Bond Case Briefs

Municipal Finance Law Since 1971

Muni Bonds Falter on Prospect of Divided Government in Washington.

Generous aid to state and local governments is less likely if Democrats fail to control both White House and Congress

The prospect of a divided government in Washington has been received rapturously in the stock market this week, but it hasn't made municipal-bond investors happy.

"It's probably one of the more negative outcomes for the asset class," said Mikhail Foux, head of municipal strategy at Barclays PLC.

Prices on bonds issued by states and local governments fell relative to Treasurys in the immediate aftermath of the election and then rebounded, but didn't receive the big bump many analysts had expected would follow in the event of a sweep by Democrats.

Yields on 10-year AAA, tax-exempt municipal bonds were 109.1% of 10-year Treasury rates Wednesday, up 2.4 percentage points from Tuesday, according to Municipal Market Data, reflecting an increase in investor concern about the risk of munis relative to U.S. government bonds. Yields fall when prices rise.

The importance of the Senate to muni prices was made clear as the week wore on. By Friday yields had slipped to 99% of 10-year Treasury rates as results in Georgia pointed to potentially two runoffs that could hand the Senate majority to Democrats come January.

For muni-bond investors, a divided government diminishes the probability of two scenarios that would have likely driven a rush into the asset class.

A Democratic sweep could greatly increase the prospects for a large state and local-government aid package meant to solidify the finances of many of the municipalities that have been crushed by the impact of the coronavirus pandemic. In addition, a Democratic House and Senate could raise the likelihood of large income-tax increases that would make tax-exempt munis more desirable to investors.

Also weighing on munis was the possibility that the bonds of Illinois could be rated as junk after voters there rejected a plan for a statewide tax increase on affluent residents.

Analysts and investors said muni bonds tied to sectors most affected by the pandemic such as tourism and mass transit were most likely to be hit by election developments.

Over the past several months, coronavirus budget shortfalls have dragged down the trading price of some municipal bonds, and October data from Municipal Market Analytics show new defaults in the roughly $4 trillion municipal market are at an eight-year high since the start of the pandemic.

Heading into this week, investors had said that muni bonds would rally if former Vice President Joe

Biden defeated President Trump and the Democrats got clear victories in the House and Senate. Under that scenario, the White House and Congress might push for more aid to state and local governments or champion an infrastructure plan or income-tax increases.

But as of Friday morning, closer races and the reduced likelihood of Democratic control of Congress and the White House mean there are likely to be more limits on such moves. Senate Majority Leader Mitch McConnell has said he doesn't favor using federal-assistance money borrowed "from future generations" to fill in state budget gaps.

Moreover, should Republicans maintain control of the upper chamber of Congress, a state and local-government aid package that the Senate might support could drive up the supply of tax-exempt debt, pushing down prices, analysts said. That is because even fairly stable governments might rely more on borrowing to manage through coronavirus-induced shortfalls. About $45 billion in local borrowing measures was on the ballot Tuesday, according to IHS Markit.

One source of new debt would remain limited under a divided Congress, however.

If Republicans stay in control of the Senate, Democrats are less likely to be able to end the ban added by Republicans in late 2017 on tax-exempt refinancing of municipal debt before the agreed-upon refinancing date. That would keep closed one longtime avenue for tax-exempt debt to enter the municipal market, helping to stabilize prices.

Before the ban, state and local governments could reap more savings from early refinancing as rates dropped. Hennepin County, Minn., for example, saved more than $30 million in 2017 by refinancing debt used to help build Target Field, where the Minnesota Twins play.

Many in the market were surprised by an outcome of the Illinois election.

Yields rose by about a third of a percentage point Wednesday on 10-year Illinois general obligation bonds relative to AAA rates and remained at about that same level Thursday, according to Municipal Market Data, after Illinois voters rejected the ballot measure proposing to increase taxes on incomes over $250,000.

A February poll of 1,000 Illinois registered voters by the Paul Simon Public Policy Institute at Southern Illinois University, Carbondale, found that they favored the tax by 2-1. During a state bond sale two weeks ago, investors agreed to prices significantly higher than where the state's debt was trading Wednesday, Thursday and Friday, according to Municipal Market Data and the Municipal Securities Rulemaking Board's Electronic Municipal Market Access platform.

The state tax plan would have brought in more than $1 billion in yearly revenue, according to an estimate by Fitch Ratings. The refusal to approve the tax increases the chances that Illinois, currently rated one notch above speculative grade by multiple credit-rating firms, will become the only U.S. state in junk-bond territory.

"Unless there's a surprisingly large federal stimulus bill or state lawmakers very quickly come up with another solution to raise a lot of new revenue, Illinois is likely to suffer a downgrade from at least one of the rating agencies in the next several months," said Adam Stern, co-head of research at Breckinridge Capital Advisors.

Higher-grade bonds are expected to fare better and could even experience a longer-term bump as investors look to quality credits. The state of Florida, despite a tourism industry suffering from the pandemic, has benefited substantially from aid sent in the spring, said Ben Watkins, director of the Florida Division of Bond Finance.

“It’s been a godsend,” Mr. Watkins said. If cities and states don’t get much more aid, the resulting market distress “will be much more isolated than a widespread problem,” he added.

The Wall Street Journal

By Heather Gillers

Nov. 6, 2020 8:00 am ET