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Spotlight on long-term trends: Themes for yield

16 April 2024, 8:09 pm CEST, written by UBS Editorial Team

The UBS Chief Investment Office (CIO) discusses how fixed income can play a role in thematic investing. Given their current preference for fixed income over US equities, they review thematic investments in the context of municipal and emerging market bonds.

Municipal bonds

Investors may be interested in a longer-term investment theme but lack the risk appetite to allocate significant capital to thematic equities. For these investors, municipals offer a direct way to lend capital to companies operating in industries undergoing transformation, with the added bonus of being tax-exempt. The taxable equivalent yields for longer-dated AA rated munis can exceed 7.5% in states that impose income taxes at high marginal rates. On a risk-adjusted basis, that is arguably superior to other fixed income asset classes. In the near term, we're encouraging investors seeking income to view the recent decline in municipals as an opportunity to buy tax-exempt bonds at attractive yields in advance of the heavy summer redemption season. We currently prefer municipal sectors that should exhibit credit quality resilience in an uncertain economic environment. Several of these sectors align with areas of opportunity that we've identified in our suite of longer-term investment themes, including bonds issued by water and sewer (W&S) enterprises and public power agencies.

Municipal water and sewer utilities

There are over 100,000 water and sewer providers in the US, the majority of which are publicly owned. They are typically owned by state and local governments or a public service authority and serve about 88% of the US population. Drought conditions had been acute in the western region for the past several years before a series of atmospheric rivers brought much need relief to the region this past winter. The drought, however, challenged water supplies and raised questions about utilities' capacity to function effectively in a demanding operating environment. Scientists believe the western region in particular, will continue to experience abnormally dry periods and suffer through cycles of extreme heat and drought, which will continue to test the region's water supply and dictate how utilities manage, obtain, use, store, recycle, and conserve water. Capital-intensive projects such as aqueducts, desalination plants, and water storage projects will strain some issuers' credit profiles.

The good news is that large municipal W&S issuers are generally well positioned to meet today's challenges. They tend to maintain strong levels of liquidity and low-to-modest leverage. W&S issuers possess key attributes, including monopolistic service territories and independent rate-setting authority, which enhances credit quality.

In CIO's opinion, W&S issuers are well positioned to handle the challenges facing the sector; however, not all issuers are created equal, and we recommend large well-established issuers that have a diverse client base, strong reserves, and adequate water rights.

Municipal electric utilities

Public power agencies tend to exhibit stable and resilient credit characteristics driven by essentiality, rate autonomy, and strong financial metrics. State and local government-owned power utilities account for 16% of the nation's total electricity generation, providing power to over 50 million customers. The sector is undergoing its own energy transition, with the three pillars of affordability, decarbonization, and reliability driving the fundamental credit quality of issuers.

While higher power prices pose headwinds for the sector related to customers' ability to pay, prices have since come off the peak, and municipal electric utilities enjoy a price advantage relative to investor-owned utilities, and rate-setting autonomy helps mitigate the adverse impact on credit quality. The sector will also see an added benefit from the Inflation Reduction Act (IRA), which provides incentives for the public power industry to reduce the gap in renewable power capacity between municipal electric utilities and investor-owned utilities. Prior to the IRA, municipal electric entities were unable to take advantage of tax incentives due to their tax-exempt status.

Our CIO municipal risk frameworks help investors identify which issuers are better positioned than peers in terms of credit risk, and it identifies states where electric utilities have elevated environmental risk.

Emerging market bonds

Another thing to consider when investing for the long term is the significant relevance of emerging markets for global growth in the years ahead. The secular trends that underpin our thematic framework, particularly population growth and urbanization, are oftentimes most relevant in emerging regions of the world. In addition, we currently view hard-currency emerging market sovereign bonds as a most preferred asset. While we don't have a list of bonds specific to our emerging market LTIs like "Emerging market infrastructure," we do provide two emerging market bond lists that contain several issuers with exposure to the energy transition and energy infrastructure.

Energy demand is estimated to rise sharply over the next 20 years, and heavy investment in energy resources will be needed to meet that demand. To achieve the three-pronged goal of affordability, reliability, and decarbonization, we expect an "all-of-the-above approach" to the energy transition, opening up opportunities not just for alternative energy providers, but also for traditional energy providers. The "Short-duration Pan-American bonds" theme includes companies operating in the oil and gas industry, as well as in metals and mining industries that should benefit over the long term from the increased demand for transition materials like copper. We also believe select short-duration bonds in emerging markets lie in a "sweet spot" in the current environment, characterized by high inflation, high US Treasury yields, and global economic growth concerns. In a similar vein, the "Yield opportunities in Latin America" theme identifies a list of issuers offering attractive yields that exhibit low probabilities of default, in our view. This list also includes several issuers in the energy sector.

Fixed income investing is not always the most obvious way to gain thematic exposure, but we believe there's an opportunity to be had for investors that can lock in attractive yields, and investors interested in long-term secular trends will likely find overlap between the themes we've identified and bond issuers in the industries we describe above. In volatile markets, this can be a prudent strategy for thematic investors who may be unwilling or unable to take additional equity risk.

For more, including a brief overview of CIO's global equity focus lists, see the full report **Spotlight on long-term trends: Themes for yield** 31 May 2023.

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This content is a product of the UBS Chief Investment Office.