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Why a Blue Wave Could Boost the Municipal Bond Market.

The $3.9 trillion municipal bond market could be a big winner if Democrats sweep the White House and both houses of Congress. Such a "blue wave" scenario is now given odds of better than 50% in betting markets.

The muni market would benefit in multiple ways. Financially strapped state and local governments could be expected to get relief from a stimulus bill along the lines of the $2.2 trillion bill that passed the House of Representatives, providing about $436 billion to them.

"A Democratic sweep is a grand slam for state and local governments," says Dan Clifton, head of policy research for Strategas. He points to a stimulus bill and the prospect of additional federal Medicaid funding for states, as well as the potential reinstatement of full deductibility of state and local taxes.

Such a move could curb the flight of wealthy residents from high-tax states like California, New York, and New Jersey to places like Florida and Texas, which have no income taxes.

Joe Biden wants to raise the top federal income-tax rate back to 39.6% from 37%, and that would enhance the allure of munis for individuals. Biden also wants to raise the corporate tax rate to 28% from 21%, and that would probably increase demand from corporations for muni debt.

"If we get a blue wave, it's likely that tax-exempt bonds would do very well," says Peter Hayes, head of the municipal bond group at BlackRock. "Munis are very cheap and are not factoring in higher tax rates."

Triple-A-rated 10-year munis now yield about 0.95%, 110% of the yield on the 10-year Treasury note, now at 0.85%. That is a high percentage relative to the past 20 years. It has usually been below 100%.

The yield on the 10-year muni is up from a low of 0.55% in August but is historically low, dampening demand from individual investors. Hayes sees a favorable backdrop for the rest of the year.

Muni issuance was heavy in October, at about $70 billion, although a growing chunk of that—now about 30%—is in the taxable muni market. Muni supply is expected to fall in November, and that could bolster the market.

While state and local governments are apt to get more financial relief from a Democratic-controlled Washington, long-term fiscal challenge stemming from the pandemic are likely to persist. Barron's highlighted this risk in a cover story in August.

"There's an enormous loss of revenue going on, and we don't know how long it will last," Richard Ravitch told Barron's at that time. Ravitch is the former Metropolitan Transportation Authority chairman who helped pull New York City back from the brink of bankruptcy in the mid-1970s. He is now director of the Volcker Alliance, a nonprofit group that advises on effective government.

The metropolitan New York area has been hard hit economically by Covid-19. Moody's Investors Service recently downgraded the credit ratings of New York City, New York state, and the Metropolitan Transportation Authority, which operates the city's subways, buses, and commuter rail networks.

The city and state remain highly rated at double-A2, while the MTA, which faces a grave financial outlook because of sharp declines in ridership, has a still-solid investment-grade rating of single-A3.

Reflecting fears about the region's outlook, long-term New York City debt yields about 2.5% and MTA debt yields 4%. That compares with a yield of about 1.75% on top-grade long-term munis.

Investors, however, may want to steer clear of MTA bonds, given the agency's high debt load of $44 billion, large projected deficits in the coming years, and a need for federal financial help.

Barron's

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