CIO views the recent increase in muni yields as an opportunity for income-oriented investors to seek attractive values on longer dated munis. (UBS)

Opportunities in high-quality bonds

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The UBS Chief Investment Office continues to favor positioning in high-quality municipal sectors, including bonds issued by states. They explain why in this edition of the *Municipal Market Guide*.

Outlook

In the near term, we anticipate market technicals to remain relatively weak before strengthening in the December-January time frame, consistent with historical precedent. However, before that happens, we expect the pace of tax loss harvesting activity to accelerate into year-end, adding volatility to an already disorderly market.

For selective buyers willing to withstand the year-end volatility, the current environment still provides a good opportunity to lock in attractive yields on tax-exempt municipal bonds. The yields now on offer from high-quality issuers have not been seen in 16 years. Which begs the question: buy now or wait it out until the new year? We are inclined to seek opportunities to buy highly rated bonds now and become more aggressive into the early part of December before new issue supply wanes. As a point of reference, taxable equivalent yields (TEYs) on short-dated high-quality munis now range from about 6.5% to 8%. Meanwhile, the value on longer-dated munis is more compelling. TEYs can exceed 10% for taxpayers residing in states that impose lofty personal income taxes, as an example.

We expect the pace of US economic growth to slow to below trend over the next 12 months. An environment in which economic growth slows, inflation declines, and the Fed loosens monetary policy bodes well for high-quality munis. The timing is difficult to predict but we are obliged to remind our readers that municipals encounter higher friction costs than other asset classes and are not as easily traded in smaller block sizes. For private clients, tax exempt municipals are best viewed as a vehicle for income-oriented investors seeking shelter from higher taxation. To that extent, a short-term unrealized loss may be a small “price” to pay to lock in a portfolio of high-quality bonds for the longer term.

Portfolio themes

Lock in high taxable equivalent yields amid volatility

We view the recent increase in muni yields as an opportunity for income-oriented investors to seek attractive values on longer-dated munis. As a point of reference, tax-equivalent yields (TEYs) on AA rated high quality municipal bonds at the 20-year maturity point now sit at levels (~7.8%) that are higher than the average (5.1%) over the past 15 years.

Buy high-quality bonds

At current spreads, we continue to favor positioning in high-quality muni sectors rather than lower-rated high-yield credits. As a point of reference, the yield gap between high-yield munis and investment grade munis sits at 194bps. By comparison, this spread rests below its longer-term average (235bps), suggesting that higher-quality bonds offer the better value.

Target tax-loss harvesting to save taxes

Following the increase in muni yields over the past few years, many individual bonds are now posting unrealized losses. By realizing a capital loss — harvesting a loss — to offset taxable gains, reported investment gains and tax liabilities decrease. Therefore, US tax regulations may have the effect of granting losses of noteworthy value to an investor, because these losses can be used to defer taxes.

While “wash sale” rules exist, municipal bond investors should consider tax-loss strategies along with other portfolio improvement strategies such as duration adjustments, sector and geographical diversification, or consolidating positions. Investors may be able to lower their tax liability while shifting from underperforming securities to those securities better positioned for current market conditions.

For more on why CIO still favors high-quality bonds, read the full ***Municipal Market Guide* report**, published on 26 October 2023.

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