Investors should take advantage of the increased supply of bonds ahead of the redemption season (UBS).

How can investors benefit from recent muni trends?

02 July 2024, 6:17 pm CEST, written by UBS Editorial Team

June's declining yields have pushed investment-grade munis into positive territory for the year, with the yield curve showing signs of normalization. Despite rich valuations relative to Treasuries, high-quality long-duration bonds remain attractive, especially for investors in high-tax states.

June gains brings muni returns into positive territory

On a year-to-date (YTD) basis, IG munis are now posting a gain of 0.1%, helped by declining yields in June. Over the past month the 2s10s on AAA muni curve has continued to steepen while the 10s30s flattened some more. The shape of the curve continues to normalize, although the 2s10s portion remains inverted. Despite softening yields, the long end still looks attractive to us given our lower rate outlook by year-end. Valuation continues to skew rich with the 10-year muni, as the Treasury ratio is now at 66%, compared to its three-year average of 72%. However, taxequivalent yields on high-quality bonds, particularly in high tax states such as New York and California, remain attractive from a long-term investment perspective.

Outlook

Lower inflation and favorable summer technicals, powered by heavy bond redemptions, should help near-term performance, albeit tempered by strong supply and still rich valuations relative to Treasuries. The municipal credit outlook remains stable given our expectation of a soft landing. A and BBB spreads remain tight relative to historical levels. We continue to favor long duration high-quality bonds.

As the Presidential election draws near and the politics of fiscal deficits and national debt assume more prominence, we expect more headlines about the federal tax exemption on municipal bonds being at risk of elimination. However, despite the heightened focus, we believe the municipal tax exemption will remain, albeit with some potential limited modifications. Finally, hurricane season is upon us. Given the rising frequency and cost of weather-related events, we encourage investors to consider physical climate risk factors when building a balanced and diversified municipal bond portfolio by state and sector, avoiding home state bias.

RECOMMENDATIONS AND PREFERENCES

- Take advantage ahead of the redemption season and increased supply: In the near term, we continue to see an opportunity to place assets into the muni market ahead of a heavy wave of seasonal bond redemptions expected this summer. Robust supply might temper performance but also helps investors with a wider choice of bonds in which to invest.
- Lock-in high taxable equivalent yields (TEYs):TEYs on longer-dated munis of around 7.5% for investors in top tax brackets in New York and California are particularly attractive.
- Curve positioning: We favor longer-dated high-quality bonds for a more durable source of income with capital gains potential. Investors could also consider some smaller allocations to the short end to create barbell portfolios and the intermediate portion of the curve to take advantage of recent steepening of the 2s10s.
- Credit quality and sectors: Given relatively tight spreads on lower-rated bonds we see better value in higher-quality issuers.

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