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UPDATE: Muni Bonds Could Gain From Obama Victory; Tax Reform Still Unclear

--Obama victory suggests higher taxes, making tax-free munis more attractive

--Proposal to curb muni tax exemption could gain traction

--Top-rated muni bonds rally after election

(Updates market performance in fourth paragraph, adds commentary from Barclays in ninth and 10th paragraphs.)

By Mike Cherney

President Barack Obama's re-election Tuesday will likely increase demand for municipal bonds--at least in the short term--as his victory suggests taxes will rise, making the tax exemption on munis more attractive.

What is less certain, however, is whether Mr. Obama's proposal to limit the tax exemption on munis will gain any traction in the longer term. While the U.S. Senate remains controlled by Democrats, the House of Representatives is in the hands of Republicans, which could lead to further gridlock on fiscal issues. But some market participants said a change to munis' tax exemption could still be in the cards.

"There might be some continued inaction, but tax reform is on the forefront of everyone's minds," said Burton Mulford, portfolio manager at Eagle Asset Management, which oversees $1.8 billion in munis. "I think something's going to give, but it's too early to tell."

Either way, the municipal-bond market is reacting favorably to the election. Yields on top-rated, 10-year municipal bonds fell eight basis points Wednesday, while yields on 30-year debt dropped seven basis points, according to a benchmark scale from Thomson Reuters Municipal Market Data, which termed the day's trading the "Obama bond market rally." Bond prices move inversely to yields.

Ballot initiatives in two states were also closely watched by muni investors. In California, voters approved Proposition 30, which provides more funding to schools by temporarily increasing income taxes for higher-income taxpayers, as well as boosting the state's sales tax. In Michigan, voters rejected a law that allows the state to appoint emergency managers to run troubled municipalities; the state is operating under an older law that gives managers less power.

RBC Capital Markets said in a research note Wednesday that the results mean California "dodges a credit bullet." Ratings companies, it noted, had said a "no" vote would have had negative implications for California school districts. Alan Schankel, managing director at Janney Capital Markets, said the California vote should increase investor comfort with bonds from California school districts.

The result in Michigan was more of a "mixed bag," RBC said. While bondholders generally favor more robust state-oversight programs, voters also struck down a proposal that would have made it more difficult for the state to increase taxes, RBC noted.

Standard & Poor's expressed concern with the latter measure, which would have required a two-thirds majority vote in each chamber of the legislature, or a simple majority of voters, to enact a new tax or rate increases. S&P noted it would limit the state's "budget flexibility in future downturns."

Barclays, meanwhile, sounded a more somber tone. Although the California vote could be viewed as a credit positive, it does not solve the state's "long-term structural deficit issues within the budget."

It called the Michigan vote a "meaningful credit negative" that would increase the likelihood of municipal bankruptcy filings in the state. The law that was voted down gave emergency managers enhanced powers to modify contracts outside bankruptcy. Now, managers with more limited power might be forced to use bankruptcy "as the mechanism with which to absolve municipalities of burdensome expenses," Barclays said.

Mr. Obama's tax-reform plan calls for raising the top two individual income-tax brackets from their current rates of 33% and 35%, to 36% and 39.6%, respectively, according to Morgan Stanley. But his plan would also limit the tax exemption on munis to 28% of the interest, limiting the appeal of tax-free munis to high-income individuals.

John Loffredo, senior managing director at MacKay Shields and co-head of the municipal managers team that oversees $6.8 billion in munis, downplayed the possibility that the muni tax exemption will be limited. He said that the first priority of Mr. Obama and the new Congress will be jobs, and that taking away the tax exemption for munis wouldn't help that cause.

"One of the best generators of jobs is capital spending in infrastructure projects, and a good portion of that is done through local and state governments through the issuance of tax-exempt debt," Mr. Loffredo said. "We believe that leaving that funding vehicle as the status quo is the best way to move forward on creating new jobs and new infrastructure projects."

Kevin Woods, principal at Asset Preservation Advisors, which manages $2 billion in munis, said he didn't think Mr. Obama's proposals to limit municipal bonds' tax exemption would be successful, as similar efforts in the recent past weren't. Capping munis' tax exemption would hurt the borrowing costs of state and local governments and be a politically unpopular move, he said.

"I don't think he'll have backing from his own party on this," he said. "State and local governments are not in favor, Democratic governors are not in favor...I think it's more of a negotiating tool" than an actual threat.

However, research advisory firm Municipal Market Advisors said Mr. Obama's re-election makes his proposal to cap the muni tax exemption at 28% more plausible.

Senate Republicans had previously expressed support for the measure, it noted. In addition, the inability of the Republicans' more conservative tea-party wing to make inroads in the Senate "may put that caucus to the side as the Republican Party reorganizes itself," perhaps making it easier for both parties to work together.

"We believe the financial press is incorrect in predicting further gridlock as a result of this election," the firm said in a research note Wednesday.

--Kelly Nolan contributed to this article.

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