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Third quarter 2025 outlook

Taxable municipal bonds: sunny side of the street

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Market conditions present a compelling entry point for taxable municipal bonds. Yields remain historically attractive, driven by heavy issuance and federal policy uncertainty, while a steepening yield curve offers opportunistic duration extension. Looking ahead, reduced summer issuance, combined with strong reinvestment demand and robust fundamentals, should create favorable conditions, potentially offering a sunnier disposition heading into fall.

KEY TAKEAWAYS

- **Market dynamics:** Technical factors including increased issuance have caused taxable municipals to underperform other fixed income sectors, raising yields and creating relative value opportunities.
- **Attractive entry point:** Taxable municipal yields ended the second quarter at 4.99%, equal to that of U.S. corporates. Municipal yields have not equaled or exceeded corporate yields since 2021. This yield parity creates an attractive entry point given taxable municipals' stronger credit profile compared to corporates, with over 75% of the Bloomberg Taxable Municipal Index rated AA- or better.
- **Higher education trends:** The higher education 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 to start the second half of the year.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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- **Credit selection:** As sector-specific challenges widen the gap between stronger and weaker credits, careful security selection becomes increasingly important for portfolio performance.
- **Tax policy:** Previously proposed Section 899 of the One Big Beautiful Bill Act (OBBBA), intended to increase U.S. income tax and withholding tax rates from "discriminatory foreign countries," was removed from the final legislation.

BEST IDEAS FOR Q3

Current market conditions remain attractive for taxable municipal bond investors given the elevated yields, favorable valuations, strong fundamentals and supportive technical factors. As we look ahead, we offer our best ideas for portfolio positioning:

Build America Bonds cheaper than BBB corporates

Build America Bonds (BABs) continue to offer meaningful spread opportunities compared to non-BABs and BBB rated corporate bonds. For investors who can tolerate potential extraordinary optional redemptions, this presents an opportunity to replace current holdings with higher-quality investments that offer slightly better yields. The Bloomberg BAB Index ended June at 107 option-adjusted spread (OAS), higher than BBB corporate bond OAS of 104 basis points (bps). The Bloomberg BAB Index has an average AA credit rating, offering less credit exposure than BBB rated corporate bonds.

Investors may also consider rotating from non-BABs to BABs from the same issuer to secure additional spread. BABs also offer 49 bps of incremental spread when compared to non-BABs' spread of 58 bps. California State general obligation (GO) non-BABs with 5.875% coupon maturing in 2041 ended June with 73 OAS. California State GO BABs 7.6% coupon maturing in 2040 ended the same period with 111 OAS. In this instance, investors could retain the same credit risk but rotate from non-BABs to BABs California GO bond and pick up 38 bps of additional spread.

Optimizing portfolios by replacing weaker structures

Investors may capitalize on current curve steepness through new issue participation and bonds with 10-and 20- year maturities. A strategic approach involves replacing lower-coupon holdings with new, more attractively structured issues.

Tactical exposure in pressured sectors

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 U.S. Federal Reserve (Fed) held rates steady in June while adopting a slightly dovish tone. The central bank 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 2025. 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.

TAXABLE MUNICIPAL BONDS INCREASE YTD RETURNS IN SECOND QUARTER

Despite long-end yields moving higher during the second quarter, taxable municipals achieved positive performance of 0.81%. Taxable municipals performance improved to 3.82% year-to-date, slightly outpacing Treasuries (3.79%) but trailing corporates (4.17%) over the same period.

The U.S. Treasury yield curve steepened during the quarter as well, causing long maturities to underperform. 20-year Treasury yields increased by 18 bps, while 2-year Treasury yields decreased by 16 bps. A steeper yield curve creates more opportunity in long duration going forward, but it negatively impacts portfolios focusing on the long end of the curve. Demand for taxable municipals continues to be robust among long-duration buyers. Expected higher-for-longer yields and solid credit fundamentals should continue to attract investors as we enter a period of higher inflation and elevated economic uncertainty.

TECHNICAL FACTORS CAUSE MUNICIPALS DISCOUNT

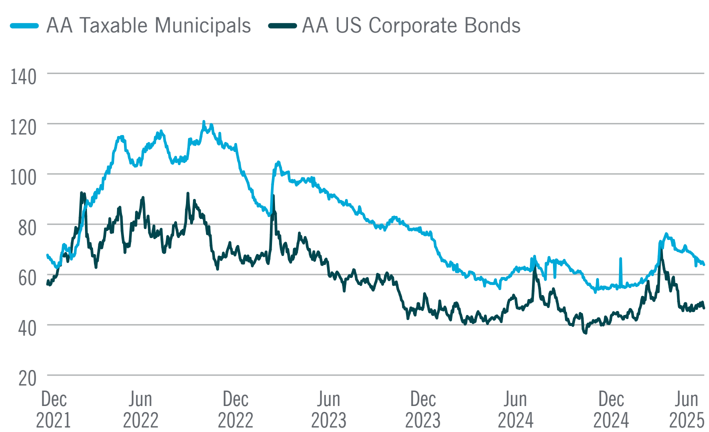
- Municipal issuance reached $281.4 billion year-to-date through June (both taxable and tax-exempt), up +14.6% versus $245.6 billion issued during the same period last year.
- New money issuance increased +25% compared to a year prior, at approximately $209.3 billion, while refunding supply decreased -8% to $72.1 billion.
- Taxable municipal issuance totaled $17.8 billion year-to-date, +10% higher than the same period last year, which had issuance of $16.1 billion.

Notably, taxable issuance activity came from higher education, with $2.2 billion issued year-to-date, approaching 2024's full-year total of $2.6 billion. Higher education issuance was driven by institutions proactively borrowing amid policy uncertainties. Post-issuance, many deals saw spread compression. For example, in early May, Massachusetts Institute of Technology (MIT) issued $750 million of bonds maturing in 2055, receiving strong investor demand. The bonds initially priced at a spread of +78 bps to Treasuries and tightened in secondary market, trading at quarter end at 57 bps.

For the second quarter, taxable municipal credit spreads lagged tightening seen in corporate spreads, but, were less volatile. Corporate credit spreads began Q2 at +93 bps and widened +25 bps in early April, before tightening to +84 bps at quarter-end, a round trip tightening of -9 bps. Taxable municipal spreads were more contained, widening +13 bps at the beginning of April before recouping nearly all the movement, ending Q2 just +1 bp wider.

Taxable spreads widening on a relative basis versus corporates should contribute to positive taxable municipal performance for second half of 2025, as we believe there is room for spread compression. AA rated taxable municipals also remain attractive relative to AA rated corporate bonds, with average spreads for AA being +17.3 bps wider for taxable municipals (63.9 bps vs 46.6 bps).

Figure 1: Taxable municipal credit spreads remain wider relative to corporates



Data source: Bloomberg, L.P., 31 Dec 2021 – 30 Jun 2025, shown daily. Spread represents option-adjusted spread (OAS). Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: taxable municipals: Bloomberg U.S. Taxable Municipal Bond Index; U.S. corporate bonds: Bloomberg U.S. Corporate Bond Index. **Performance data shown represents past performance and does not predict or guarantee future results.**

MUNICIPAL BOND FUNDAMENTALS SHOWCASE STRENGTH

The long-term impact of the OBBBA garnered considerable public debate, including fears that municipal tax exemption might be at risk. Municipal investors received good news when the final bill kept the municipal bond exemption unchanged. However, certain market segments — particularly higher education issuers — may remain vulnerable to changes from provisions in the OBBBA over time, including higher taxes on endowment earnings.

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.

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. Furthermore, the median state rainy day fund balance is projected to be 15% of FY25 spending or nearly double the 8% levels seen in 2019. Strong reserves and budgetary autonomy make state budgets better positioned to adjust to potential federal funding cuts.

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 a portion of healthcare revenue streams.

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 within each sector. The varying impact of these changes makes careful credit selection increasingly critical for investors navigating the municipal market.

> *Nearly all municipal borrowers are essential service monopolies with broad ability to raise revenues and reduce expenditures*

SECTION 899 "REVENGE TAX" REMOVED FROM OBBBA

In June, the Treasury Department announced a deal with G-7 allies in exchange for removing Section 899 from OBBBA. The original House bill included Section 899, which received a large amount of attention from foreign investors concerned the "revenge tax" proposal would create additional withholding costs for foreign individuals and companies investing in U.S. The removal of Section 899 was seen as a positive by market participants and investors.

MUNICIPAL POSITIONING IMPROVES AS THE MARKET RECALIBRATES

The municipal bond market is beginning to show signs of improvement. Taxable municipal spreads peaked in April before tightening in May and June. Supply conditions are expected to normalize, at least over the summer months, and greater certainty over 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 Fed rate cuts. We believe these favorable dynamics, coupled with strong credit fundamentals, position municipal bonds for enhanced performance going forward.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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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, Securities Industry and Financial Markets Association (SIFMA), Bloomberg (subscription required). 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: 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.

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