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First quarter 2024 outlook

Taxable municipal bonds: Starting strong

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In the fourth quarter, the taxable municipal bond market posted its strongest quarterly return since 2011. Taxable municipals rallied in sympathy with U.S. Treasuries on expectations that the U.S. Federal Reserve (Fed) will begin easing rates in 2024. While rates have rallied from the highs, yields are at their highest point to start a year since 2011. We believe portfolios should be rewarded by assuming a modestly longer duration profile while selectively adding credit through essential service providers.

KEY TAKEAWAYS

- The Fed's dot plot in December suggested rate cuts in 2024, and the resulting Treasury rally supported the taxable municipal market in the fourth quarter.
- We believe attractive yield levels and the prospects of rate cuts should bolster demand for long-duration fixed income.
- Taxable municipal bonds should be well placed to capitalize on solid fundamentals.

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OUTLOOK: ATTENTION SHIFTS TOWARD FED RATE CUTS

We believe the Fed is finished hiking interest rates. Given our outlook for modest rate cuts to start in 2024, we expect the Treasury yield curve to move lower.

Rate cuts are expected to help alleviate hedging cost pressures, likely attracting foreign demand back to the Treasury market. The Fed may also end its balance sheet runoff policy, further reducing excess supply. We believe fair value for the 10-year Treasury yield in the medium-term is around 3.50%.

In this environment, investors may enjoy attractive total returns from income alone, ***a dynamic absent for nearly a decade.***

U.S. INFLATION OFFERS OPTIMISM, WITH POTENTIAL FOR FURTHER SQUEEZES

Our base case is for core inflation to finish 2024 around 2.75% – 3.00%. This view is driven by:

- Shelter costs decelerating materially, normalizing near 3% annualized by mid-2024.
- Non-housing core services slowing from around 4% to 3%.
- Goods price inflation remaining near zero amid the pivot from manufactured goods to services.
- Energy prices stabilizing.

However, these factors could push inflation higher than our forecast:

- Housing prices have rebounded somewhat. Given the lag of approximately 15 months between actual housing market activity and housing price inflation, we may see upside risks in late 2024.
- Energy prices reflect international dynamics, and geopolitical uncertainty could weigh heavily.
- Wage inflation has been decelerating, along with a softening labor market, which helps moderate core services inflation. A stronger-than-anticipated labor market may put upward pressure on wage inflation.

MANY REASONS FOR CONFIDENCE

We believe the taxable municipal market is poised for improvement in 2024, depending on how the economy responds to the end of Fed rate hikes. The Fed and others believe a soft landing is still possible, but we remain unconvinced. Regardless, we believe municipal credit may help stabilize investment portfolios.

While the Fed's torrid pace of rate hikes has impacted taxable municipal bond yields, credit fundamentals remain strong. State and local governments remain flush with cash after several rounds of stimulus during the pandemic, and revenues remain well above pre-pandemic averages.

Taxable municipal bonds should be well placed to capitalize on these solid fundamentals, with yields starting 2024 at their highest level since 2011. In this environment, investors may enjoy attractive total returns from income alone, a dynamic absent for nearly a decade.

2023 was the second consecutive year of increased market volatility for municipals, keeping some investors out of the market as they wait for the end of the Fed's hiking cycle. We believe attractive absolute yield levels should encourage demand once investors remaining on the sidelines feel confident the Fed's rate hikes are done.

Total new issue supply ended 2023 down 2% compared to 2022, the second consecutive year of lower year-over-year supply. Taxable municipal supply was even more suppressed, ending the year down -31% compared to 2022 levels. If investor sentiment shifts positively, as we expect, strengthening demand could absorb secondary market supply and act as a further catalyst for spread tightening given the scarcity of new issue paper over the last two years.

With a focus on fundamental strength, we believe municipal bonds have attractive potential in well-diversified, long-term portfolios.

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2024 THEMES

Economic environment

- Inflation has softened in recent months via goods and the rollover of housing costs, providing favorable trajectory entering 2024.
- Core services inflation excluding housing remains sticky but is starting to trend down.
- The fed funds rate has risen by 525 basis points (bps) during this cycle (to end 2023). Fed policy remains data dependent, with a focus on core services inflation.
- We expect 150 bps of rate cuts in 2024 with the timing dependent on inflation, wage and employment data.
- U.S. growth should trend lower as the impact of Fed policy is fully absorbed. Key factors include interest rates, geopolitical issues and declining money supply.
- While a soft landing remains possible, once the economy begins moving one direction, it tends to stay on that course absent outside forces.
- Uncertainty regarding the end of Fed policy will continue to cause rate volatility.
- Fed funds could decline more than anticipated if the economy slows more than forecast.

Municipal market environment

- Credit remains strong, with robust levels of rainy day and reserve funds.
- While revenue collections are below peaks witnessed in 2022, they remain above pre-pandemic levels.
- We expect municipal defaults will remain low, rare and idiosyncratic.
- Supply throughout 2024 could hover near levels seen in 2023. Predictions include more coupons, calls and maturities than new issues.
- Demand has favored owning duration, a trend which could continue and even accelerate in 2024 with investors who don't want to miss out.
- Yields remain attractive despite a strong rally in November. Demand could increase in 2024 as investors gain conviction that the Fed is done hiking.
- Municipal performance rebounded sharply in November. Absent a meaningful catalyst, municipals can still post attractive returns based on elevated income generation from adjusted rates.
- Long-term tax-exempt and taxable municipal valuations are attractive on a spread basis, compared to similar-maturity U.S. Treasuries and corporate bonds.

THE FED AND TREASURY PIVOT LEADS TO A RALLY

Fixed income investors were fatigued at the end of October. The 10-year Treasury yield touched 5.0%, inflation remained sticky and the labor market strengthened further, offering no relief to the Fed. The highest yields in decades spurred demand, and the municipal market remained constructive through the turbulence. Yields for taxable municipals reached nearly 6% during the October sell-off in U.S. Treasuries. This level bolstered the market and caused long-duration demand to increase.

Market sentiment shifted quickly in November, and municipals were off to the races with the Fed on hold and weaker-than-expected employment and inflation data. The fed fund futures market quickly priced in a near zero probability of future rate hikes and the U.S. Treasury announced less supply than expected for coupon bonds, supporting Treasury market technical factors.

The Fed's December dot plot suggested rate cuts in 2024, and markets were rightfully delighted. A balancing act between taming inflation and supporting labor means the Fed could change direction if the economy shows signs of recession over the next year.

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The resulting Treasury rally supported the taxable municipal market in the fourth quarter. Going forward, we believe performance should continue to improve. As the economy continues to cool, interest rates should moderate further, supporting high-quality fixed income. In addition, a record amount of cash on the sidelines could make its way to longer-term investments.

TAXABLE MUNI BONDS FOLLOW TREASURIES STRONGER

Taxable municipal bond yields declined in sympathy with Treasury yields during the quarter. The yield on the Bloomberg Taxable Municipal Bond Index declined by -73 bps, finishing at 4.86%. Yields for the index peaked in late October, reaching as high as 5.93%. While the Bloomberg Taxable Municipal Bond Index returned -2.05% during October, the strong rally in November and December produced a fourth quarter total return of 7.89% and 2023 year-to-date return of 8.84%.

Performance during the quarter was mainly a function of the rally in Treasuries as credit spreads only narrowed by -2 bps. Municipal credit maintained its positive momentum as upgrades outpaced downgrades by a 4:1 ratio in 2023 and credit spreads for the year tightened by -38 bps.

The essential service nature of the municipal market has historically afforded resiliency in the face of economic uncertainty. Enthusiasm around higher yields continues to build, especially as they offer more cushion against Treasury volatility.

*The essential service nature of the municipal market has **historically afforded resiliency in the face of economic uncertainty**.*

Figure 1: Year-to-date returns

Index	Yield to worst (%)	Spread (bps)	Effective duration (years)	2023 YTD	2023 Q4
Taxable municipal (AA-)	4.86	82	7.84	8.82	7.89
U.S. Treasury (AA+)	4.09		6.11	4.05	5.66
U.S. aggregate bond (AA)	4.54	42	6.20	5.53	6.82
U.S. corporate investment grade (BBB+)	5.06	98	7.06	8.52	8.50
Global aggregate (unhedged) (A+)	3.51	43	6.64	5.72	8.10

Data source: Data as of 31 December 2023. Source: Bloomberg, L.P., December 2023. All returns in USD, unhedged: Bloomberg Municipal Index Taxable Bonds Total Return Index Value, Bloomberg US Corporate Total Return Value Unhedged USD, Bloomberg US Treasury Total Return Unhedged USD, Bloomberg Global-Aggregate Total Return Index Value Unhedged USD, Bloomberg US Agg Total Return Value Unhedged USD, Bloomberg Global Agg Corporate Total Return Index Value Unhedged USD, Bloomberg US Agg ABS Total Return Value Unhedged USD, Bloomberg US MBS Index Total Return Value Unhedged USD. Disclaimer: Past performance does not predict or guarantee future results. The format and content of this report may not be modified or altered (including, but not limited to, via deletion or addition) in any way. The BLOOMBERG PROFESSIONAL service, BLOOMBERG Data and BLOOMBERG Reporting (the "Services") are owned and distributed locally by Bloomberg Finance L.P. ("BFLP") and its subsidiaries in all jurisdictions other than Argentina, Bermuda, China, India, Japan and Korea (the "BLP Countries"). BFLP is a wholly-owned subsidiary of Bloomberg L.P. ("BLP"). BLP Provides BFLP with global marketing and operational support and service for the Services and distributes the Services either directly or through a non-BFLP subsidiary in the BLP Countries. BFLP, BLP and their affiliates do not provide investment advice or guarantee the accuracy of prices or information in the Services. Nothing on the Services shall constitute an offering of financial instruments by BFLP, BLP or their affiliates.

TECHNICAL ENVIRONMENT REMAINS SUPPORTIVE

Supply

Total new issuance declined 2.8% in 2023 versus 2022. Taxable municipal issuance was $37.4 billion during the year, a 31% decline compared with 2022 levels. Issuance was down in 2022 as well, making two consecutive years of light supply.

The taxable municipal market saw historically large amounts of reinvestment from outsized bonds maturing and coupon payments, resulting in periods of net negative supply. In addition, tender activity increased, pulling bonds out of the market. Total net issuance for 2023 was roughly -$2 billion.

First quarter issuance trends are typically benign, but declining rates could bring more issuance than is typical. After two consecutive years of light supply and refreshed enthusiasm for fixed income, any uptick should be readily absorbed.

In 2024, we expect supply to trend more in line with historical averages, with total supply being approximately $375 billion and taxable municipal bond supply expected to be closer to $75 billion.

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Demand

Following the extreme U.S. Treasury volatility in 2022 and a strengthening U.S. dollar, demand weakened from a combination of currency hedging losses and investors' desire to wait out the Fed's rate hike cycle. In 2023, we saw some improvement. Demand for long duration remained a bright spot. Liability driven investors with an objective of hedging their long duration liabilities exhibited very strong demand over the course of 2023.

Total return investors remained patient, as the Fed's rate hike program was unclear until late in the year. Now with more clarity from the Fed and continued moderation in inflation, we expect demand from total return focused investors to increase in 2024.

Defaults

First-time municipal bond defaults totaled $1.8 billion in par during 2023, trending with historical averages. Defaults were concentrated in three sectors, with 62% coming from senior living, project finance and non-profits. Defaults have predominantly been focused in the tax-exempt high-yield market.

While economic uncertainty exists, widespread issues are not expected in 2024, as record balance sheets should provide ample protection for most issuers. We expect municipal bond defaults to remain low, rare and idiosyncratic, reflecting the resiliency of the asset class even in economic downturns.

The credit backdrop overall has been robust. Upgrades have outpaced downgrades by a 4:1 ratio for two years in a row. However, given the pace of upgrades since 2020, this momentum is much less likely to continue. We expect closer to a 1:1 ratio for upgrades versus downgrades.

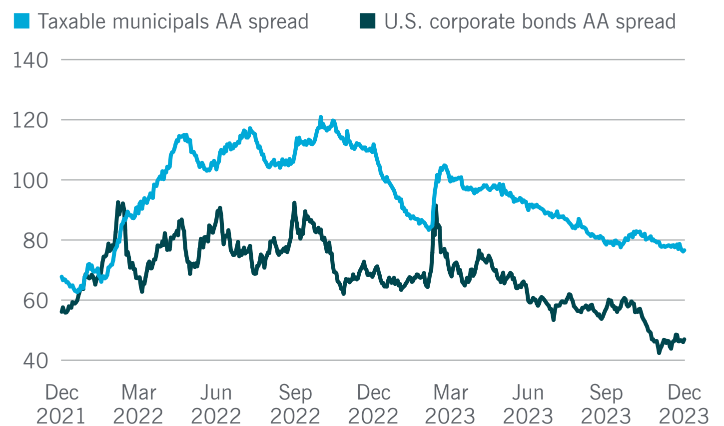
Credit spreads

Taxable municipal credit spreads narrowed during the fourth quarter from 84 bps to 82 bps on an option adjusted spread basis. In a period where U.S. Treasuries are declining sharply, it is not unexpected to see benign credit spread movement overall.

With market participants feeling enthusiastic over the possibility of a soft landing, lower quality areas of the market tightened more. BBB rated option adjusted spread tightened by -7 bps while A rated option adjusted spread tightened by -5 bps.

Credit spreads overall are near their 2021 year-end levels, reversing the widening that occurred during the extreme volatility of 2022. While spreads overall are tight, taxable municipal bonds remain attractive on a relative value basis compared with corporate bonds. More specifically, AA rated taxable municipals ended 2023 with 30 bps spread advantage over AA rated corporate bonds.

Figure 2: AA Taxable municipal bond spread vs AA U.S. corporate bond



Data source: Bloomberg, Taxable Municipal Index December 2021 - 31 December 2023. AA rated option adjusted spreads. Bloomberg Municipal Index Taxable Bonds Total Return Index Value, U.S. Corporate Total Return Value Unhedged USD.

STATES' ACCUMULATED CASH AND RESERVES OFFER STABILITY

Heading into 2024, many state and local governments are planning for budget deficits, as they expect revenue collections to decline. Total state and local tax revenues were down 5.7% through the first half of 2023, driven by a steep 23.6% decline in individual income tax collections compared to the first half of 2022.

Despite this decline, total tax collections remain above pre-pandemic nominal levels. Total tax revenues for the first half of 2023 are nearly 24% higher than 2019, and almost 31% higher than in 2020. Income tax collections are also strong compared to pre-pandemic levels.

2022 peak tax revenue collections were boosted by an influx of federal aid, higher capital gains taxes from strong stock market returns, sales taxes boosted by higher inflation, and accelerated consumer spending. As many of these factors have waned, tax collections are unsurprisingly lower in 2023 compared to the tremendous, unanticipated revenue growth seen in 2021 and 2022.

States rely on income taxes for about 40% of revenues and sales taxes for more than 35% of total revenues, and some states with progressive tax structures, like California, may be more sensitive to economic conditions. However, the revenue slowdown will not necessarily cause a sector-wide deterioration in credit quality, as states have prepared for revenue declines. States originally forecasted lower revenues for fiscal year (FY) 2023 with initial budgets projecting a 3.1% decline. The presumed tax revenue decline was based on lower economic growth, consumption patterns shifting from goods to services and the impact of tax policy changes. Some revenue declines were intentional as many states had cut tax rates and revised income tax bracket structures.

Given conservative budgeting, most states ended FY23 with a budget surplus, adding to historically high reserves. Rainy day fund balances are projected to remain at all-time high levels in FY24 which can soften the impact of revenue declines. Adopted state budgets for FY24 project lower revenues and less spending.

Strong municipal credit fundamentals are reflected in credit ratings. Moody's ratings saw the tenth consecutive quarter of rating upgrades outpacing downgrades.

For more information, please visit nuveen.com.

Endnotes

Sources

State and local tax burdens, calendar year 2022. Tax Foundation. (2023, August 2); Explaining changes to the state and local tax deduction. SmartAsset. (n.d.).; Hulehan, K. (2023a, December 7). Policymakers must weigh the revenue, distributional, and economic trade-offs of SALT deduction cap design options. Tax Foundation.; State tax rates: Tax Foundation; 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: Seibert 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.invtools.com/. Flow of Funds, The Federal Reserve Board: http://www.federalreserve.gov/releases.pdf. 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.

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