their finances.

On the opposite end of the bond market outlook post election is the Commercial Mortgage Backed

Securities (CMBS) market, which supports commercial real estate. “I would feel a lot more comfortable investing in CMBS if I was working out of an office building now,“ said DiChiaro.

He said it was a “bit early to go heavily into CMBS right now” because of the impact the pandemic is having on commercial real estate hough data warehouse credits have attractive values.

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