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Breaking Down What to Expect from Municipal Bonds in 2021.

UBS Global Wealth Management's Head Americas Fixed Income Thomas McLoughlin joined Yahoo Finance Live to discuss what the outlook for municipal bonds is for 2021.

Video Transcript

THOMAS MCLOUGHLIN: As we head toward the closing bell, one place that investors look for yield, as well as protection sometimes, is fixed income. Let's bring in Tom McLoughlin, UBS Global Wealth Management's Head of America's Fixed Income, because in your most recent note on municipal bonds, you wrote about something that just struck me as well.

I thought that would go counter to the whole point of purchasing munis, which is that a third of them issued in 2020 actually are subject to federal tax. And I was always raised that you go to munis to get the double bang of the return, but also the non-tax prospect. So what's going on here?

THOMAS MCLOUGHLIN: Yeah, you know, it's interesting, Adam. This is probably the most pronounced new trend that we've seen in municipals since at least 2010. The Tax Cut and Jobs Act provided a change to the tax regime, which prevented state and local governments from doing what we call advanced refunding.

So if a state or local government wants to refinance their debt, similar to how a homeowner might refinance their mortgage, they used to be able to do it well in advance of the optional redemption date. And they can no longer do so by law since the end of 2017. So many are actually issuing bonds to refinance their prior taxed bonds with taxable securities. And we do expect the trend to continue.

- And we saw that there was no new aid for local and state governments as part of that new stimulus legislation that President Trump signed a week ago. How long is it going to take for municipal balance sheets to recover?

THOMAS MCLOUGHLIN: I expect it will probably take the better part of a year to another year and a half. And part of that reason is because municipal credit conditions tend to lag the real economy. A lot of that has to do with the fact that property taxes, for example, any reduction in the assessed valuation of property within a specific city or town will take the better part of a year and a half in order to basically flow through the tax rolls.

And similarly, any reduction in income tax is not likely to be felt for about a year after a recession hits. So what we expect is that municipal ratings will probably will have more downgrades in 2021 than we will see in upgrades.

And that may even persist into 2022. The good news is that the depth of the recession was more severe than it was 10 years ago. But it was shorter. And we're actually expecting to see municipals not feel quite as much pain and suffering as they did in the period of 2009, '10, and '11.

ADAM SHAPIRO: But as you point out, there are going to be a group that capture the attention of the broader market because of the downgrades. And any name recognition that, as investors, we should be aware of? I would just assume New York City. Although New York City is a good bet in the long run, it's taken a big hit.

THOMAS MCLOUGHLIN: Yeah, for sure. I mean, I should emphasize that very point, which is that New York City over a long period of time is a good bet. It's not going anywhere. It is a foundational very important part of the US economy.

At the same time, New York City has basically seen an exodus of population and of income. And a lot of that is a national trend, as people from the Northeast and the Midwest begin to migrate South and West. But the pandemic accelerated this. So New York is likely to basically be faced with two or three years of particularly difficult budgets that they have to construct.

In terms of broader sectors, it's not going to surprise our viewers to learn that things like continuing care retirement communities, privatized student housing, or local housing deals are also going to basically be subject to greater difficulties, for example, than utilities, electric utilities and water utilities, which are relatively more insulated.

- You were talking about taxes earlier. So how much of the uncertainty we're seeing in the markets right now, the sell-off, has to do with the uncertainty around which party is going to actually control the Senate and basically dictate tax policy?

THOMAS MCLOUGHLIN: Yeah, it's fair to say that the volatility we're seeing the market has, to some degree, is based on the uncertainty related to the election. But I would suggest that we basically break it up and look at it two ways, the short term volatility associated with the election uncertainty and a lot of the stuff that's going on with the president's call to the Georgia Secretary of State and things like that.

The bigger, longer term, you're going to take more of a performance we think is going to be the pattern of the pandemic and the vaccinations. And as we've seen in the last 24 hours with the heavy lockdowns first in Scotland, then in England, we're in a position where we've seen the highest infection rate on a daily basis come out in the last couple of days. That is actually the bigger long term story.

And the good news there is that as the vaccine, basically, the rollout proceeds, and we actually have a greater vaccination rate across society, then the US economy will be poised for a much stronger 2021.

ADAM SHAPIRO: You have a happy New Year. Tom McLoughlin is UBS's Global Wealth Management Head of America's Fixed Income. Good to see you. Thank you for joining us.

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