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2025 MUNICIPAL MARKET OUTLOOK

Time to shine

Five themes for municipal fixed income

Muni bonds are coming into favor

Municipal yields are set to end the year higher than where they started, and we believe muni bonds continue to be a compelling asset class that can offer investors attractive taxable-equivalent yield. We are bullish on municipal fixed income given attractive current yields and solid credit fundamentals. We believe municipal bonds have upside potential in well-diversified, long-term portfolios for investors looking past broader economic trends and focusing on strong fundamentals.

KEY TAKEAWAYS

- The U.S. Federal Reserve has reduced inflation, but now ***the market is focused on fiscal policy.*** Keep an eye on taxes.
- ***Municipal bond yields and spreads are compelling,*** which should garner demand across investment grade and high yield municipal bonds.
- ***Supply is expected to remain elevated,*** driven mainly by issuers' pent-up demand for infrastructure projects amid acceptance of a higher-for-longer rate environment.
- ***Demand continues to favor owning duration.*** Investors do not want to miss out.
- ***Muni credit is strong but requires discerning credit research.*** Republican control in Washington is not expected to materially shift municipal credit trends.

Five themes for 2025

1. Taxes are in the spotlight

Markets shift focus from monetary to fiscal policy

Nuveen believes interest rates could stay higher for longer, benefiting investors seeking higher investment yields. As the Fed began cutting rates in late 2024, market expectations for a soft landing gained momentum, and long-term rates moved higher as stronger economic growth was priced into the yield curve. Following the Republican sweep in the November elections, the prospect of higher stimulative measures, coupled with a less dovish Fed, could mean U.S. Treasury and municipal yields stay higher for longer.

We expect a push to extend several key provisions of the 2017 Tax Cuts and Jobs Act (TCJA), including the current marginal tax rate levels for high-income earners and the cap on deductions for state and local taxes (SALT). In addition, alternative minimum tax (AMT) provisions are likely to remain in place, reducing the number of individuals subject to that tax from about 5 million to 200,000 (Figure 1).

Discussion about tax reform usually leads to debate about whether the muni tax exemption might be eliminated to fund broader tax cuts. While we expect meaningful headlines, we believe muni tax exemption will be retained well into the future due to its importance in financing local infrastructure.

Figure 1: The tax landscape is likely to be status quo for muni investors

Tax Cuts and Jobs Act (TCJA)	State and Local Tax (SALT) deduction cap	Muni bond tax exemption
Extended • Top marginal tax rate most likely extended • AMT exemption remains higher, impacting fewer taxpayers • Spreads may narrow for AMT bonds	**Uncertain policy implications** • If maintained, SALT deduction could stay capped at $10K • Deduction cap supports higher federal and state income tax collections	**Some sectors may be impacted** • No indications this will be revisited • Private activity bond (e.g., not-for-profit hospitals and higher education) restrictions discussed in 2017 but not enacted

2. Valuations are a tailwind

Compelling muni yields and spreads boost demand

Right now, many investors are evaluating relative value for municipal bonds. The historical average for 10-year municipal-to-Treasury ratios is 84%. However, the market experienced a structural shift over the last five years. U.S. households, the main buyer of municipal bonds, have doubled their liquid net worth while the muni market has seen little growth in outstanding bonds. The structural supply/demand imbalance has moved the ratios lower, making sub-70% ratios the new normal (Figure 2).

While other corporate credit markets have tightened toward all-time lows, high yield munis continue to offer compelling spreads. High yield municipal bond spreads ended October 2024 at +186 basis points (bps) over the 30-year AAA-rated municipal bond rate (Figure 3).

Conditions remain favorable for continued tightening in high yield municipals. Over the last two decades, the risk of wider credit spreads has been associated with liquidity events or contagion. In contrast, the current environment is healthy, credit conditions are robust, and contagion risks that existed over the last two decades (Puerto Rico, Detroit, Jefferson County and Illinois) are no longer present. In addition, investors have ample liquidity, with more than $6 trillion held in cash equivalents.

TAXABLE SPOTLIGHT:

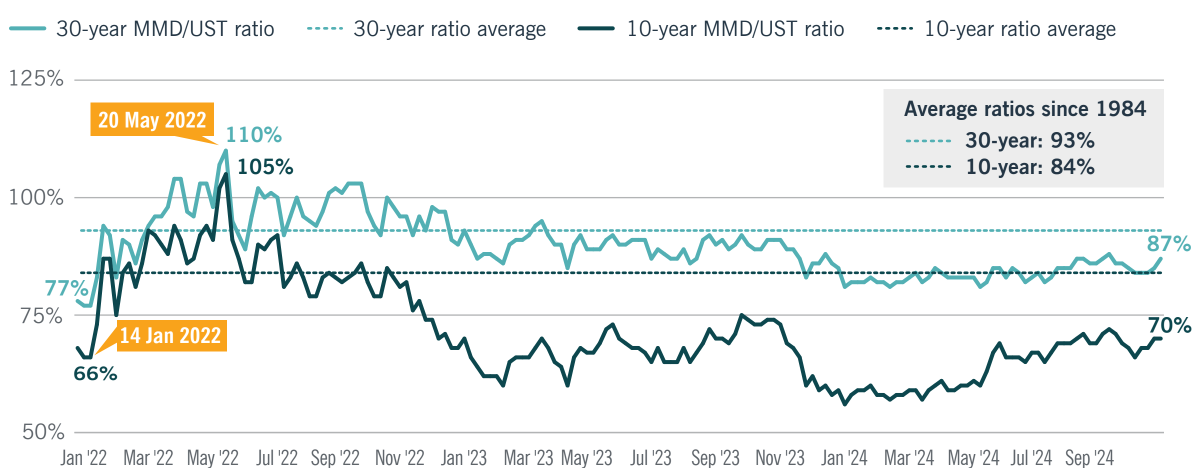
Taxable muni bonds offer a spread advantage

Taxable credit markets overall are approaching the tighter conditions experienced after the global financial crisis. Taxable municipal option-adjusted spreads ended October at +64 bps. This is -19 bps tighter than the beginning of the year and slightly wider than the +59 bps record tight levels reached in May 2024. Corporate bond markets have seen similar tightening of -15 bps year to date.

Taxable municipal bonds offer a spread advantage over corporate bonds on an equally rated basis. AA rated taxable municipal bonds have an average spread of +61 bps, versus a corporate bond average spread of +45 bps as of 31 October 2024. Considering these spread levels amid economic uncertainty as the Fed navigates a soft landing, taxable municipals may offer more downside protection relative to corporate bonds.

Figure 2: Absolute yield levels are attractive, but technical conditions have lagged

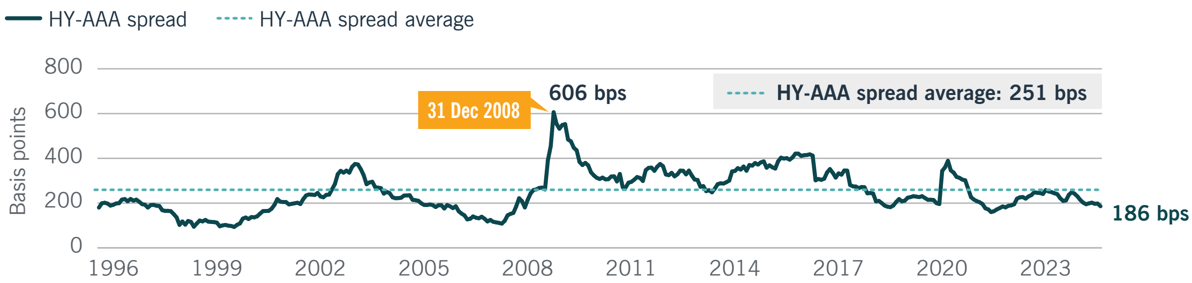
Municipal-to-Treasury ratios: AAA municipal bonds value relative to Treasuries



Data source: Refinitiv MMD for fair value Municipal 10- and 30-Year Index AAA General Obligation bonds; Bloomberg for 10- and 30-year U.S. Treasury yields, shown weekly, 31 Dec 2021 – 31 Oct 2024, averages shown from 01 Jan 1984 –31 Oct 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Municipal-to-Treasury ratio represents the value of AAA municipal yields relative to U.S. Treasury yields.

Figure 3: High yield municipals continued to offer compelling spreads

Bloomberg High Yield Municipal Index versus AAA yields



Data source: Bloomberg, Refinitiv MMD, 31 Oct 1995 – 31 Oct 2024, shown monthly. Chart shows data to the earliest period available. **Performance data shown represents past performance and does not predict or guarantee future results.** High yield municipal yields represented by the Bloomberg High Yield Municipal Index; AAA municipal yields represented by Municipal Market Data (MMD) yields for AAA rated 20-year bonds. High yield or lower-rated bonds and municipal bonds carry greater credit risk, and are subject to greater price volatility. Ratings shown are from S&P and are subject to change. AAA,AA,A, and BBB are investment grade ratings; BB,B, CCC/CC/C and D are below-investment grade ratings. Different benchmarks, economic periods, methodologies and market conditions will produce different results.

3. Elevated muni supply continues

Issuance influenced by taxes, infrastructure and refunding

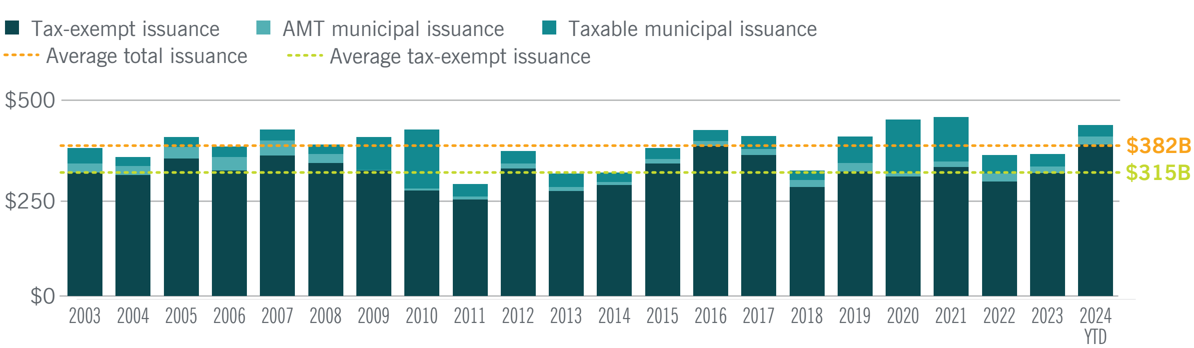
Tax-exempt municipal bond supply rebounded in 2024, after tepid environments in 2022 and 2023 (Figure 4). Issuance through October 2024 was 43% higher than last year at $436 billion ($406 billion tax-exempt, $30 billion taxable). Taxable municipal bond supply, which was more robust in lower interest rate environments, remained light in 2024. We expect the supply of taxable municipals to remain light in the current higher interest rate environment.

Supply volume in 2025 will be influenced by federal tax policy. While our base case is that the TCJA will be extended in some form, any discussions around tax changes could shift supply trends. Outside of tax policy, we anticipate robust tax-exempt supply due to ongoing infrastructure needs and current refunding volume. We expect another year of supply that could touch $500 billion.

Importantly, municipal supply should be more diversified. We expect more high yield municipal issuance to address infrastructure needs, especially in areas of population growth. We also anticipate that more smaller issuers have accepted the higher-for-longer rate cycle and will tap the market in 2025.

Figure 4: We anticipate robust tax-exempt supply in 2025

Municipal issuance ($ billions)



Data source: Securities Industry and Financial Markets Association (SIFMA.org), *U.S. Bond Market Issuance and Outstanding*, 04 Nov 2024 for period ending 31 Oct 2024. The average total issuance and average tax-exempt issuance shown are for the period 01 Jan 2003 – 31 Dec 2023. AMT municipal issuance is part of the tax-exempt municipal market.

4. Demand remains strong

Cash returns should diminish with Fed cuts

The municipal market still has room to recover. 2024 fund inflows of $28.7 billion through October have not yet matched the -$170 billion in outflows in 2022 and 2023 as investors exited municipal funds in response to the Fed's aggressive policy stance (Figure 5). One reason for the lag is that high net worth individuals continue to receive adequate compensation in cash equivalents, suppressing demand for municipal bonds.

Diminishing returns in cash equivalents are expected as the Fed continues to cut rates. A reduced fed funds rate combined with a robust economy creates a steeper yield curve. That steepness may attract more long-duration municipal bond demand from individuals with cash on the sidelines.

TAXABLE SPOTLIGHT:

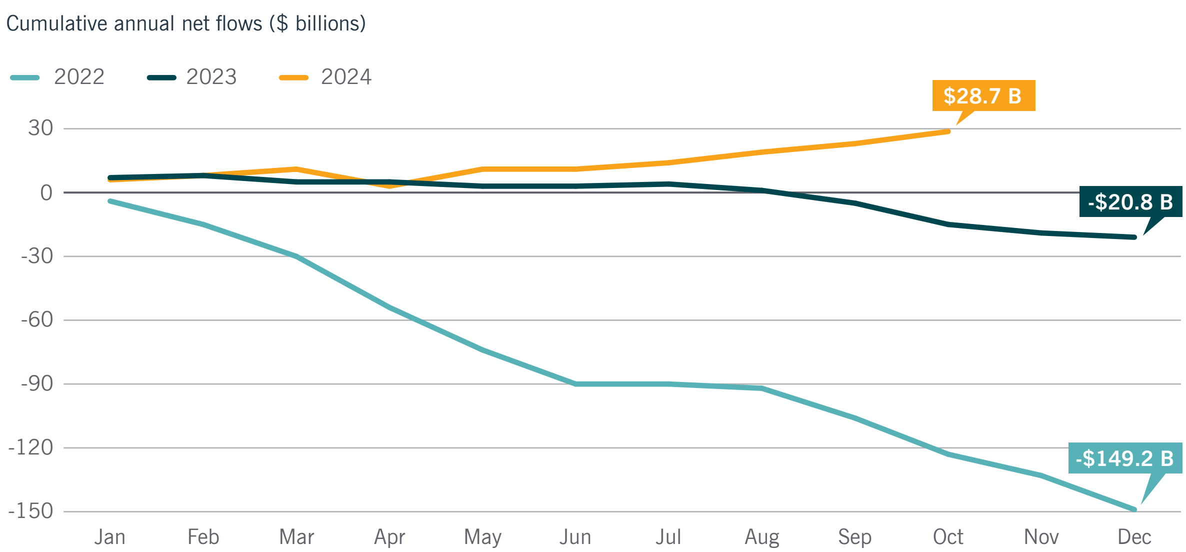
Taxable muni bond technicals are expected to remain solid

Taxable municipal bond supply will likely remain suppressed due to higher interest rates. But the prospect of a steeper yield curve in 2025 may mean upwards of $50 billion in supply, surpassing this year's expected $35 billion.

2025 could produce net negative supply, which is positive for taxable muni investors. Bond calls and bond maturities may exceed the amount of new issue paper, considering that $37 billion in taxable municipal bonds are set to mature and $49 billion can be optionally called. And 2025 could continue the trend of elevated tender offer volume, further constraining net supply.

On the demand side, long-duration high quality bonds are likely to be a focus for insurance companies and pension funds. Also, in a steeper yield curve environment, these investors should continue to strengthen their allocation to taxable munis. Taken together, net negative supply and sustained investor demand should create an environment for additional spread tightening.

Figure 5: Fund flows remain positive as we approach the end of 2024



Data source: Morningstar Direct, 01 Jan 2022 – 31 Oct 2024, cumulative flows for each calendar year, shown monthly. Net flows represent the total of all municipal bond open-end funds.

5. Muni credit strength endures

Issuers should be well-positioned after the U.S. election

In-depth credit research is key to portfolio performance, helping to identify opportunities for relative value and credit upside. Through the second quarter of 2024, Moody's notes the number of credit rating upgrades continued to outpace downgrades by a 3 to 1 margin. We expect the pace of upgrades to slow and for credit to remain stable. Looking forward, robust revenues and record funding of reserves for state and local governments make municipal credit well-positioned to manage through any economic downturns.

With the Republican sweep in Washington, we do not expect essential service providers, especially those funded with local tax revenues, to be materially affected by policy changes at the federal level. Many municipal issuers benefit from broad autonomy and local control, providing relative stability regarding revenues pledged to debt service. Municipal bonds backed by property taxes, dedicated state and local taxes, transportation revenues, tolls or project-specific revenues should remain relatively insulated from federal policy changes.

However, potential shifts in federal government policies and spending may impact specific municipal bond sectors (Figure 6).

Figure 6: Select sectors may be influenced by the Republican sweep

HEALTH CARE	EDUCATION	UTILITIES
• M&A may be easier due to less focus on regulation, which could support smaller, struggling hospitals • Medicaid may shift toward privatization, which may challenge profitability for hospitals • State funding may shift toward block grants, pressuring state budgets	• School choice policies could gain momentum, which could support charter schools over public K-12 schools and states • Pro-union policies may see reduced support, which could help public K-12 schools • Student loan forgiveness could be rolled back, and private higher education endowments may be taxed, potentially impacting higher ed	• Environmental regulations enforcement may be relaxed, supporting the sector • Fewer mandated capital upgrades could benefit balance sheets but impair water quality

> "**We expect credit conditions to remain stable since municipalities are well-capitalized, although the pace of ratings upgrades may slow.**"

Looking forward: We see reasons for optimism

Nuveen believes the outlook for municipal bonds in 2025 is favorable. With elevated municipal yields and attractive spreads, the asset class should garner demand across investment grade, high yield and taxable bonds. While supply is expected to remain elevated, demand should increase as cash alternatives wane and investors are able to generate sufficient returns from coupon income alone. Against this backdrop, we're carefully monitoring both monetary and fiscal policies to assess the impact on municipal credit.

*Nuveen is honored to be named the **#1 team** in the 2024 Smith's All-Star Municipal Analysts Awards.*

For more information, please visit nuveen.com.

Endnotes

Sources

Treasury yields and ratios: Bloomberg (subscription required). Municipal bond yields: Municipal Market Data. Fund flows: Morningstar. 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: Federal Reserve Board. Bond ratings: Standard & Poor's, Moody's, Fitch. State revenues: U.S. Census Bureau.

About the Smith's awards: Smith's All-Star Municipal Analyst Awards Program is the only program that consistently and prominently provides recognition in the municipal space. Smith's Research & Gradings announced the annual awards on 04 December 2024. The program starts with the formation of Smith's Blue Ribbon Ballot Committee of Portfolio Managers. Members of the committee nominate the nation's leading municipal analysts to the ballot. Once the ballot nominations for the 29 different categories are compiled and verified, the final ballot is sent to 1,000 institutional investors for voting. The entire process is transparent, and the voting increases the democratization of the municipal bond market. Please see https://www.smithsresearch.net/events/ smiths-municipal-all-star-awards for more information. Used with permission.

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