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Fourth quarter 2024 outlook

Taxable municipal bonds: seasonal strength

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The U.S. Treasury yield curve steepened during the third quarter, encouraging investors to extend duration. Pockets of volatility persisted, with the market focused on economic data and the U.S. Federal Reserve (Fed) attempting a soft landing. Taxable municipal new issue supply remained muted. But with favorable near-term valuations, we anticipate municipal bonds will outperform as supply trends wind down and demand strengthens following expected further Fed rate cuts. We think this makes current valuations an attractive entry point for long-term investors.

KEY TAKEAWAYS

- Taxable municipals exhibited positive performance as Treasury yields declined, but credit spread movements were benign, making valuations attractive going forward.
- Municipal credit resiliency can strengthen portfolios against a backdrop of economic uncertainty.
- Investors are looking to extend duration as the Fed cuts rates and the yield curve steepens.

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OUTLOOK: POST-ELECTION LULL IN SUPPLY COULD BOLSTER TECHNICALS

The municipal bond market is well-positioned to begin the fourth quarter.

Technicals should further improve to end 2024 and beyond. Taxable municipal new issuance has been steady at $3-4 billion per month in 2024, but that pace could decline in November and December following the U.S. election. At the same time, the market is pricing in 25 basis points (bps) of Fed rate cuts at its November and December meetings, which can support demand.

Yields remain historically elevated, at nearly 100 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. Taxable municipal bonds tend to enjoy more stable credit spreads, making income a dominating force for total return. These elevated yields continue to provide investors with a long-term opportunity for attractive income.

The yield curve should steepen more meaningfully as the Fed continues to cut rates. 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. As reinvestment rates for cash equivalents and short-term debt diminish in value, we expect more duration extension to capitalize on curve steepening.

Municipal credit remains in a strong position to weather potential economic uncertainty. Statutory reserves remain high, despite some excess reserves being drawn down. Though the economy remains on strong footing, We expect municipals to perform well even if markets move to a conservative 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 has trended lower since the first quarter. We expect Core PCE inflation to decline further by year end, driven by a decrease in both core services inflation and the cost of shelter.
- After increasing the fed funds rate 525 bps the Fed cut 50 bps at the September meeting. We expect measured rate cuts of 25bps through next summer, with the terminal fed funds rate 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 anticipating less risk of recession, but we continue to monitor developments closely.
- Uncertainty regarding the upcoming US election and the timing of future rate cuts will continue to cause short-term volatility in the rates market.

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.
- Taxable supply has been fairly steady compared to 2023. We anticipate that supply will slow after the first week of November while election results are digested.
- 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.
- Despite tight ratios, municipals should generate attractive returns based on elevated income.

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Moving past inflation fears

Overall core inflation is approaching the Fed's 2% target due to several dynamics. Tight Fed policy has put loosening pressure on the labor market, housing has moderated substantially and global growth has softened overall.

In the labor market, the pace of job creation has dropped below pre-Covid trends, and unemployment has ticked higher. This is partially due to positive supply side dynamics, with prime-age labor force participation at its highest level in more than 20 years. But hiring has also slowed, and more people are spending longer periods of time unemployed. Some of the best leading indicators have softened, and we expect unemployment to move higher in future quarters, weighing on overall economic growth.

In this environment, it makes sense that the Fed began the cutting cycle. However, markets may be too optimistic about future cuts, even after the Fed started strong at 50 bps. The central bank has indicated a preference to move steadily, which likely means 25 bps cuts at each meeting with flexibility to accelerate or pause. This allows time to gauge the impact of rate cuts as the Fed moves toward a neutral policy stance of around 3.25% to 3.50%. We expect the Fed to reach that level in mid-2025.

Credit and duration lead the way during the third quarter

The U.S. Treasury yield curve steepened during the quarter, reflecting market expectations for Fed easing going forward. The 2-year Treasury yield declined by -111 bps while the 30-year yield declined by -44 bps. The spread between 2- and 10-year Treasuries increased from -30 bps to +14 bps during the period after being inverted since July 2022.

Taxable municipal credit spreads across AAA, AA, A and BBB rated categories were relatively unchanged, but widened marginally. This made income and changes in the Treasury yield curve the predominant drivers of return during the quarter. The Bloomberg Taxable Municipal Bond Index returned 5.42% versus the Bloomberg U.S. Treasury Bond Index at 4.74% and the Bloomberg Corporate Bond Index at 5.84%.

Duration and credit performed well during the quarter. Within the taxable municipal bond market, bonds with durations longer than 12 years performed best, returning 6.97%. Likewise, BBB rated bonds were the best performing credit segment, returning 5.87%. Hospital bonds, which returned 6.15%, were the best performing sector and generally combine both features of lower quality and longer duration. Transportation bonds also performed well, returning 5.97%.

Figure 1: Year-to-date returns

Index	Yield to worst	OAS	OAD	Q3 returns	YTD total returns
Taxable municipal (AA-)	4.61	68.11	7.71	5.42	5.33
US Treasury (AAA)	3.77	-0.32	6.05	4.74	3.84
US aggregate bond (AA)	4.23	35.85	6.13	5.20	4.45
US corporate investment grade (BBB+)	4.72	87.77	7.09	5.84	5.32
Global aggregate (unhedged, A+)	3.32	37.60	6.58	6.98	3.60

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

TECHNICAL FACTORS SHOULD STRENGTHEN FURTHER

Supply

Municipal bond issuance through the third quarter was $380 billion, 35% higher than the same period in 2023. Issuance is primarily coming from tax-exempt municipal bonds. Taxable municipal supply, which is more sensitive to interest rates, remains

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somewhat suppressed due to overall elevated yields. Year-to-date taxable municipal issuance is $26.3 billion, which is down -7% versus 2023 levels and has been easily digested.

We expect higher rates of issuance in October, but meaningful supply should taper off following the election. The potential post-election lull in supply should last into February 2025. This could produce a favorable technical environment over the course of the next several months.

Demand

Demand remains strongest in the longer duration market segments. Buy-and-hold investors are seeking long duration ahead of declining short-term yields. However, demand is tempered 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. Through the fourth quarter of 2024, $7.5 billion in taxable municipal bonds are due to mature. Given post-election supply dynamics, we believe this volume of maturities combined with potentially callable securities could add significant reinvestment demand to support the market from a technical perspective.

Defaults

First-time municipal bond defaults totaled $1.1 billion in par year-to-date at the end of the third quarter, trending lower than the annual totals over the last five years.

Defaults continue to be disproportionately weighted toward nursing homes and assisted living facilities in the tax-exempt municipal market. Essential services monopolistic providers continue to thrive. Taxable municipal defaults remain extremely rare.

The credit backdrop overall remains robust. While upgrades outpaced downgrades by a 4:1 ratio for three years in a row, this trend has slowed to approximately 2:1. This reduced ratio does not represent declining quality. Rather, it reflects the tremendous momentum of municipal credit in which many credits are reaching their credit ceiling.

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Credit spreads

Credit spreads overall showed little movement during the third quarter. The average credit spread for the Bloomberg Taxable Municipal Bond Index widened by 2.6 bps. Across credit buckets, spread movements were similar. However, corporate bond spreads saw some narrowing during the quarter.

While spreads were relatively benign at the index level, movement varied across sectors. State general obligation bonds (GOs) experienced the most spread tightening, with option-adjusted spreads narrowing by -3 bps during the quarter. Industrial development, which tends to be more credit sensitive, widened by 13 bps during the period. The tightening in state GOs could be related to higher beta areas of the market seeing stronger demand, particularly in late September following the Fed rate cut. As these trends persist, we expect spread tightening in lower beta segments of the market.

MUNICIPAL CREDIT REMAINS RESILIENT

Higher education and hospitals: the haves and have-nots

Higher education institutions and hospitals are two sectors that remain in headlines as they recover from pandemic-era challenges, ongoing demographic pressures, inflation and roll-off of federal pandemic support.

For colleges and universities, the pandemic negatively impacted enrollment when campuses shuttered their doors. In many cases, students have not fully returned and now institutions face a declining number of high school graduates – a peak of 3.5 million high school graduates is expected in 2025 followed by projected declines of up to 15% over the next 10 years.

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Hospitals saw median profit margins fall 2-5% between 2021 and 2023 as wages skyrocketed because of wage inflation. However, this only tells part of the story, as credits within these sectors are experiencing bifurcated trajectories.

What's happening: Credits in these sectors increasingly fall into one of two categories: the haves and have-nots. For both sectors, typically larger institutions with robust liquidity, solid operating performance and strong market positions are increasingly experiencing improving or stable credit conditions. They navigate macro challenges such as inflation, demographic changes and shifting regulatory environments with relatively little impact on their credit profiles. In contrast, smaller institutions with limited liquidity and thinner operating margins tend to be losing market share and struggle to keep up with peers.

Bottom line: Investors have an opportunity to invest in bonds issued by higher education and hospital borrowers that might be discounted by the market in part because of perception that headline trends are affecting all colleges/universities and hospitals alike.

Nuveen's credit research, which focuses on credit-specific, bottom-up fundamental research, uncovers value amongst credits in these sectors and identifies buying opportunities in undervalued bonds.

Tax revenue growth returns to normal

State revenue growth has returned to historic norms following several years of post-pandemic revenue volatility. Strong economic growth and federal aid boosted revenues well above historic trends for most states in 2021 and 2022, followed by a much flatter year in 2023. Halfway through 2024, tax revenue collections were up 5.1% year-over-year. States primarily rely on income and sales taxes to fund operations, and both have demonstrated resilience. Individual income tax collections were up 7.1%, and corporate income taxes were up 6.4% over the prior year for the first half of 2024.

Revenue growth is notable given a number of states recently enacted income tax rate cuts or adjusted tax brackets. Nearly all states (48) enacted tax cuts or tax relief between 2021 and 2023 and more than half of states implemented permanent income tax rate cuts. Sales tax performance has been more muted, with revenue growth at just 1.4% year-to-date in 2024. Slower sales tax revenue growth may suggest a slowing economy.

The unexpected revenue surge combined with tax cuts meant states struggled to accurately forecast revenues and has kept budgets conservative. Rather than increasing operating budgets in an uncertain environment, states used excess revenues to cut taxes, pay down liabilities, make one-time infrastructure investments and boost reserves.

State rainy day funds reached an all-time high in 2023. Given recent revenue volatility and one-time federal support, states were prudent to craft conservative budgets for fiscal years 2024 and 2025 and only a few planned to spend down reserves. States are generally projecting flat revenue growth for the current 2025 fiscal year.

Moderate state tax collection growth so far this year signals a return to normality for state budgets. State credit quality remains strong, evidenced by broad revenue, flexible expenditure and maintenance of record reserve levels.

Hurricane Helene causes mass destruction

Hurricane Helene made landfall in late September as a Category 4 storm, causing destruction along the Florida Gulf Coast, then moving on to impact communities as far north as western North Carolina and Tennessee. The loss of life and property is devastating. Damage caused by days of rain, flash flooding and landslides will no doubt take years to rebuild.

Past natural disasters, even unprecedented large-scale events like this one, have not precipitated municipal bond payment defaults or long-term credit quality deterioration.

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It's likely still too early to assess the full cost of losses, but states and communities impacted by the storm are expected to meet their municipal obligations. Past natural disasters, even unprecedented large-scale events like this one, have not precipitated municipal bond payment defaults or long-term credit quality deterioration.

Debt service payments due in the next few months are likely already funded, as many municipal obligations are funded well in advance of payment dates. Property taxes for GO debt service are typically set aside ahead of time, as is debt service for obligations backed by sales taxes or water and sewer utility revenues. Revenue pledges can often draw upon reserve funds should there be a deficiency of collections or a timing issue.

Longer-term, rebuilding efforts following natural disasters often provide a boost to the local economy and tax base. Homeowners with uninsured damages will seek federal disaster assistance through the Federal Emergency Management Agency. Deployment of recovery funding normally provides short- and long-term economic benefits. Reconstruction efforts bring new jobs in the short-term and can improve infrastructure, strengthening the tax base in the long-term.

We expect the widespread damage to prompt many communities to reconsider their resiliency and readiness for extreme weather events. Assessing climate risk and disaster readiness has always been a key part of our credit quality assessment.

For more information, please visit nuveen.com.

Endnotes

Sources

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