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How the U.S. election may shape the muni market



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The results of the November U.S. presidential election will have policy implications for the municipal bond market and its issuers. But these changes should not materially affect the prospects of essential service providers or the fundamental tax advantages of muni income. Here we explore the potential effects on select muni bond sectors, as well as how changing tax policy could affect the asset class.

KEY TAKEAWAYS

- Hospitals with strong credit quality, robust liquidity and leading market positions should successfully manage through any policy changes.
- The election outcome could influence funding for K-12 schools as well as student demand and endowment spending for higher education.
- Electric utilities and water/sewer systems are well positioned to navigate potential policy changes given their essential service mission, monopolistic market positions, independent rate setting ability and strong liquidity.
- Policies related to tariffs, housing and immigration could be meaningful, particularly for ports; affordable and multifamily housing projects; and large cities impacted by the migrant crisis.
- Higher taxes should heighten demand for muni bonds, as tax exemption becomes more valuable at higher tax brackets.
- Most muni issuers are essential service providers, thus the bonds they issue are typically highly insulated from the operating environment.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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MANY MUNI SECTORS SHOULD REMAIN UNAFFECTED

We do not expect essential service providers, especially those funded with local tax revenues, to be materially affected by policy changes at the federal level. Many muni issuers benefit from broad autonomy and local control, providing relative stability and certainty regarding revenues pledged to debt service. Municipal bonds backed by property taxes, dedicated state and local taxes, transportation revenues, tolls or project-specific revenues should remain relatively insulated from election outcomes.

SELECT SECTORS MAY BE INFLUENCED BY FEDERAL POLICIES

Potential shifts in federal government policies and spending may have a greater impact on specific municipal bond sectors.

Not-for-profit hospitals

Focus: government funding of hospital systems

The federal government plays an important role in setting policy and funding levels for hospitals. The financial strength and performance of many hospital systems is impacted by Medicaid and Medicare reimbursement, which comprises more than half of patient revenue for most hospitals. Federal legislation sets reimbursement rates.

A Republican sweep of the White House and Congress may signal an easier path for M&A activity due to less focus on regulation, which could support smaller, struggling hospitals seeking partners. But it could also mean a shift toward more privatization of government funding, with insurers playing a larger role in administering Medicare and Medicaid.

This could challenge hospital profitability, as it may mean less negotiating power and lower reimbursement rates in dealing with private insurers, particularly for single site, smaller hospital systems.

Alternatively, a Democratic sweep could mean stricter regulation and less M&A activity, making it more challenging for weaker hospital credits to partner with stronger systems. In a divided government scenario, we expect no major changes in government funding, maintaining the status quo for hospital systems and state budgets.

TAKEAWAY: *Hospitals with strong credit quality, robust liquidity and leading market positions should successfully manage through any policy changes.*

Public school districts, charter schools and higher education

Focus: school choice, student loan forgiveness, taxing of endowments and funding for community colleges

Education funding is mainly determined at the state and local level, but federal policies can influence public K-12 school districts, charter schools and higher education institutions.

With Republican control of the presidency and Congress, school choice policies could gain momentum, bolstering support for charters and other school choice initiatives and potentially supporting further redistribution of funding for K-12 school districts. Student loan forgiveness efforts could be rolled back, potentially negatively impacting the demand for higher education, as student loan subsidies would be more at risk. Support could grow for taxing college and university endowments, limiting endowment support for operations and financial aid.

Democratic control would likely mean more support for student loan forgiveness, pending decisions from the courts. Additional federal funding for community colleges and increased Pell Grants would also be positive for higher education.

TAKEAWAY: *The election outcome could influence funding for K-12 schools as well as student demand and endowment spending for higher education.*

Public electric and water/sewer utilities

Focus: funding for green energy, regulation and capital investment

Energy policies impacting electric utilities and environmental policies governing water and sewer utilities may look different depending on which party takes power.

Republican control makes it more likely that provisions in the Inflation Reduction Act (IRA) could be rolled back, which may be negative for electric utilities. The IRA included \$31 billion in funding for clean electricity, but not all of the funds have been spent. Efforts to boost clean energy tax credits and a transition to green energy could lose momentum in a Republican sweep.

However, a looser regulatory environment and fewer mandated costs could boost the finances of electric utilities and water and sewer systems. Fewer mandated capital investments for water and sewer systems could benefit system balance sheets and lead to lower rate increases, but that could also mean less investment in ensuring water quality.

Democratic control could mean additional capital investment and support for green energy priorities. Stronger Environmental Protection Agency (EPA) regulations under Democratic control or divided government may translate to increased capital costs requiring rate increases.

TAKEAWAY: *Electric utilities and water/sewer systems are well positioned to navigate potential policy changes given their essential service mission, monopolistic market positions, independent rate setting ability and strong liquidity.*

Tariffs, housing and immigration

Focus: port-backed bonds, affordable housing, labor supply and the migrant crisis

Republican control may mean broad-based tariffs on durable goods and imports. Higher tariffs on imports could impact port activity and port revenues, with potential ramifications

for port-backed bonds. Some tariffs are likely under a Democratic sweep, but perhaps not as broadly applied.

Given the strong demand for housing, support for affordable housing should continue regardless of political control. Multifamily housing bonds have historically benefitted from strong political support at both the federal and state levels.

Regarding immigration policy, stepped up control in a Republican sweep could restrict the labor supply, which may be inflationary and increase costs across most sectors. However, fewer migrants arriving in cities like New York, Denver and Chicago should mitigate budgetary pressure on those governments.

TAKEAWAY: *Policies related to tariffs, housing and immigration could be meaningful, particularly for ports; affordable and multifamily housing projects; and large cities impacted by the migrant crisis.*

Tax policy

Focus: tax rates, municipal bond tax exemption

The Tax Cuts and Jobs Act (TCJA) made major changes to the U.S. tax code, but many provisions are scheduled to sunset at the end of 2025. This means the current tax policy cannot be maintained without legislative action, so continuing the status quo is unlikely. The TCJA reduced top marginal income tax rates, expanded tax brackets and narrowed the number of taxpayers subject to the alternative minimum tax (AMT). The TCJA also capped the federal deduction for state and local taxes (SALT) at \$10,000 for all income tax filers.

Under Republican control, maintaining lower top marginal income tax rates is expected to be a priority. Under Democratic control, higher income households are more likely to see tax rate increases, and portions of the TCJA may be allowed to expire, including the SALT deduction cap. Higher marginal tax rates would likely mean increased demand for muni bonds, as the value of the muni tax exemption rises with tax rates.

We could also hear fresh talk about a potential change to the muni tax exemption to help subsidize other changes in tax law. But the exemption is critically important to state and local governments, schools, hospitals, electric utilities, water and sewer systems, airports and toll roads that fund the nation's vital infrastructure. Additionally, the exemption's cost to the U.S. Treasury is quite modest — about \$40 billion annually or \$400 billion over 10 years — compared with the \$4.6 trillion estimated cost of extending the TCJA for 10 years.

Because the tax exemption is essential to financing U.S. infrastructure, we think it is unlikely to be eliminated. However, in that extreme scenario, current tax-exempt munis — if grandfathered into the exemption — would become significantly more valuable. This could have considerable benefit for current investors.

TAKEAWAY: *Higher taxes should heighten demand for muni bonds, as the tax exemption becomes more valuable at higher tax brackets. For example, the taxable-equivalent yield on a tax-exempt muni bond yielding 5% is 7.93% at a 37% tax rate, but it increases to 8.27% at a 39.6% tax rate. Further, the muni tax exemption is essential to financing U.S. infrastructure and is unlikely to be eliminated.*

ESSENTIAL SERVICE PROVIDERS ARE INSULATED FROM THE OPERATING ENVIRONMENT

The U.S. election outcome could result in significant differences in federal policy, impacting muni issuers in varied ways. Policy shifts could present issuers with both challenges and opportunities.

At the same time, most muni issuers are essential service providers. Thus, the bonds they issue are typically highly insulated from the operating environment, making muni debt a relatively stable investment in an uncertain environment.

In the post-election period, Nuveen's muni credit research team will be integral to our investment process, helping to inform careful credit selection and investment. The team conducts bottom-up, fundamental research on all market issuers to discern meaningful differences in issuer credit quality. The team's insights help our portfolio managers drive relative value in their investment selections and provide the information and support to make educated investing decisions.

For more information, please visit nuveen.com.

Endnotes

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A word on risk

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This information should not replace an investor's consultation with a financial professional regarding their tax situation. Nuveen is not a tax advisor. Investors should contact a tax professional regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. The taxable-equivalent yield is based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income (the net investment income tax). Individual tax rates may vary.

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