

First quarter 2025 outlook

Taxable municipal bonds: bouncing back

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The U.S. Treasury yield curve flattened during the fourth quarter with yields increasing across the curve, reflecting continued stubborn inflation and shifting U.S. Federal Reserve (Fed) policy expectations. Taxable municipal bonds underperformed corporate bonds and Treasury bonds due to their long duration stance in a rising rate environment. With favorable near-term valuations, taxable municipal bonds should see improved performance through a more range bound U.S. Treasury market environment. This environment makes current valuations an attractive entry point for long-term investors.

KEY TAKEAWAYS

- Taxable municipals exhibited negative absolute performance as U.S. Treasury yields increased, but the fundamental credit story remains intact, supporting long-term investment.
- Municipal balance sheets remain well positioned; however, active management is important to avoid potential impacts from idiosyncratic credit events.
- Following Fed interest rate cuts during 2024, and the yield curve to steepen further, investors should explore extending duration.
- With credit spreads across various asset classes near all-time tights, Build America Bonds offer attractive up-in-quality trade while gaining additional yield.



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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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OUTLOOK: SEASONAL STRENGTH SHOULD SUPPORT MUNICIPALS

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

Supply remains suppressed amid persistently high interest rates, with advanced refunding volume remaining muted compared to 2020 and 2021 levels. While supply remains benign, the elevated pace of maturities, calls and coupons in January may provide additional technical support. Throughout 2025, we expect a net negative supply environment for taxable municipal bonds.

Credit spreads remain relatively attractive, with A rated municipal bonds at 77 basis points (bps) option adjusted spread. While credit markets have broadly tightened in response to a robust economy and strong appetite for yield, the taxable municipal market continues to offer greater spread relative to corporate bonds for equally-rated bonds.

The credit spread curve continues favoring investors through absolute yield and relative value. Despite interest rate policy expectations shifting in the final quarter of 2024, the taxable municipal spread curve continues to provide value for investors looking to increase duration and yield. The steepness of the taxable municipal spread curve out to 12-year duration rewards investors with higher income than typically associated with longer-dated bonds, and potential to earn additional total return through a combination of stable or declining rates and credit spread narrowing through the holding period. However, active yield curve management is important, as duration longer than 12 years sees diminished benefits and requires careful selection.

Municipal credit is in a strong position to weather potential economic uncertainty. Statutory reserves remain high, despite excess reserves being drawn down. Municipal bonds have been resilient during past economic downturns and we expect solid performance, even if markets move to a risk-off tone. Municipal bonds should be well placed to capitalize on these solid fundamentals, and we expect spread compression to continue.

2025 THEMES

Economic environment

- The Fed expects the lower inflation trend of 2024 to continue, with inflation working toward 2.5% in 2025.
- The Fed cut rates aggressively by 100 bps in the latter half of 2024. Rate cuts should continue as long as inflation moves toward the target.
- U.S. growth remains resilient. We will be watching unemployment data, consumer spending and excess household savings.
- Capital markets anticipate low risk of recession, but we continue to monitor developments closely.
- Federal policy, along with the timing and magnitude of future rate cuts, could trigger yield volatility.

Municipal market environment

- Credit remains strong, with robust revenue collections and reserve funds.
- State governments are adjusting for normalization of revenue collections.
- Municipal defaults are expected to remain low, rare and idiosyncratic.
- We anticipate another year of heavy new issue supply in 2025, approaching \$500 billion. Taxable municipal supply has become more muted in the elevated rate environment, making up roughly 10% of the overall municipal market.
- Demand for owning duration continues, driven by higher-for-longer yields.
- Attractive valuations relative to other credit markets will continue to garner demand.

U.S. ECONOMIC STRENGTH AND UNCERTAIN FISCAL POLICY MEAN CONTINUED VOLATILITY

U.S. economic activity slowed slightly but remains solid. Real GDP is on track to expand around 2.5% in 2024, down from 3.2% in 2023. We expect this trend to continue, with growth slightly below 2.0% in 2025. The labor market has already slowed markedly, with unemployment up around 0.7% from its cyclical low. Higher unemployment and the parallel slowdown in household income growth should weigh on overall economic growth moving forward, but it also should ease some inflationary pressures. We expect softening to continue but believe the U.S. can avoid a recession.

In contrast, the likelihood of further tax cuts and looser fiscal policy in the U.S. could provide a counterbalance. We expect inflation to remain partially sticky as these forces compete. Core goods and core services inflation have already returned to target, while housing remains elevated.

Economic resilience and inflation not returning as quickly as expected to 2% make the Fed’s long-term policy path less clear. However, we expect the central bank to cut rates in the first quarter, making its way to a terminal rate of 3.75%-4.00%.

The incoming Trump administration will likely propose a significant tax package early in 2025, given the impending expiration of numerous individual tax provisions from the 2017 Tax Cuts and Jobs Act (TCJA). We expect President Trump will push to extend several key provisions, including the current marginal tax rate levels for high-income earners and the cap on deductions for state and local government taxes (SALT). Importantly, we do not expect changes to the provision that requires advanced refunding deals to be issued in the taxable municipal market.



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Figure 1: Year-to-date returns

| Index | Yield to worst (%) | Spread (bps) | Effective duration (years) | 2024 YTD |
|----------------------------------------|--------------------|--------------|----------------------------|----------|
| Taxable municipal (AA-) | 5.21 | 58 | 7.57 | 1.57 |
| U.S. Treasury (AA+) | 4.45 | | 5.74 | 0.58 |
| U.S. aggregate bond (AA) | 4.90 | 34 | 6.02 | 1.25 |
| U.S. corporate investment grade (BBB+) | 5.33 | 80 | 6.77 | 2.13 |
| Global aggregate (unhedged) (A+) | 3.67 | 35 | 6.48 | -1.69 |

Data source: Data as of December 31 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 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.

FUNDAMENTAL STRENGTH STABILIZES THE MARKET

Supply

Municipal issuance in 2024 totaled \$507.6 billion, or +32% more than 2023 issuance of \$385.1 billion. New money issuance was up +19% compared to prior year, at approximately \$355.6 billion.

Taxable municipal issuance, however, was \$35.6 billion or -11% lower than 2023 issuance of \$39.8 billion. Taxable issuance remains suppressed due to elevated interest rates reducing advanced refunding opportunities for issuers. Modest taxable issuance is expected to continue in 2025 and create a strong technical backdrop for taxable munis and supporting performance.

Demand

Taxable municipal bond demand continues to face cross winds. Investor flows overall remain healthy but the strong U.S. dollar remains a headwind for non-U.S. investors with hedge rolls stimulating selling activity, particularly in the Asia-Pacific region. We expect healthy demand for taxable municipals will persist in 2025 as the U.S. economy remains resilient and the Fed may be more patient with easing policy.

Selling pressure from FX hedge create short-term technical opportunities for investors to enhance yield and performance potential.

Organic demand in the taxable municipal market remains strong. Maturities are anticipated to exceed \$36 billion in 2025, while callable bonds are greater than \$15 billion. Maturing bonds and callable bonds alone could offset supply further supporting technical tailwinds supporting performance in the market.

Defaults

Defaults trended lower in 2024 with first time municipal bond defaults totaling \$1.8 billion 2024 which is lower than annual totals for previous five years. More recently, first-time distressed debt came in the fourth quarter was 34% lower compared to same period last year.

Defaults continue to be disproportionately weighted toward nursing homes and assisted living facilities. Essential services monopolistic providers such as airports and water and sewer systems continue to thrive given strong credit fundamentals.

The credit backdrop overall has been robust. While upgrades outpaced downgrades by a 4:1 ratio for three years in a row, the trend slowed to approximately 2:1 in 2024. Importantly, the reduced upgrade ratio does not represent a decline in quality. Rather, it reflects tremendous momentum in which many municipal credits are showcasing their potential.

Credit spreads

Taxable municipal option-adjusted spreads narrowed during fourth quarter, from 68 bps to 58



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bps. This spread tightening, combined with high embedded yields, allowed lower-quality credit bonds to outperform higher quality.

Under the surface, spread dispersion among taxable municipal issuers continues to narrow. With robust economic data being released, the largest issuers tightened during the quarter, such as large state general obligation bonds. However, over time we expect additional trading activity will allow smaller issuers to see similar spread tightening and outperform.

AA rated spreads ended the quarter at +56 bps compared to AA rated corporate at +44 bps. Given the essential and resilient nature of high-quality municipal bonds, we believe this spread advantage continues to be attractive.

Build America Bonds provide a high-quality exit from lower-quality bonds

Build America Bonds (BABs) experienced an increase in extraordinary redemption provisions (ERPs) being exercised in 2024. Nearly all BABs have an ERP indicating the issuer can redeem the bonds at the higher price of par or U.S. Treasury yield +100 bps of spread. Given that the ERPs must be exercised at a +100 spread to U.S. Treasuries, the valuations of outstanding BABs have been close to +100 bps spread level without much movement over the last three quarters. While BABs spreads remain near+100 recently, non BAB spreads have seen significant spread tightening from 58 bps to 48 bps in fourth quarter.

Credit spreads broadly moved tighter given the resilience of the U.S. economy. High yield corporate bonds and investment grade corporate bonds are also trending toward all-time tight. However, BABs have not participated in similar tightening activity given ERP risk of being called at spread of

+100. The lack of BABs spread tightening creates a unique opportunity for investors willing to invest.

BBB rated corporate bonds have tighter spreads than BABs, while BABs have an average credit rating of AA (Figure 2). With robust tightening across credit markets, we believe BABs offer an up-in-quality exit for investors to harvest credit spread tightening in more risky areas of the market. By purchasing BABs investors can improve portfolios multiple ways by replacing a income from BBB rated corporate bonds, moving higher in credit quality and reducing the risk of credit spread widening going forward.

Figure 2: BABs vs. BBB rated corporate bonds



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The education sector splits between the haves and have-nots

Certain sectors remain bifurcated among haves and have-not issuers, as the strong get stronger and weak get weaker. Investors may see this dynamic come into play with higher education and health care. In higher education, greater numbers of small colleges are struggling, while larger and wealthier institutions have seemingly inelastic demand. As such, some of the high-grade higher education institutions tend to be stable and attractive from a credit perspective, particularly since spreads remain wide compared to their historical averages. Fundamental research and careful credit selection is key to determining which entities are poised to succeed.

Under the Trump administration, we anticipate school choice policies should gain momentum, bolstering support for charters and potentially supporting further redistribution of funding for K-12 school districts. Student loan forgiveness efforts are likely to be rolled back, potentially negatively impacting the demand for higher education. Support could grow for taxing college and university endowments, limiting endowment support for operations and financial aid. One potential outcome could be taxable endowments emerging as a new buyer in the municipal market.

“*Greater numbers of small colleges are struggling, while larger and wealthier institutions have seemingly inelastic demand.*”

For more information, please visit nuveen.com.

Endnotes

Sources

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