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Third quarter 2024 outlook

# Taxable municipal bonds: Long term opportunities persist


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*Positive returns in May and June brought taxable municipal performance close to breaking even (-0.19%) for the second quarter, following a challenging April. The power of income has offset weaker months, and the combination of price appreciation and income has resulted in strong relative performance. Taxable municipals have been supported by technical factors and strong credit fundamentals. We believe demand for municipals could strengthen as investors consider shifting to longer duration ahead of anticipated U.S. Federal Reserve (Fed) rate cuts.*

## KEY TAKEAWAYS

- The power of higher income generation helped taxable municipal bonds absorb fluctuating, upwardly biased U.S. Treasury yields.
- The taxable municipal bond market remains supported by above-average yields, strong fundamentals and an improving technical backdrop.
- For certain investors, we believe there is a unique, compelling opportunity currently present in Build America Bonds.

## OUTLOOK: TECHNICAL TAILWINDS SHOULD SUPPORT THE MARKET IN Q3

The taxable municipal bond market is well positioned to begin the third quarter.

**Supply showed signs of increasing** during the second quarter. Taxable municipal supply is approximately $19.5 billion year-to-date, on track to outpace the 2023 total of $35 billion. Issuers brought deals that had been long delayed due to execution uncertainty and sought to avoid volatility that may accompany the U.S. election. Despite the lumpier issuance calendar, meaningful coupon payments and bond maturities provided a natural buyer for the elevated supply.

July and August are showing signs of further technical strengthening through organic demand created by reinvestment from maturing bonds. According to Bloomberg, $6.1 billion in taxable municipal bonds outstanding will mature during July and August. This reinvestment, coupled with historically light new issuance during these months, could shift technical factors favorably.

We anticipate positive technical conditions for municipals later this year, as continued reinvestment income combines with expected slower issuance. Taxable municipals could be further assisted by an expected Fed rate cut in the fourth quarter, which may drive inflows as investors seek to lock in yields.

**Yields are historically elevated,** at more than 100 basis points (bps) above the trailing 10-year average. Investors may enjoy attractive total returns from income alone, a dynamic that has been absent for nearly a decade. The ability for yield to be a greater component of total return moving forward offers the defensive characteristics fixed income investors have historically desired within the portfolios. Income alone may provide annual returns of more than 5% in the current market.

**The yield curve should steepen** with Fed action expected later this year. Such an environment should be positive for longer-duration bonds. Investors receive the higher income typically associated with longer-dated bonds while earning additional total return through a combination of declining rates and rolling down the yield curve.

**Municipal credit is in a strong position** to weather potential economic uncertainty. Statutory reserves remain high, despite excess reserves being drawn down. Though the economy remains on strong footing, we expect taxable municipal bonds to perform well even if markets move to a lower-risk tone due to their resilience during past economic downturns. Municipal bonds should be well placed to capitalize on these solid fundamentals, and we expect spread compression to continue.

## 2024 THEMES

### *Economic environment*

- Inflation trajectory has trended lower year-over-year. The Fed projects marginally lower Core PCE Inflation by year-end. Core services inflation excluding housing remains sticky but is trending down.
- After increasing the fed funds rate by 525 bps during this cycle, the Fed has been on hold since July 2023. Fed policy remains data dependent. We expect rate cuts, with the timing dependent on inflation, wages and employment data.
- U.S. growth has been resilient, but the consumer is softening. Influential factors include unemployment data, consumer spending and levels of excess household savings. Capital markets are at less risk of recession, but we continue to monitor developments closely.
- Uncertainty regarding Fed policy will continue to cause rate volatility. Rates could decline if a slowdown or recession develops.

### *Municipal market environment*

- Credit remains strong, with robust levels of rainy day and reserve funds. Governments are adjusting for normalization of revenue collections.
- We expect municipal defaults will remain low, rare and idiosyncratic.
- Supply has picked up relative to 2023 levels and could be more predominant before the U.S. election. The largest sectors for new issuance have been single family housing and general obligation. Attractive Build America Bonds (BABs) spreads over non-BABs provide an opportunity for some investors to enhance yield.
- Demand favors owning duration, driven by higher-for longer yields. Investors don't want to miss out.
- Municipals have displayed strong relative performance this year.
- Absent a meaningful rate rally or spread contraction, municipals should generate attractive returns based on elevated income generation.

## ECONOMIC CRACKS ARE EMERGING

The U.S. economy continues to expand at a healthy pace, but we anticipate growth will start to decelerate over the balance of the year. After several quarters of upside surprises, key indicators are softening. Job creation sharply decelerated in April and resurged in May. Other labor market data – including job openings, quits rate and surveys of business sentiment – have shown weakness.

First quarter U.S. GDP showed an unwelcome mix of weak growth and high inflation. However, we think both halves of the stagflation concern are overblown. We're penciling in a slowdown from 1.5 to 2% by year-end, representing an acceptable growth rate.

Regarding inflation, we anticipate modest easing in key areas like housing and services, but movement will likely be slow and uneven. PCE inflation data met expectations for May, showing significant deceleration after a surprisingly quick increase in the first quarter. Overall, core inflation is easing. Goods inflation is fully normalized around zero, housing has decelerated to a cyclical low, though it remains elevated on an annualized basis and non-housing core services have dropped to around 3% annualized.

Fed funds futures are pricing in two rate cuts this year, with the first one projected to come the day after the U.S. election. While election uncertainty will increase volatility, removing uncertainty following the election should eventually calm markets and possibly increase risk appetite.

## TAXABLE MUNICIPAL BONDS ARE SUPPORTED BY YIELD GENERATION

Taxable municipal bond spreads remained relatively unchanged during the quarter, widening by 2 bps on average. At the same time, U.S. Treasury yields increased across the curve through a steepening trend, with 10- and 30-year yields ending 20 bps and 22 bps higher, respectively.

Despite a benign environment for credit spreads, income generation provided an effective cushion. Price returns for the Bloomberg Taxable Municipal Index were negatively impacted by the increasing rate environment, coupled with marginally widening spreads. The index price return of -1.49% was offset by a robust yield return of 1.30%, resulting in a total return of -0.19%.

While credit spreads widened marginally, BBB rated credit spreads saw material tightening of -20 bps during the period. The BBB rated universe comprises just 2% of the index. Strong fundamentals and attractive valuations in lower quality areas of the market continue to garner strong demand, resulting in outperformance of BBB rated bonds, returning 0.35% during the quarter.

Investors recognize that lengthening duration may benefit their portfolios should yields decline. Choosing to extend duration before the Fed begin cuts may offer a cushion against volatility that could emerge from inconsistent economic data and concerns surrounding the election. While income is expected to be a meaningful driver of total return for the rest of 2024, price appreciation could be equally helpful if signs of economic weakness show and the Fed becomes more accommodative.

> *Choosing to extend duration before the Fed begin cuts may offer a cushion against volatility that could emerge from inconsistent economic data and concerns surrounding the election.*

### Figure 1: Year-to-date returns

| Index | Yield to worst (%) | Spread (bps) | Effective duration (years) | Q2 2024 | 2024 YTD |
|---|---|---|---|---|---|
| Taxable municipal (AA-) | 5.19 | 65.49 | 7.60 | -0.19 | -0.08 |
| U.S. Treasury (AA+) | 4.58 | – | 5.88 | 0.10 | -0.86 |
| U.S. aggregate bond (AA) | 5.01 | 39.18 | 6.08 | 0.07 | -0.71 |
| U.S. corporate investment grade (BBB+) | 5.48 | 93.03 | 6.84 | -0.09 | -0.49 |
| Global aggregate (unhedged) (A+) | 3.90 | 40.67 | 6.48 | -0.10 | -3.16 |

Data source: Data as of 30 June 2024. Source: Bloomberg, L.P., June 2024. 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 GlobalAggregate 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.

## THE TECHNICAL ENVIRONMENT SHOULD IMPROVE IN THE NEAR TERM

### Supply

Total municipal bond issuance for the second quarter was $139 billion, 35% higher than the same period last year. Year-to-date issuance is up 32%, but is primarily coming from tax-exempt municipal bonds. Taxable municipal supply, which is more sensitive to interest rates, remains somewhat suppressed due to the overall elevated yield environment. Year-to-date taxable municipal issuance is $19.5 billion, which the market has easily digested.

We expect higher rates of issuance to continue as issuers bring deals ahead of the election, but the pace should cool post-election. Such an environment should present a buying opportunity during the third and fourth quarters. Taking advantage of new issue concessions ahead of any lull in supply may benefit portfolios.

## Demand

Demand remains strongest in the longer duration market segments. Buy and hold investors seeking long duration ahead of Fed rate cuts remain prevalent. However, demand is suppressed by higher hedging costs in the APAC region, particularly Japan. These cross currents should continue in the near term, but overall demand is strong from domestic buyers in the U.S. and the eurozone.

Organic demand is also strong. Maturities, calls and coupon payments have been robust throughout the year. Build America Bond redemptions, which account for $12 billion year-to-date, have created strong reinvestment demand in addition to regular maturities and calls generating cashflow.

These reinvestment dollars should continue in the near term, with approximately $6 billion in maturities and calls hitting the taxable municipal market in July and August.

## Defaults

First-time municipal bond defaults totaled $294 million in par during the second quarter, 31% lower than the same period last year. Additionally, newly distressed debt was down 22% compared to second quarter last year. There have been no Chapter 9 bankruptcy petitions filed in 404 days – the second longest period since July 1987.

Widespread issues are not expected in 2024, as record balance sheets should provide ample protection from economic uncertainty 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. While upgrades have outpaced downgrades by a 4:1 ratio for three years in a row, this trend has slowed recently with upgrades being more in line with downgrades. Going forward, we do not expect downgrades to outpace upgrades in the near future.

> *Record balance sheets should provide ample protection from economic uncertainty for most issuers.*

## Credit spreads

Credit spreads overall showed little movement during the second quarter. The average credit spread for the Bloomberg Taxable Municipal Bond Index widened by 2 bps. However, as noted previously, BBB rated bonds outshined, narrowing by -20 bps.

While spreads were relatively benign, the relative value for taxable municipal bonds remains attractive. Compared to AA rated corporate bonds, AA rated taxable municipal bonds have a 12 bps spread advantage. This continues to be an important factor given municipals show more resiliency in times of economic stress. Investors may be compensated for moving into an asset class with a proven track record of stability should the economy show signs of weakening.

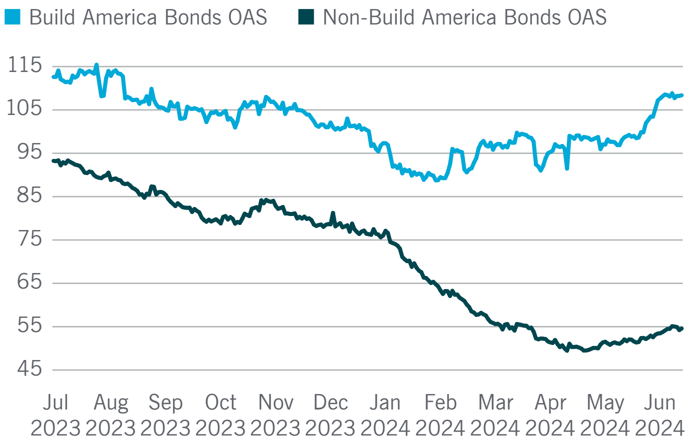
### DON'T THROW THE BAB-Y OUT WITH THE BATHWATER

Nearly all Build America Bonds (BABs) contain extraordinary redemption provisions (ERPs) that allow the issuer to redeem the bonds at the higher price of par or U.S. Treasury yield +100 bps of spread. The valuations of outstanding BABs have been close to the +100 spread level over the last several months, pricing in the risk that they will be called.

Meanwhile, the rest of the market has seen significant spread tightening during the last 12 months, given the resilience of the U.S. economy in the face of tight monetary policy with a higher probability of a 'no landing' scenario. Investment grade and high yield corporate bonds are also trending toward all-time tights. BABs have not participated in this tightening environment because of their call risk, which is creating a unique investment opportunity.

The taxable municipal market has seen a significant divergence between BABs spread and non-BABs spreads over the last six months (Figure 2). BABs have failed to persistently tighten through +100 bps due to ERP risks. At quarter end, BABs offered nearly two times the spread of the index average excluding BABs. By identifying BABs with low risk of ERP, investors have an opportunity to enhance yield and spread without taking on additional credit risk.

### Figure 2: BABs versus non-BABs spreads have diverged significantly




Data source: Data as of June 30, 2024. 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.

While BABs can provide opportunity within the municipal sector, they are also potentially attractive as an up in quality replacement for corporate bonds. Corporate bond spreads have tightened meaningfully recently. BBB rated corporate bonds have an average spread of +110 bps. BABs, which have an AA average credit rating, can be purchased near +100 bps of spread.

We think the spread available in BABs is a good opportunity to capture the tightening trend in lower quality bonds while reinvesting in a security that continues to deliver enhanced income with the potential for performance over time. Not all BABs have an equal risk of their ERP being exercised. The ability to identify the BABs where the economics of exercising their ERP is unfavorable can unlock opportunities. Over time, as the market identifies and understands which BABs face more risk of extraordinary redemption, we believe spreads could selectively tighten.

The potential for up in quality income and spread tightening is unique and likely temporary, and we believe purchasing BABs can benefit portfolios that can accept the risk of ERPs being exercised.

## CONGESTION PRICING IS SUSPENDED IN NEW YORK CITY

On 5th June, New York Governor Kathy Hochul announced her intention to indefinitely suspend the implementation of the Metropolitan Transit Authority's (MTA) Central Business District Tolling Program (CBDTP), the first congestion pricing program in the U.S. The affected region stretches from 60th Street in Manhattan to the southern tip of the Financial District.

The program was anticipated to be implemented on 30 June and forecasted to generate $1 billion annually, while also securing up to $15 billion in new bonds for the system's 2020-2024 Capital Program. Given the pause on the rollout of the CBDTP, the MTA will defer $16.5 billion in less-urgent capital projects while prioritizing state-of-good-repair works. The MTA expects to release an updated financial plan for 2024-2028 in late July that reflects the financial impact of the suspended CBDTP.

Congestion pricing has been a highly politicized and sensitive issue. Numerous lawsuits were filed in federal courts, with plaintiffs including the Trucking Association of New York and Governor Murphy of New Jersey, aiming to halt the implementation of the CBDTP. Governor Hochul favored the program prior to her abrupt reversal in early June, when she expressed concern that the program would create another obstacle for New York's post-pandemic economic recovery. She worried that it would burden working-class and middle-class families.

Pundits quickly pointed out that the program is largely unpopular in suburban areas, and political motivations may have informed the governor's decision.

According to Governor Hochul, the state intends to find an alternate revenue source for the MTA to compensate for the loss of revenue the CBDTP would have generated. However, the program could eventually be implemented if no other funding mechanism is approved. On 26 June, the MTA's board of directors approved a resolution to continue to prepare for the eventual roll out of the CBDTP.

**For more information, please visit 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: 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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