

## Third quarter 2025 outlook

# Summer tailwinds boost municipal market prospects



**Daniel J. Close, CFA**  
Head of Nuveen Municipals



**Margot A. Kleinman**  
Head of Research for Nuveen Municipals

*Market conditions present a compelling entry point for municipal bond investors. Yields are historically attractive, driven by heavy issuance and tax policy uncertainty. The steepening yield curve offers opportunities for duration extension and tax-loss harvesting. Looking ahead, greater tax policy certainty and reduced summer issuance, combined with strong reinvestment demand, should create favorable technical conditions, potentially sparking positive momentum into fall.*

## KEY TAKEAWAYS

- **Market dynamics:** Technical factors including substantial issuance have caused municipals to meaningfully underperform other fixed income sectors, raising yields and creating relative value opportunities.
- **Attractive entry point:** Municipal-to-Treasury yield ratios are at their most favorable levels since the post-October 2023 interest rate selloff, presenting an appealing opportunity for new investments.
- **Higher education trends:** The sector experienced heightened issuance as institutions sought financing amid federal policy uncertainties. Issuance should normalize once policy implications become clearer.
- **Seasonal factors:** Increased reinvestment demand from July and August maturities and calls, combined with typical summer supply reduction, may lead to stronger performance in the second half of the year.
- **Credit selection:** As sector-specific challenges widen the gap between stronger and weaker credits, careful security selection becomes increasingly important for portfolio performance.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE

---

## **BEST IDEAS FOR Q3: MUNIS OFFER A COMPELLING ENTRY POINT**

Current market conditions are attractive for municipal bond investors, with elevated yields, favorable valuations, strong fundamentals and improving technical factors. As we look ahead, we offer our best ideas for portfolio positioning:

### **Investment grade exposure in 10- to 20-year bonds offers enhanced yield with limited duration risk due to 10-year call structures.**

The steep municipal yield curve offers strategic advantages, particularly as municipal-to-Treasury ratios increase at longer maturities. Currently, investors can capture 197 bps of additional yield by extending from short to long maturities, with half of this pickup (104 bps) concentrated in the 10- to 20-year segment. Importantly, the prevalent 10-year muni bond call features typically limit additional duration risk when extending beyond 10 years, allowing investors to enhance yield without proportional duration exposure.

### **Short-duration high yield provides compelling opportunities for rate-sensitive investors, offering enhanced spreads and efficient yield per unit of duration.**

Short-duration high yield municipals currently yield 4.74% (8.01% TEY), offering attractive income for rate-sensitive investors. With spreads at +186 bps — 66 bps wider than long-duration high yield spreads — the current inverted credit spread curve offers a unique opportunity for short-duration portfolio diversification as the Fed balances rate stability against potential cuts.

For investors seeking enhanced total return potential, extending duration within high yield strategies using tender option bonds (TOBs) may prove beneficial. While duration has recently been a headwind, the steeper yield curve combined with anticipated Fed rate cuts in the second half of 2025 could benefit longer-duration strategies. Lower borrowing costs from expected rate cuts should support TOB-enhanced strategies, potentially delivering improved total return and income through leverage as market dynamics shift.

### **Portfolio optimization by replacing weaker structures with higher yielding, more defensive positions is possible with new issue concessions.**

Institutional investors may capitalize on current curve steepness through new issue participation, particularly bonds featuring 2035 call dates and 5% coupons. A strategic approach involves replacing shorter-call, lower-coupon holdings with new, more attractively structured issues.

### **Tactful exposure in pressured sectors such as health care, higher education and infrastructure programs may offer benefits with careful credit selection.**

Discussions surrounding tax policy, federal funding initiatives and regulatory changes could introduce both near-term risks and opportunities for muni issuers. Within health care, higher education and infrastructure, we believe targeted credit selection — rather than broad sector exposure — could benefit investors.

---

## **THE FED PROJECTS RATE CUTS DESPITE ECONOMIC CROSSCURRENTS**

The Fed held rates steady in June while adopting a slightly dovish tone. The Fed revised key forecasts, lowering annual GDP growth from 1.7% to 1.4%, while raising core inflation expectations (excluding food and energy) from 2.8% to 3.1% by year-end, well above its 2% target. Unemployment projections increased marginally to 4.5%.

Recent data continue to show resilience to tariff headwinds, with the consumer on track to accelerate in Q2 versus Q1. However, residential investment is set to slow. There are early signs that trade flows are redirecting to avoid tariffs, in line with expectations, which should soften the direct impact of high U.S.-China rates.

Chair Jerome Powell faces conflicting priorities, as weaker growth and employment suggest rate cuts, while higher inflation supports higher rates. Despite these challenges, the Fed expects two rate cuts in 2025. This is in line with our views.

Should rates decline this year, we anticipate investors may rotate from cash positions into municipals to capture additional yield.

MUNICIPAL BONDS BEGIN THE THIRD QUARTER ON SALE

Municipal bonds underperformed the broader fixed income market during the second quarter, with technicals acting as a stiff headwind. The Bloomberg Municipal Bond Index returned -0.12%, compared to the Bloomberg U.S. Aggregate Index at 1.21%, resulting in 1.33% of underperformance. 10-year AAA municipal yields rose 2 basis points (bps), while the 10-year Treasury yield rose 1 bps.

The municipal yield curve aggressively steepened during the quarter as well, causing long maturities to underperform. 20-year AAA municipal yields increased by 24 bps while 2-year AAA municipal yields decreased by -10 bps. A steeper municipal yield curve creates more opportunity in long duration going forward, but it negatively impacts portfolios focusing on the long end of the curve.

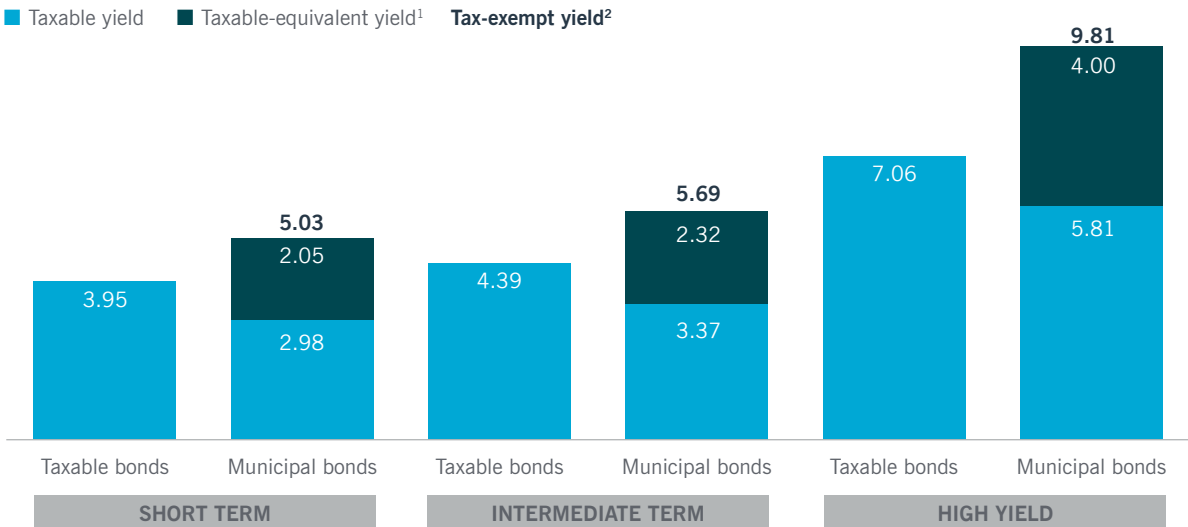
The municipal rate backup pushed second quarter yields higher, with the Bloomberg Municipal Intermediate Bond Index and the High Yield Index ending the period at 3.37% and 5.81%, respectively. For top tax bracket investors, these represent taxable-equivalent yields of 5.69% and 9.81% (Figure 1).

TECHNICAL FACTORS CAUSE MUNICIPALS TO BE DISCOUNTED

Supply trends remain robust, with year-to-date muni issuance up more than 16% versus 2024’s record-breaking levels, despite early April volatility. Issuance of \$220 billion year-to-date through May suggests 2025 could reach a record \$560 billion. Notable activity comes from higher education, with \$26 billion issued year-to-date, approaching 2024’s full-year total of \$29 billion, as institutions borrow proactively amid policy uncertainties.

Figure 1: Municipals are attractive on an after-tax basis

Yield comparison (%)



1 The taxable-equivalent yield is based on the highest individual marginal federal tax rate of 37.0%, plus the 3.8% Medicare tax on investment income (the Net Investment Income Tax). Individual tax rates may vary.

2 Some income may be subject to state and local taxes and the federal alternative minimum tax.

Data source: Barclays Live, 30 Jun 2025. Performance data shown represents past performance and does not predict or guarantee future results. Yields are yield to worst. Yield to worst is the lowest potential yield that can be received on a bond without the issuer defaulting. Taxable-equivalent yield 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. Representative indexes: short term taxable bonds: Bloomberg U.S. Government/Credit 1-5 Year Index; short term municipal bonds: Bloomberg Municipal Short Index; intermediate term taxable bonds: Bloomberg U.S. Government/Credit 5-10 Year Index; intermediate term municipal bonds: Bloomberg Municipal Intermediate Index; high yield taxable bonds: Bloomberg Corporate High Yield 2% Issuer Capped Index; high yield municipal bonds: Bloomberg High Yield Municipal Bond Index. Different benchmarks, economic periods, methodologies and market conditions will produce different results.

Demand remains healthy, with fund inflows of \$9.5 billion year-to-date, including \$3.8 billion into high yield sectors. SMA programs demonstrate a persistent appetite for high-quality bonds in the 1- to 15-year range. This preference is contributing to yield curve steepening, particularly in maturities inside of 5 years. Investors are favoring shorter duration assets amid the higher for longer rate environment and uncertainty regarding the timing and magnitude of Fed rate cuts in 2025.

Heavy supply and cautious dealer positioning have pressured municipals relative to broader fixed income. However, significant July and August reinvestment needs from bonds maturing and bond calls potentially support stronger second half performance.

MUNI YIELD RATIOS REMAIN CHEAP

Municipal-to-Treasury yield ratios have historically been a barometer of relative value in the municipal market. The benchmark 5-, 10- and 30-year ratios have averaged 65%, 67% and 86%, respectively, since the bottom of the interest rate selloff on 31 Oct 2023. Current ratios of 70%, 77% and 95% are the cheapest levels since the recovery began nearly two years ago (Figure 2 shows the 10-year ratio).

10-year AAA rated municipal bonds finished the second quarter yielding 3.30%, surpassing the trailing 10-year average by 1.23%. For top-bracket investors, this represents an additional 2.24% in taxable-equivalent yield. Similarly, AA rated 10-year municipals closed at 3.37%, delivering a 5.69% taxable-equivalent yield — notably higher than lower-rated BBB corporate bonds yielding 5.18%.

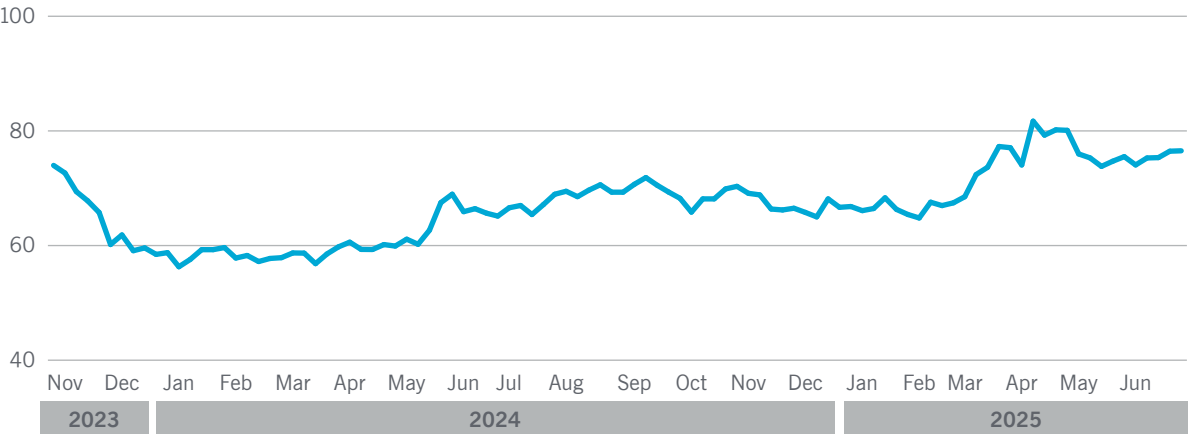
While recent technical pressures have weighed on municipal bond performance, those headwinds may prove to be temporary. Green shoots are emerging, including strong summer reinvestment demand and the potential for tempered seasonal issuance. Should the Fed implement rate cuts, we anticipate increased investor rotation from cash positions to municipals. Moreover, high-quality municipals offer attractive relative value versus mid-grade corporates, historically providing more defensive positioning during market volatility.

MUNICIPAL BOND FUNDAMENTALS SHOWCASE STRENGTH

Municipal investors welcomed good news when the U.S. House of Representatives’ draft budget reconciliation bill preserved municipal bond tax exemptions. However, certain market segments — particularly higher education

Figure 2: Municipal-to-Treasury yield ratios represent compelling relative value

10-year municipal-to-Treasury yield ratio (%)



Data source: Bloomberg, L.P., 31 Oct 2023 – 30 Jun 2025. Performance data shown represents past performance and does not predict or guarantee future results. Data represent the AAA municipal bond yield as a percentage of the U.S. Treasury yield for 10-year maturities.

issuers — remain vulnerable. Reports indicate the Treasury Department may revoke tax-exempt status for universities that consider race in college admissions, scholarships and other areas. While investors await more policy clarity from Washington on the future of the muni bond tax exemption, much of the market appears to be out of the woods, for now.

Amid federal policy uncertainty, economic fluctuations and Fed actions, Nuveen's municipal credit research team maintains confidence in most municipal borrowers' resilience. Nearly all municipal borrowers are essential service monopolies with broad ability to raise revenues and reduce expenditures as needed.



*Amid uncertainty, Nuveen's municipal credit research team maintains confidence in most municipal borrowers' resilience.*

State and local governments enter this uncertain period with historically strong reserves and healthy tax collections, which increased 5.8% in the first quarter of 2025 compared to the same period last year. Nevertheless, states are planning for a more challenged fiscal year (FY) 2026 due to expectations for slower revenue growth and federal funding uncertainty. Planned reserve draws are expected in some states, but fund balances should remain well above pre-pandemic levels. The median state rainy day fund balance is projected to be 15% of FY25 spending, nearly double the 8% seen in 2019.

However, certain sectors warrant closer monitoring for potential volatility:

**Health care:** Non-profit hospitals face pressure on Medicaid funding, with potential changes to provider tax policies and stricter eligibility requirements threatening this key revenue stream.

**Higher education:** Institutions may struggle with grant funding cuts, increased endowment taxation and reduced federal student loans, potentially affecting enrollment and limiting tuition increases.

**Infrastructure:** Large transportation projects may receive less federal support than anticipated.

These challenges will likely widen the gap between financially strong and weak entities — the haves and have-nots — within each sector. The varying impact of these changes makes careful credit selection increasingly critical for investors navigating the municipal market.

---

## MUNICIPAL POSITIONING IMPROVES AS THE MARKET RECALIBRATES

The municipal bond market is beginning to show signs of improvement. Supply conditions are expected to normalize, at least over the summer months, and greater certainty about the municipal tax-exemption should prove to be a positive catalyst. Investor demand is likely to strengthen in response to higher than average yields and potential Federal Reserve rate cuts. We believe these favorable dynamics, coupled with strong credit fundamentals, position municipal bonds for enhanced performance going forward.

**For more information, please visit [nuveen.com](https://nuveen.com).**

#### Endnotes

#### Sources

Gross Domestic Product: U.S. Department of Commerce. Treasury Yields and Ratios: Bloomberg (subscription required). Municipal Bond Yields: Municipal Market Data. Open-end fund flows: Investment Company Institute. Municipal Issuance: Siebert Research. Defaults: Municipals Weekly, Bank of America/Merrill Lynch Research. State Revenues: The Nelson A. Rockefeller Institute of Government, State Revenue Report. State Budget Reserves: Pew Charitable Trust. Global Growth: International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD). Standard & Poor's and Investortools: <http://www.invttools.com/>. Flow of Funds, The Federal Reserve Board: <https://www.federalreserve.gov/releases/z1/default.htm>. Payroll Data: Bureau of Labor Statistics. Bond Ratings: Standard & Poor's, Moody's, Fitch. New Money Project Financing: The Bond Buyer. State revenues: U.S. Census Bureau.

Losing tax exemption would increase borrowing costs, market-access risks, Moody's Ratings, 29 Jan 2025. Medicaid stress tests: federal spending cuts would force benefit reductions, Moody's Ratings, 06 Feb 2025. U.S. Local Government Credit Quality Could Wobble as Federal Policy Shifts, S&P Global Ratings, 27 Feb 2025. Federal policy proposals skew to credit risk for public finance sectors, Moody's Ratings, 06 Mar 2025. U.S. States Brace for Potential Medicaid Funding Gaps, S&P Global Ratings, 20 Mar 2025.

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals.

The views and opinions expressed are for informational and educational purposes only as of the date of production/writing and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections, forecasts, estimates of market returns, and proposed or expected portfolio composition. Any changes to assumptions that may have been made in preparing this material could have a material impact on the information presented herein by way of example. **Performance data shown represents past performance and does not predict or guarantee future results.** Investing involves risk; principal loss is possible.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. For term definitions and index descriptions, please access the glossary on [nuveen.com](https://nuveen.com). **Please note, it is not possible to invest directly in an index.**

#### Important information on risk

Investing involves risk; principal loss is possible. All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments. This information should not replace an investor's consultation with a financial professional regarding their tax situation.

Nuveen is not a tax advisor. Investors should contact a tax professional regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

Taxable-equivalent yields 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.

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

Nuveen, LLC provides investment solutions through its investment specialists.

This information does not constitute investment research as defined under MiFID.

**NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE**

# nuveen

A TIAA Company