

Bond Case Briefs

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Munis Lag Sharp Swings Seen in Taxable Bond Markets.

In February, munis continued to lag the abrupt moves seen in the taxable bond markets prompted by heightened geopolitical risk and anxiety over inflation and monetary policy.

Keeping tabs on performance

For the first two months of 2022, tax-exempt paper (-3.2%) had underperformed an index of US Treasury securities (-2.6%) in the midst of high rate volatility. By contrast, munis held up better than investment grade corporate debt which witnessed steeper losses of over 5% on a year-to-date basis. We attribute the better performance from munis vis à vis corporate debt in large part to subdued new issuance. Thus far in 2022, the pace of new municipal bond sales is down by about 20% compared to the same time last year, as an example.

Outflows persist

The spike in rate volatility in the early weeks of 2022 had prompted municipal mutual fund inflows to reverse course. Munis have now posted losses for two straight months. And, muni mutual funds have witnessed net cash outflows for five consecutive weeks totaling roughly USD 10.6bn according to the Investment Company Institute (ICI). In the near-term, we anticipate outflows to continue leading up to the Fed meeting taking place in two weeks.

Portfolio themes

In the midst of heightened volatility, we recommend that muni investors consider the following portfolio strategies:

- **Consider short-dated munis for liquidity strategy.** Investors seeking opportunities to position assets for a liquidity strategy may now find better absolute values in short-dated munis. Yields on high grade AA munis at the two-year spot have jumped to now rest at over 1%, up from only 25bps in the first week of January.
- **Position in high coupon premium bonds at the longer part of the curve.** We prefer 4% to 5% premium bonds for their defensive characteristics. By contrast, low coupon bonds (2.5% to 3%) are more sensitive to interest rate changes and are vulnerable to become market discount bonds subject to unfavorable tax treatment.
- **Practice municipal sector diversification.** CIO provides detailed research coverage for 601 municipal obligors nationwide. This coverage spans across nine different sectors and serves as a useful guide for investors seeking diversification opportunities in the midst of volatile markets.

by UBS Editorial Team

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