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'We've Seen a Really Good Rally in Municipal Bonds': BlackRock Municipal Bond Group Head

Peter Hayes, Head of BlackRock's Municipal Bonds Group joined Yahoo Finance Live to break down his thoughts on the municipal bond market.

Video Transcript

SEANA SMITH: Peter, it's great to see you again. And we know the muni bond market has been attracting pretty significant inflows so far this year, right around $49 billion so far. So now that it seems like we have some progress at least on infrastructure talks, is that going to be enough do you think to keep this rally going in the muni market?

PETER HAYES: Yeah, I think, I mean, look, there's a lot of positive things and from a fundamental credit standpoint, it's about as constructive as I've seen in the market perhaps ever. You think about the stimulus, the accommodative Fed policy, all that has really been a boon to state and local revenues. Even many of the revenue sectors, like transportation are coming back as the economy reopens. So all that's positive. And I think even talk of infrastructure, some kind of package will ultimately lead to some degree of increased issuance in the market.

But the demand is just insatiable. It's on track to be more than we saw in 2019, which is probably the largest we've ever seen in terms of those flows that you spoke about. So I don't think an infrastructure package necessarily derails the market rally that we've seen. I think it's more what we see it going on in the bond market, and that's interest rates being a bit volatile here.

ADAM SHAPIRO: In regards to the volatile interest rates, Peter, and it's good to see you, a lot of us are approaching that age where we need to start looking at ways to protect future retirement income with less risky assets. Muni bonds would be one of the ways to do that. But you wrote here in your most recent note that long duration, lower credit quality bonds outperform as coupon return drove performance.

A lot of us get that. But then you added, as a result, the yield toward the S&P municipal bond high yield index pushed to a new all time low. Give us a 101 from the investor standpoint. What are you talking about here? Because a lot of us really do want to protect future income.

PETER HAYES: As most people know, that interest rates and prices have an inverse relationship. So as yields go down, prices go up. So we've seen, as Seana mentioned, we've seen a really good rally in municipal bonds really that began in April of last year, and it's continued again through this year, which means the higher prices go, the lower yields go. So you're taking more risk obviously the further out the curve you go to get some of that incremental income.

And it's interesting, when you break down the flows this year, a lot of those flows have gone to the long-term category and the high yield category, which means people are taking more duration risk, they're taking more credit risk. And what happens when interest rates go up, is the value of their investments actually go down. So it's a precarious situation, because yields are so low and as people stretch for that income. So I think you've got to be careful about where we are in the cycle, what are interest rates likely to do. It may not be a bad time to just sit in cash, sit in very low duration, protect some of that principal, wait for a better opportunity ahead.

SEANA SMITH: Peter, how about state finances? Because going back what, 16 months ago, 15 months ago to the start of the pandemic, there was lots of questions, lots of uncertainty about how state finances were going to be impacted. And I know the last time we spoke with you, they were actually faring much better than we had initially anticipated. Is that still the case right now?

PETER HAYES: It is. The bounce-back has been incredible. I think about a year ago came on the show, we were talking about California projecting the potential for a $56 billion deficit given the impact of the shutdown of the US economy and what that means for state and local government. And here, we're actually talking about a $75 billion surplus. That's an enormous swing.

And we've seen that in other states as well, not just California. Some states that are a little bit more reliant on tourism haven't fared quite as well. But in general, when you think about what the stock market had done and you think about the housing market, incomes have done well. People have spent. They've spent differently, but that means sales taxes are up as well. So I would say yes, fundamental credit picture in the muni market is as good as we've seen it in some time.

ADAM SHAPIRO: And Peter, we've talked about the tax implications with muni bonds. With the current discussion about changing the tax code in the United States, are you hearing anything pro or con coming out of Washington which will impact again, those people I talk about who may be looking at protecting capital going forward?

PETER HAYES: We have. And I think that the marginal rate going from its current 37% to 39.6% is certainly a possibility as they figure out ways to pay for this infrastructure package, but at the margin. Does 2 and 1/2 percentage points make a big difference in the after tax value of municipals? Probably not. I think people are already anticipating that, and that's why we've seen this tremendous demand materialize.

The other aspect is the corporate rate. After the 2017 tax change, we went from a 35% corporate rate to 21%. And we did see corporations, who are often big buyers of municipals, pare back their holdings. So we saw some selling. If that rate were to go back up to 25% however, you wouldn't see all that demand materialize.

You wouldn't see all that selling that took place in 2018 all of a sudden turn into buying. One of the reasons is that our valuations are very, very stretched, and they could probably do better by buying corporates or other fixed income asset classes. So I don't think the change in the tax code is necessarily going to be a big benefit or a game changer for munis any time this year.

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