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CIO Weekly Commentary
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CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Municipal bond deals: Let's make a yield

Bottom line up top

Earnings season wrapping up. With 93% of companies having reported third-quarter financial results, the S&P 500 Index is set to complete its fifth consecutive quarter of earnings growth. But even though 75% of those reporting have exceeded estimates for earnings per share (EPS) growth, the magnitude of outperformance has been disappointing, bringing to mind the classic quip, "Earnings beat expectations, but not by as much as expected." Index-level earnings growth for Q3 currently sits near 5.4%, roughly 200 basis points below the pace that analysts had estimated at the end of the second quarter, according to FactSet. In fact, only three of the S&P 500's 11 sectors have delivered earnings growth higher than their 30 June projections (Figure 1). And though U.S. equities appear to be settling after a powerful post-election rally, rapid price appreciation paired with decelerating earnings growth has led to frothy valuations: The S&P 500 is trading at 22.2x its 12-month forward price to earnings (P/E) ratio — a 20% premium over its 5-year average of 18.1x.

Portfolio positioning for the post-post-election world. Barring a meaningful pullback during the last six weeks of 2024, extended S&P 500 valuations are unlikely to prevent the index from gaining at least 20% for the fifth time in eight years. Dominant mega cap technology stocks, which propelled much of the index's rise in prior years, have seen their influence wane in favor of broader sector participation and leadership during the 2024 rally. This broadening has coincided most notably with the significant shift in interest rate expectations in July and the outcome of the November election. Market expectations for deregulation and pro-growth fiscal policies fueled outperformance

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On behalf of Nuveen's Global Investment Committee

As Head of Equities and Fixed Income, Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's Equities Investment Council and is a portfolio manager for several key investment strategies.

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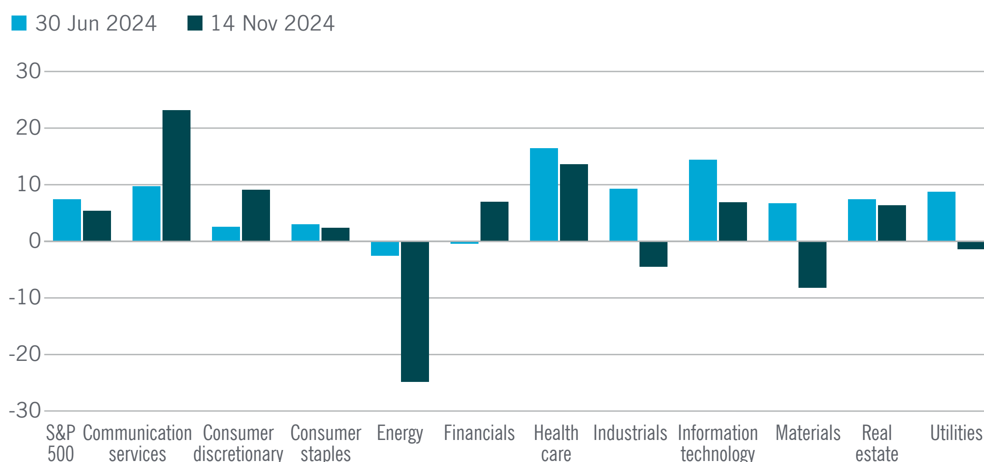
by areas like the financials sector (especially banks) and small cap stocks, which jumped +7% and +11%, respectively, in early November. Meanwhile, though U.S. equities could realize further upside heading into early 2025, we recognize that some of the anticipated policy changes — namely, tax cuts, deficit spending and tariffs — have the potential to reignite inflation and keep Federal Reserve policy rates higher than previously forecast for this easing cycle. Such a backdrop supports portfolio allocations to asset classes that can serve as a hedge against inflation and/or may benefit from a higher-for-longer interest rate environment.

U.S. equities are on track to return over 20% in 2024, although valuations are looking increasingly stretched.

FIGURE 1: U.S. EARNINGS GROWTH ESTIMATES CONTINUE TO MOVE LOWER

Q3 2024 S&P 500 earnings-per-share growth estimates (%)



Data source: FactSet, as of 14 Nov 2024. Data depicts the 12-month forward estimated EPS for the S&P 500 Index and individual sectors. **Past performance does not predict or guarantee future results.**

Portfolio considerations

In the wake of the U.S. presidential election, **municipal bonds** remain one of our favorite asset classes. The prospect of expanded stimulative measures from the incoming administration, coupled with a potentially less dovish Fed, could result in higher-for-longer U.S. Treasury and municipal yields, thereby offering muni investors higher levels of income over a more extended period than previously anticipated. Meanwhile, state and local government coffers are flush with record levels of cash as tax collections — the main source of repayment for municipal bonds — continue to increase.

Healthy economic data since the September rate cut, the first of the Fed's new easing cycle, has caused the Treasury curve to steepen, with the 10-year yield up by more than +60 bps. Even with that steepening, the overall Treasury curve is still a nearly flat line (Figure 2). In contrast, both the investment grade and high yield municipal curves show investors being

rewarded for extending duration. The highest-quality municipals (AAA rated) are outyielding Treasuries across the curve, with the differential growing larger as maturities increase. High yield municipals have a longer duration than their investment grade counterparts and were yielding 5.4% as of 14 November, with a taxable-equivalent yield of 9.1% for investors in the top income tax bracket.

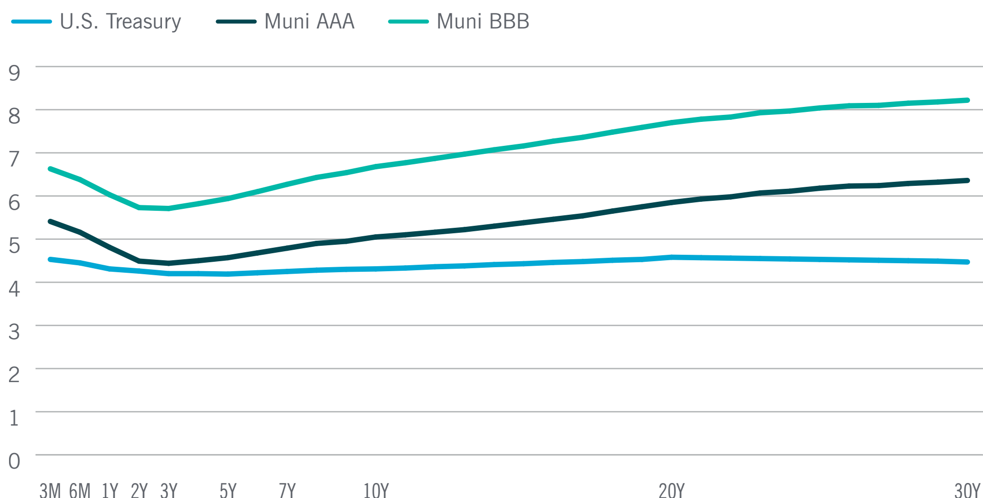
In the investment grade muni space, airports are one of our highest-conviction segments. Air passenger volume continues to fly high and is projected to rise +10% this year versus last, to a new record level. We also like water/sewage providers, as these essential service monopolies benefit from ample liquidity and cash from federal COVID relief programs.

As for high yield munis, health care continues to stabilize after facing post-COVID challenges, with operating margins beginning to recover as expenses normalize. Among health care municipal issuers, we favor large systems with sizable balance sheets and strong market positions. In addition to health care, municipal land-secured deals look attractive amid still-robust housing demand and diminished selling due to high mortgage rates, which pushes buyers into new housing communities and supports sector credit quality.

The higher-for-longer rates environment may prove to be especially beneficial for municipal bonds.

FIGURE 2: AAA MUNIS ARE OUTYIELDING TREASURIES ACROSS THE CURVE

U.S. Treasuries versus AAA and BBB municipal yield curves (taxable-equivalent yield, %)



Data sources: Bloomberg, L.P., 11 Nov 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Representative Indexes: U.S. Treasury: US Treasury Actives Curve; **Muni AAA:** Bloomberg Municipal AAA Curve; **Muni BBB:** BBB general obligation (GO) securities. Taxable-equivalent yield (TEY) is the yield a taxable investment needs to possess (before taxes) for its yield to be equal to that of a tax-free municipal investment. The yields shown are based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income. Individual tax rates may vary. They do not take into account the effects of the federal alternative minimum tax (AMT) or capital gains taxes.

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Regular meetings of the GIC lead to published outlooks that offer:

- macro and asset class views that gain consensus among our investors
- insights from thematic “deep dive” discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

For more information, please visit nuveen.com.

Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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