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IN FOCUS
14 April 2025

Muni bond sectors brace for potential tariff shocks

The Trump administration's tariff policies have sparked economic uncertainty, with potential ripple effects across financial markets. Municipal bonds are somewhat insulated due to their backing by essential public services like education, water and transportation, which are less exposed to global trade dynamics. The impact of shifting tariff policies on municipal credit will vary greatly by sector and region, primarily driven by a potential slowdown in economic growth.

Update from the
Nuveen Municipal Credit Research Team

ECONOMIC UNCERTAINTY HAS AFFECTED SECTORS DIFFERENTLY

More economists are forecasting a slowdown in economic growth. If that comes to fruition, local economies and tax revenues may be pressured as a result. Favorably, state and local government credits are well positioned to weather an economic downturn, with strong balance sheets and significant control over expenditures. Fiscal year 2025 reserve funds are projected to reach 15% of spending versus 8% in fiscal year 2019, and states have broad authority to adjust budgets.

Many municipal issuers are essential service monopolies that have proven resilient during past economic slowdowns. People continue to pay taxes, water and electric bills, and use other essential services like toll roads and hospitals throughout economic downturns. Supply chain disruptions and construction cost increases will likely slow capital projects and increase borrowing costs for all issuers. Sectors likely to be most impacted by this dynamic are those that rely heavily on infrastructure renewal, such as transportation (airports, ports, mass transit), multi-family housing and utilities. Unlike the recent pandemic downturn, federal aid is not expected to provide monetary support to issuers dealing with cost escalations and revenue pressures. The pace of credit upgrades is likely to slow from cautious rating agencies.

STATE AND LOCAL GOVERNMENT: VARYING IMPACT

- State and local tax revenues could be pressured to the extent tariffs create a drag on economic growth and curb consumer spending. State impacts will vary based on state-specific revenue structures and economic composition.
- States that rely heavily on capital gains taxes or those with steeply progressive tax structures could see volatile swings in income tax collections.
- States that rely on sales taxes, especially those without a state income tax, may face budgetary

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pressure. Higher inflation may support sales tax collection growth, but reduced consumer demand could net out to flat to declining collections.

- Historically, high fund balances mean states have room to draw down rainy day fund balances, if needed.
- Declines in oil prices could negatively impact oil producing state economies and revenues.
- States that rely on manufacturing – particularly automotive manufacturing – are considered more vulnerable to economic downturn. Rising vehicle prices may depress consumer demand, leading to layoffs and idled plants. Tariffs on steel, aluminum and auto imports set at 25% will be especially challenging for large auto manufacturers, as well as smaller parts manufacturers.
- States with a high concentration of agricultural exports will also likely see a decrease in activity leading to depressed revenues, absent some form of federal government subsidy or support.
- Communities that depend more on cross-border trade may see a decline in commerce and trade flows.
- Local governments that rely more on property taxes, which are unlikely to see near-term declines from tariffs, should remain stable.

HEALTH CARE: HIGHER OPERATING EXPENSES

- Rising costs due to tariffs represent a headwind for hospitals still recovering from post-pandemic cost spikes.
- Weaker providers without the ability to absorb higher costs will be disproportionally impacted.
- Supplies and pharmaceuticals are large cost centers for most hospitals and often sourced from outside the U.S. A portion of growing costs may be passed on to insurers and patients, but some issuers will likely absorb these increases through lower margins.

TRANSPORTATION: REDUCED VOLUME

- The transportation sector is cyclical, with performance sensitive to economic fluctuations. Higher tariffs may lead to a lower volume of shipments (maritime and air cargo) and reduce cross-border freight (vehicle transactions on toll roads).
- A decline in consumer spending driven by higher inflation could reduce cargo volumes at ports, the demand for discretionary air travel, and the number of passengers at larger cruise ports.
- Higher construction costs may slow down large-scale capital projects critical to transportation that rely on well-maintained infrastructure.

HIGHER EDUCATION: SHIFTING ENROLLMENT

- In the past, enrollment at colleges and universities has increased during economic downturns.
- Tariffs will increase costs of goods for families and decrease discretionary income, negatively impacting parent and students' ability to pay for college.
- Stock market declines, especially if prolonged, will also lower families' wealth and impede ability to pay for college. This will be further exacerbated by potential reductions and delays in processing federal student loans.
- State funding for public higher education may be reduced due to pressured state finances, as observed in past recessions.
- Proposed endowment taxes coupled with investment market return declines, if prolonged, would hurt university endowments and fundraising. If a prolonged hit to markets extends an average return below 5%, annual spending for operations would be challenged.

HOUSING, RESIDENTIAL COMMUNITIES: HIGHER INVENTORY

- Home construction costs are expected to increase due to rising lumber, insulation and drywall costs. Increases in the number of available homes for sale will pressure builder pricing power across the market and limit the ability for builders to pass along price increases from tariffs to homebuyers. New home inventories are at higher levels than the market has seen since 2013.
- Builders are expected to reduce margins and increase incentives to maintain current pricing levels in new communities. National homebuilders are expected to continue their preference for carrying inventory rather than reducing home prices in the short term.

HOUSING, MULTIFAMILY HOUSING: INCREASED COSTS

- Early-stage multifamily housing projects may need to be renegotiated as cost increases from tariffs are realized. Even with guaranteed maximum price contracts, regional contractors are typically not induced to continue projects at an economic loss. Because there is limited recourse to enforce existing price contracts, developers will look to renegotiate and seek additional support from project partners, such as capital contributions from equity partners or grant and loan funding through housing programs.
- Construction delays should be expected, as projects currently under development will need to work with local housing agencies and equity partners to identify and manage impacts of tariffs on a project-by-project basis to ensure the project is completed in line with full distribution of bond proceeds.

UTILITIES: HIGHER RATES

- Tariffs could push up construction supply costs to power systems, such as steel and aluminum, but also may increase costs for other inputs like solar panels and battery systems.
- Rate increases will likely be passed on to utility customers as input costs into large electrical systems rise.

PROJECT FINANCE AND CORPORATES: MORE DEFENSIVE

- Most corporate credits are expected to temper capital expenditure plans and refocus growth initiatives to a more defensive posture.
- Some business relationships and supply contracts may not hold up to tariff pressures as supply chains are potentially pressured and disrupted. While some domestic producers such as steel and aluminum may seem to benefit from the tariffs, downside risk potential remains. Upward pressure on prices could weaken downstream customer demand.
- Guaranteed maximum price contracts should be shielded from inflationary pressures, but some tension is to be expected if contractors see significant cost pressures.

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Endnotes

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