Munis Rally Despite Election Suggesting 'Least Bullish' Outcome.

- **Divided government promises less aid, obstacle to tax hikes**
- **UBS sees 'headwind' for credit quality of muni market**

After Tuesday's election, state and local government bonds staged their biggest rally in more than six months as traders wagered a divided federal government would spend less aggressively — a positive shift for investors worried about long-term inflation.

But municipal analysts say such an outcome, with Democrat Joe Biden in the White House and a Republican-led Senate, is less welcome to the $3.9 trillion market than a clean Democratic sweep.

That's because a political gridlock would likely reduce the scope of the aid state and local governments will get to bridge budget gaps created by the coronavirus shutdowns. It would also reduce the odds of tax increases on the wealthiest Americans, which would make tax-exempt bonds more alluring.

Analysts from UBS AG said Thursday that a divided government increases the credit risk on the bonds, since any aid package is likely to be "less generous." Citigroup Inc. analysts led by Vikram Rai said ahead of the vote that a Biden presidency with GOP control of the Senate was the "least bullish" scenario for the municipal-securities market.

A party split between a Blue White House and a Red Senate would likely mean "legislation for future fiscal aid packages will not flow through easily and aid will be less generous," Citigroup's analysts said. "This would not bode well for municipal credit."

The outcome of the election is still in flux, with ballots being counted in several key states and President Donald Trump pushing legal challenges intended to sway it in his favor. Georgia may also need to hold a second run-off election for one of its Senate seats, which could help tip the balance of power in that chamber to the Democrats.

Treasury yields edged up slightly Thursday. But those on municipal bonds, which are far less volatile, dropped for a second day, with 10-year yields falling 2 basis points to 0.82%. That follows a 9 basis point drop Wednesday, the biggest one-day decline since mid-April.

The results are crucial for states and cities that have been battered as the pandemic cut into two major sources of revenue — income- and sales-tax collections — while the coronavirus drove the economy into the deepest downturn since World War II. That's left states and local governments facing combined shortfalls of $450 billion through fiscal 2022, according to a September estimate by Moody's Analytics.

Extending them federal aid was a key sticking point in negotiations over a new stimulus bill ahead of the election, with Trump mischaracterizing it as a bailout of states run by his Democratic foes. House Democrats included $1 trillion of such aid in the bill they passed.

“Fiscal stimulus to state and local governments is now expected to be less generous than under a Blue Wave scenario,” wrote analysts at UBS’s wealth management arm in a note published Thursday. “This represents a headwind for municipal credit quality.”

Biden’s campaign has reiterated that state and local government aid would be central to his economic stimulus. Jared Bernstein, a senior economic adviser to the campaign, said such aid is a high “fiscal multiplier” and would help to build “a fiscal bridge to the other side of the crisis.”

Such aid would prevent the need for large budget cuts, tax increases or layoffs that would deal a further setback to the economic recovery. It could also prevent a surge of borrowing by some states to temporarily paper over their shortfalls, which could put pressure on their credit ratings.

Kentucky Senator Mitch McConnell said on Wednesday it’s a “possibility” that he would support more aid for states and cities.

Lyle Fitterer, co-head of municipal investments at Robert W Baird & Co Inc speculates that a state and local government stimulus would be around $250 billion under a divided government.

“We would still argue that that’s plenty and that’s sufficient until we see what’s going to happen to the economy from a longer term perspective, so that gets them over the hump for the next year,” he said in an interview.

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