U.S. Municipal Bond Market

Our 2024 Election Preview: We Could See an Unprecedented Threat to U.S. Municipals from Potential Tax Policy Changes

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- The race for the White House between former President Donald Trump and Vice President Kamala Harris is as close as a coin-toss.
- We have identified several policy topics specifically related to public finance and the municipal bond market that are likely to interest our readers. The table on Page 6 outlines the potential outcomes for each policy topic under four possible election scenarios.

This Time It's Different

America is searching for its next political and fiscal path, and we will likely know more about its psyche come November. Comparisons to past election cycles or campaigns have been made in recent months, but this time it is different- much different. Will voters embrace the progressive option on the ballot in Harris-Walz, or will they double down on the more familiar choice in Trump Part II? Last night was another historic presidential debate this time between former President Donald Trump and Vice President Kamala Harris. There is not another debate scheduled yet, so last night could be the final time we see the candidates on stage together. Only 55 days are left until the next U.S. presidential election on Nov. 5, 2024.

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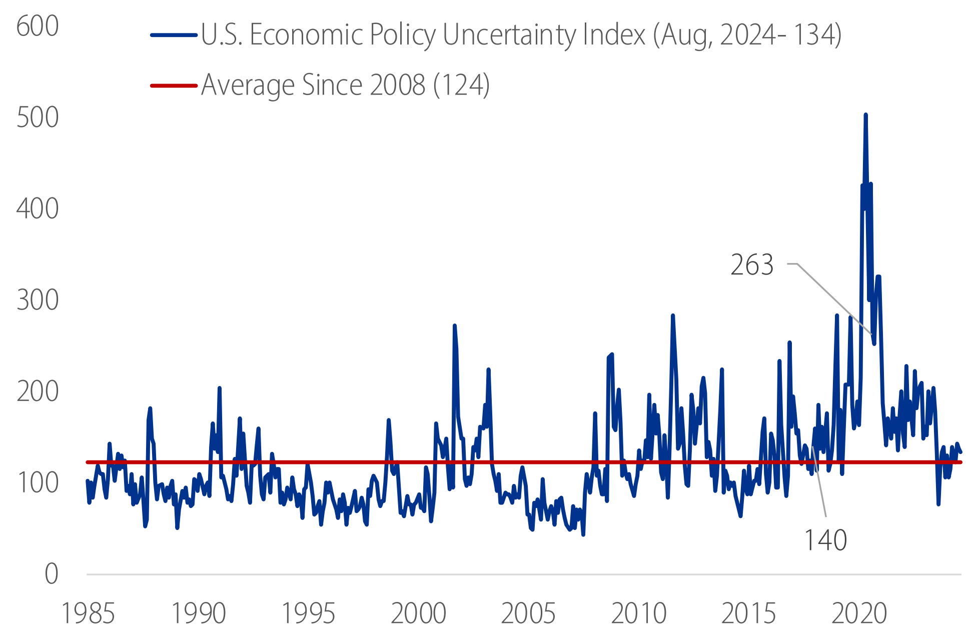
There has never been a presidential campaign season like this, and there has never been a more consequential fiscal policy backdrop. The fiscal status of the U.S. is close to the worst condition ever, and the fiscal/economic policy hanging in the balance has never been more crucial to public finance. This sets the stage for key social and economic shifts. Potential sweeping changes to federal tax policy could have a massive impact on the U.S. municipal bond market and public finance. The "Uncertainty Index" we cite below does not accurately account for the potential change, just as it didn't at the end of 2017.

Select Important Upcoming Financial and Political Dates

Date	Event	Note
Sept 17-18	U.S. FOMC Meeting	"The time has come…"
Sept 30	Federal Funding Deadline	Shutdown unlikely
Nov 5	Election Day in U.S.	White House is a coin-toss
Nov 6-7	U.S. FOMC Meeting	Data, outlook, risks to be considered
Dec 17-18	U.S. FOMC Meeting	Data, outlook, risks to be considered
Jan 1, 2025	End of debt limit suspension	Extraordinary measures can last a few months
Jan 6, 2025	Congress to certify election results	In Washington D.C.
Jan 20, 2025	60th Presidential Inauguration	In Washington D.C.

Source: HilltopSecurities.

Don’t Believe the Low Reading, the Potential Impact on Municipals is Massive



Source: 'Measuring Economic Policy Uncertainty' by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com and HilltopSecurities.

This time, leading up to the 2024 elections, the circumstances are very different than in the past.

This time, leading up to the 2024 elections, the circumstances are very different than in the past. Federal deficit spending on entitlements, defense, tax policy, COVID-era fiscal policy, and most recently higher interest rates have helped the U.S. debt to GDP level balloon from 35% in 2008, to 66% in 2011, then to 99% in 2024 and now is forecast to rise as high as 122% by 2034. This level would be higher than at any point in U.S. history-it rose to 106.1% in 1946, just after WWII. The Congressional Budget Office (CBO) projects we will rise to 106.2% in 2027.

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Demographic shifts in the electorate are helping to determine what D.C. lawmakers prioritize in fiscal policy. The U.S. federal fiscal standing can no longer afford the priorities policymakers have championed since 2021. S&P downgraded the U.S. sovereign credit rating to AA+ from AAA back on August 5, 2011, and Fitch Ratings downgraded the U.S. sovereign rating to AA+ from AAA on August 1, 2023. The high and growing debt burden has been a common reason for the U.S. credit deterioration. The economy (and inflation) is the No. 1 issue according to voters in the upcoming 2024 presidential election. Eight in ten voters reported “the economy” would be very important to their vote come Nov. 5, according to a Pew survey.

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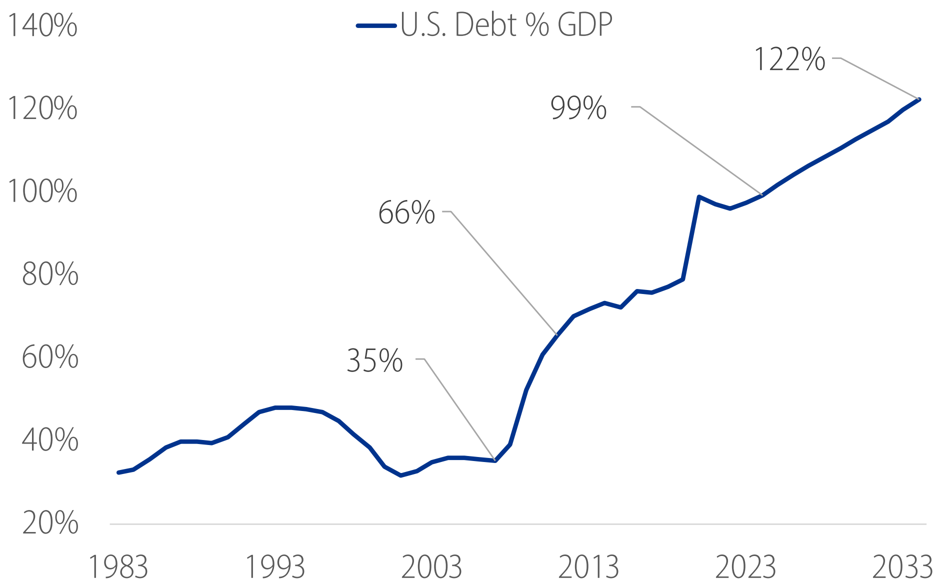
Federal Debt Held by the Public: Rises from 35% in 2008, to 66% in 2011, to 99% in 2024 and is Forecast to by 122% in 2034- Higher Than at Any Point in History



Source: CBO and HilltopSecurities.

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Scenario Analysis

The race for the White House between former President Donald Trump and Vice President Kamala Harris is as close as a coin-toss. Recent polling suggests Trump may be back in the driver's seat. A New York Times/Siena College poll released Sunday indicated Trump was ahead of Harris by one point nationally. We are still waiting for polling to take into account last night's debate results.

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Both candidates have roughly equal chance of winning the White House, with a divided Congress likely. Currently, Republicans might have a slightly better shot at controlling Washington, but neither a Republican Red Wave nor a Blue Democrat Surge is probable. One thing is likely - we are not expecting any type of mandate. The results of the election are likely to be very close.

Policy Topics

We have identified several policy topics specifically related to public finance and the municipal bond market that are likely to interest our readers. The table below outlines the potential outcomes for each policy topic under four possible election scenarios.

America's Infrastructure Report Card Grade (ASCE) 2021: C-

The 2021 American Society of Civil Engineers (ASCE) Report Card gave the U.S. infrastructure a C- grade. This is the first time in 20 years the U.S received a grade in the C range. However, the funding gap still remains over $2 trillion over ten years. Here is the recent history of ASCE grades: 2017, D+; 2013, D+; 2009, D. Time will tell if traditional infrastructure spending is a priority in any of the election scenarios. So far, neither presidential candidate has highlighted infrastructure.

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Potential for Election Delays to Impact Financial Markets

Even if there are delays in the election results, we do not anticipate meaningful interruptions.

The surprise election of Donald Trump caused a ripple of uncertainty in the financial markets in the late fall of 2016. Issuers were able to access the market, but the ripple made the circumstances less than ideal. Public finance entities tried to sell debt ahead of the November 2020 elections as to avoid potential uncertainty, but financial markets operated relatively smoothly even though there was a brief delay in deciding control of the Senate by way of the Georgia run-off elections in January 2021. Recently, some have asked if we expect market uncertainty related to the November 2024 elections. Even if there are delays in the election results, we do not anticipate meaningful interruptions.

Next Step for the Trump Tax Cuts (TCJA of 2017)

The major tax policy step that could impact public finance and the U.S. municipal bond market is related to the expiration of the provisions of the Tax Cuts and Jobs Act of 2017 (TCJA), also referred to as the Trump Tax Cuts. The TCJA is set to expire at the end of 2025 because many of the provisions were enacted on a temporary basis. If former President Trump is re-elected, and the Republicans control Congress, Trump is likely to renew or even expand his tax cut package. Conversely, if Vice President Harris wins the White House and the Democrats take Congress, it is very possible that tax cuts will remain for middle and low-income voters, while those making over $400,000 are likely to see higher taxes. The Brookings Institution published a summary of the major provisions that are, and those that are not set to expire at the end of 2025 for those who would like more detail.

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Inflationary Impact of Likely Tax Policy

Many of the economic policies from both Presidential candidates, if they have their way, are likely to be inflationary. Tariffs and deficit financed tax cuts while politically popular are not likely to help reduce the deficit and improve the U.S. fiscal standing. Likewise, increased government spending- whether it is partly backed by tax revenue and/or partly deficit financed is also not likely to improve the U.S. sovereign credit rating or U.S. debt to GDP ratio.

Tax Rates (Direction)

A divided Congress, regardless of who wins the White House, is likely to produce an outcome for tax rates that is closest to the status quo. It is difficult to predict the nature of any stalemate, temporary extensions, or potential compromises at this point. We expect tax rates could fall if Republicans control all branches of government and rise if Democrats control all branches.

What are the Chances Advance Refundings with Tax-Exempt Bonds are Reinstated

There is very little chance advance refundings with tax-exemptions are reinstated. Public finance entities lost the ability to issue tax-exempt bonds for advance refundings as part of the TCJA of 2017. It is important to highlight issuers lost this tool because of a policy decision, not because of deficit reduction measures. Now, we believe it is very unlikely issuers win back this ability in any scenario.

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The U.S. federal government authorized trillions of dollars of fiscal policy in the COVID-era, which include bi-partisan infrastructure legislation. If public entities ever had a realistic chance to win back the ability to use tax-exempts it would have been then, not in coming years when tax policy is going to be closely examined and there is more of a chance that public finance entities lose the tax-exemption in part or fully - see more on this in the below policy topic.

In each of these election outcome scenarios the value of the municipal bond tax-exemption could go higher.

Possibility the Municipal Bond Tax-Exemption is Curbed or Eliminated

In each of these election outcome scenarios the value of the municipal bond tax-exemption could go higher. The value of existing bonds would rise, and possibly rise significantly because if the Republicans control all branches, like they did in 2017, it is very possible that the municipal bond tax expenditure is either completely, or partially eliminated. Please see our report, Save the Tax-Exemption, A Call to Action for U.S. Public Finance (August 17, 2023) where we indicated, "A convergence of risk has the potential to result in the elimination of new tax-exempt municipal bond issuance" for more on these risks.

Potential Change to the SALT Deduction Cap

This cap came into existence in 2017 to help Republicans pay for the TCJA. There are some Democrats in high tax states who oppose the cap and have been very stubborn about their positions. Republicans could adjust the cap if they need resources to pay for other priorities. It is slightly possible Democrats eliminate this cap, but their platform is concentrating on other priorities right now. For now we don't see enough support to change the status quo in most election outcomes.

Overall credit quality is likely to decline no matter the outcome of the elections, but it is falling from a very strong position.

Tax-Backed Municipal Credit Backdrop

Tax backed municipal credit quality remains very strong. Public finance sector upgrades outpaced downgrades in the first half of 2024, and this relationship is likely to continue until at least the end of 2024. The Golden Age of Municipal Bond is Not Over, still. Overall credit quality is likely to decline no matter the outcome of the elections, but it is falling from a very strong position.

Revenue-Backed Municipal Credit Backdrop

Some revenue-backed sectors have had a harder time this year compared to tax-backed credits. We outlined our sector-by-sector outlooks on revenue sectors in our sector outlook report. It is possible that sectors such as higher education, which is one that has experienced a significant amount of weakness already in 2024, could be even more negatively impacted depending upon the result of the elections. Slower student immigration, and lower federal support under certain scenarios would add to the higher education sector's weakness.

Primary Market Issuance Outlook (2024 and 2025)

We revised our 2024 issuance forecast to $480 billion just last week. We noted that it is possible we could see record levels of issuance in 2025 in most election scenarios, as long as economic growth remains a key driver. In one election scenario we expect it is possible there could be a missile of issuance higher, like we saw in November and December of 2017, because of the possibility of an imminent threat to the municipal bond tax-exemption.

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Expectation for Institutional and Individual Municipal Bond Demand (2025)

Overall, we expect that demand for municipal bonds is going to be rising after the election as interest rates decline. If the Democrats control the White House and all of Congress, and send tax rates higher, then it is possible that demand rise even further.

Scenario Analysis - Potential Impact on Municipals from the 2024 Elections

Policy Topic	Trump in WH, Divided Congress	Harris in WH, Divided Congress	"Red Republican Wave" (Trump, Rep, Rep)	"Blue Democrat Surge" (Harris, Dem, Dem)
Scenario likelihood	40% likelihood	40% likelihood	15% likelihood	5% likelihood
Potential for election delays to impact financial markets	Not likely	Not likely	Not likely	Not likely
Next step for Trump Tax Cuts (TCJA of 2017)	Stalemate, temp. extensions, or compromise	Stalemate, temp. extensions, or compromise	Extension and/ or expansion likely	Lower taxes remain for low mid-income, other higher taxes likely to fund other spending
Inflationary impact of likely tax policy	Tariffs, deficit-financed tax cuts likely to increase inflation	Govt. spending likely to increase inflation	Tariffs, deficit-financed tax cuts likely to increase inflation	Progressive govt. spending likely to increase inflation
Tax Rates (Direction)	Uncertain, potential for close to status-quo	Uncertain, potential for close to status-quo	Lower, generally	Higher, generally
What are the chances advance refundings with tax-exempt bonds are reinstated	Not likely at all	Not likely at all	Not likely at all	Very small chance, but still not likely
Possibility the municipal bond tax-exemption is curbed, or eliminated	Somewhat possible	Somewhat possible	Very possible	Slightly possible
Potential change to SALT deduction cap	Unlikely to expand or be eliminated	Unlikely to expand or be eliminated	Slightly possible cap is increased	Unlikely to expand or be eliminated
Trajectory of America's Infrastructure Report Card (ASCE) Grade, C-	Status-quo to slightly lower depending upon policy	Status-quo to slightly lower depending upon policy	More likely to drop over time	Status quo, or slightly improved
Tax-backed municipal credit backdrop (2024-25)	Declining, but upgrades still likely to outpace downgrades	Declining, but upgrades still likely to outpace downgrades	Declining, but upgrades still likely to outpace downgrades	Too soon to tell, but upgrades still likely to outpace downgrades
Revenue-backed municipal credit backdrop (2024-25)	Declining, adding to some already significant softeness	Declining, adding to some already significant softeness	Declining, adding to some already significant softeness	Too soon to tell, seeing significant softness in some sectors
Primary market issuance outlook (2025)	$480B in 2024, perhaps record level in 2025	$480B in 2024, perhaps record level in 2025	$480B in 2024, perhaps record level in 2025- could see a missle of issuance higher at end of 2025, similar (or higher) to 2017	$480B in 2024, perhaps record level in 2025
Expectation for institutional and individual municipal bond demand (2025)	Expect to increase as rates drop	Expect to increase as rates drop	Expect to increase as rates drop,	Expect to increase as rates drop, increase more if taxes rise

Source: HilltopSecurities.

Recent HilltopSecurities Municipal Commentary

- Revised Again: Strong GDP Growth Boosts Our 2024 Issuance Forecast to $480 Billion, September 5, 2024
- Inflation Part II, September 4, 2024
- The Time is Now, August 27, 2024
- Bonds Are Back, August 15, 2024
- Our Optimism Endures from the Growth Surge, Record Housing Prices, Still Appealing Tax-Exempt Yields, & a Fed Poised to Communicate Rate Easing Progress, July 30, 2024

Readers may view all of the HilltopSecurities Municipal Commentary here.