



We in CIO think current market conditions offer a good window of opportunity to lock-in tax-efficient, equity-like returns for a prolonged period (UBS).

# High rates won't stay forever – but tax exemption likely will

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**In the weeks leading up to the 15 April tax deadline, rate markets have been selling off and muni new issuance supply has increased, leading to higher muni yields. Thus, for residents of high tax states in top tax brackets, munis are currently offering tax-equivalent-yields (TEYs) of between 8% and 9%—returns rather in line with the long-term annual historical performance of the stock market.**

We in CIO think current market conditions offer a good window of opportunity to lock-in tax-efficient, equity-like returns for a prolonged period.

## **A reminder on tax-equivalent-yields (TEYs)**

Tax-equivalent-yields (TEYs) express the level of yield you need to capture in a taxable bond to match the returns offered by a tax-exempt one. TEYs are dependent on the investor's tax brackets, which account for federal, state, and local income tax rates.

As such, the higher an individual's income tax burden, the higher will be the TEYs that can be captured via munis. This is precisely the reason why munis are such an efficient tool for individuals residing in states that impose high income taxes.

## **Why munis' current TEYs are attractive?**

The muni market is influenced in large part by the direction of US Treasury yields, along with muni specific factors such as supply/demand dynamics and credit fundamentals.

As of late, the US macro backdrop, characterized by a stronger-than-expected economy, has raised concerns about the Fed's ability to start easing in the coming quarters. In this context, US Treasury rates have sold off, with the 10Y treasury

climbing roughly 60bps since December. Similarly, the yield on the investment grade muni market as a whole has increased by about 45bps year-to-date.

As such, 20Y and 25Y tenor munis are currently trading at a nominal yields of roughly 4.0%, which in states such as NY, California, and New Jersey implies TEYs of over 8% — equity-like levels of return. The potential upside could be even greater, considering the TCJA tax cuts that are set to expire by year-end 2025. Remember, barring action from Congress, it is likely that the top marginal tax bracket will increase by 2026; this makes the current municipal yields even more attractive as a hedge for policy risks.

### **A little background on our reasoning**

We understand why recent data has tapered the market's expectations about the extent and speed of the Fed's cutting cycle. In this context, it seems to us that the re-pricing has opened interesting opportunities to lock-in yields in fixed income assets, including munis.

In our view, while acknowledging the recent speed bumps, the fact of the matter is that inflation has declined relative to a year ago. Several measures including PPI, core PCE, as well as the Fed's Beige Book surveys, confirm that disinflation is taking place – albeit at a slower-than-expected pace. Moreover, despite rapid job growth, the labor market has moved into better balance, helped by immigrant workers, and with wage growth on a slowing trend.

In this context, CIO stands by its base-case that the Fed will be loosening its policy stance in the second half of the year.

### **But timing matters — and that moment appears to be now**

We think that when the market finally digests all the aforementioned factors, most likely in 2H24, the rates rally is likely to follow. As such, ahead of the US' tax filing deadline — and amid the current high interest rate environment — we think the time is ripe to add some exposure to long-dated munis, lock-in these yields, and embed these equity-like returns into portfolios.

For more details, please see our most recent note: [Municipal bonds chartbook](#), published 9 April, 2024, or reach out to your UBS financial advisor for the most recent Municipal Market Guide

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