CIO believes a defensive posture in the lower risk sectors has a better risk reward dynamic. (UBS)

Municipal investors should position defensively

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The value of municipal bonds suffered one of the worst declines on record in 2022 as the Federal Reserve aggressively raised interest rates to combat high inflation.

While inflation is moderating, the odds of a recession next year have risen. In this environment, we advise investors should position themselves to take advantage of attractive municipal bond yields. We prefer higher-quality bonds in low risk sectors such as states, water sewer and electric utilities as opposed to lower-rated bonds in private higher education and healthcare. This allows investors to benefit from higher yields but without exposing them to greater relative spread widening that the riskier sectors may experience.

The Bloomberg state GO index is yielding 3.15%, greater than its long-term average of 2.73% over the last two decades. The hospital bond index however, is currently yielding 111bps over the state GO Index, a little below its long-term average of 114bps. While this spread differential is influenced by various factors over time, including changes in relative duration, it tends to increase significantly in periods of crisis, reflecting the impact of greater credit risk.

In our view, this spread differential is likely to increase next year, given the increasing odds of an economic slowdown and even recession. We believe investors with a higher risk tolerance will get better entry opportunities in hospital bonds next year. Till then, we believe a defensive posture in the lower risk sectors has a better risk reward dynamic.

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Important information