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Fourth quarter 2024 outlook

Municipal bonds: Technical crosswinds create near-term opportunity

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The municipal yield curve steepened during the third quarter, encouraging investors to extend duration and move out of cash equivalents. Outsized high grade muni supply caused underperformance relative to U.S. Treasuries and corporate bonds. But with favorable near-term valuations, we anticipate municipal bonds will outperform as supply trends wind down and demand strengthens following expected further U.S. Federal Reserve rate cuts. We think this makes current valuations an attractive entry point for long-term investors.

KEY TAKEAWAYS

- Investors are looking to high yield municipals to drive additional yield and total return due to strong fundamentals and after-tax yields.
- With the Fed cutting rates and the yield curve steepening, investors are looking to extend duration.
- If the Tax Cuts and Jobs Act is allowed to sunset at the end of 2025, higher tax rates could benefit municipal bonds due to their tax-exempt status.

OUTLOOK: SUPPLY PREPARES TO EASE WHILE DEMAND STRENGTHENS

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

Supply increased meaningfully during the second and third quarters. Issuers brought deals that had been long delayed due to execution uncertainty and sought to get ahead of potential volatility around the U.S. election. Despite heavier issuance, deals have been routinely oversubscribed. This insatiable demand points to improved performance potential once supply likely tapers after the election.

Favorable technical conditions for municipals should begin in November, as continued reinvestment demand from another Fed rate cut combines with slower issuance. Investor fund flows stemming from cash on the sidelines may see continued strength, as T-bills originally purchased in the 5% range are quickly rolling off.

Yields remain historically elevated, at nearly 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. And municipal bonds offer an attractive taxable-equivalent yield opportunity, as higher yields amplify their tax-exempt nature. While taxable bonds have seen yields fall rapidly, municipal yield declines have been more benign.

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 diminish in value, we expect more duration extension to capitalize on curve steepening. In addition, the use of leverage through tender option bond trusts within portfolios is transitioning from a headwind to a tailwind as the municipal curve steepens.

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 munis to perform well even if markets move to a risk-off 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.

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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 its pre-Covid trend, 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. Fed officials have 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 central bank moves toward a neutral policy stance of around 3.25% to 3.50%. We expect the Fed to reach that level in mid-2025.

THE WINDOW TO REINVEST CASH IS SHORT

The municipal yield curve steepened more than the U.S. Treasury curve during the quarter, reflected in the change in municipal-to-Treasury yield ratios. The 5-year ratio declined from 66% to 65%, while 10- and 30-year ratios increased from 65% to 69% and 82% to 85%, respectively.

Investment grade municipal credit spreads across AA, A and BBB rated categories were relatively unchanged. This makes income and changes in AAA benchmark yields the predominant drivers of returns. The Bloomberg Municipal Bond Index returned 2.71% in the third quarter versus the Bloomberg U.S. Treasury Bond Index at 4.74%, as Treasury yields declined more meaningfully than AAA municipal bond yields.

High yield municipal credit spreads tightened 1 bps to end the quarter at 198 bps. While broader market tightening was benign, spreads narrowed more meaningfully for hospital bonds and special tax districts. Spread tightening combined with coupon cash flow provided a cushion against broader interest rate volatility. In addition, investor demand remained robust, and supply was easily digested. The Bloomberg High Yield Municipal Bond Index returned 3.21% for the quarter.

The increase in long-tenor ratios is driven by increased supply. Deals, while well received, are being priced to sell and preventing the market from keeping pace with the Treasury bond rally. But this supply dynamic is not permanent. We expect ratios will remain range bound during October and revert tighter as supply lightens in November, December and early 2025. This makes the current backdrop attractive for new allocations into municipal bonds.

THE SUPPLY SURGE IS NEARLY OVER

Supply

Total issuance for the third quarter was $136 billion, 39% higher than the same period last year. Year-to-date issuance is 35% higher, putting pressure on the municipal market. The market absorbed the much-needed supply after two consecutive years of lower overall volume.

Year-to-date new money issuance was up 19%, to $257 billion, while refunding issuance increased 80% versus the same period last year. Much of this refunding volume was due to current refunding deals and refinancing through tender offers, making the activity beneficial from a present value savings perspective. Some current refunding deals were placed to refinance outstanding Build America Bonds in the taxable municipal market.

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Demand

Municipal fund inflows strengthened during the quarter, reaching $10 billion (as of 18 Sep). This brings the year-to-date total to $21.3 billion. Flows continue to be directed toward income-oriented strategies such as high yield or longer duration.

Demand for individual bonds remains a bright spot. Higher yields continue to fuel strong demand from separately managed account programs and direct purchases, causing short-term ratios to remain anchored. This barbell approach has steepened the curve, making the long-intermediate area relatively attractive.

For the remainder of the year, support from maturities and calls should be less meaningful. But with cash rates at less than 4%, muni tax-exempt income is attracting inflows. Oversubscription during a high-supply environment bodes well for the market when supply lightens, as strong demand may push yields lower and spreads tighter.

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 be disproportionately weighted toward nursing homes and assisted living facilities. Essential services monopolistic providers continue to thrive.

The credit backdrop overall has been 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 a decline in quality. Rather, it reflects the tremendous momentum of municipal credit in which many credits are reaching their credit ceiling.

Credit spreads

High yield municipal credit spreads narrowed during the third quarter from 199 bps to 198 bps over the equivalent-maturity AAA bond. This spread tightening, combined with high embedded yields, allowed high yield municipal bonds to outperform high quality bonds.

Under the surface, the dispersion of spreads between high yield issuers narrowed. Price discovery allowed smaller issuers and more esoteric credits to experience spread tightening relative to higher beta names. This continues to drive strong performance for active managers, which we believe will be important going forward.

High yield municipal spreads remain near historical averages, spending longer periods below average separated by short bursts wider. High yield munis remain attractive, considering their fundamental strength and taxable-equivalent yields. In addition, while the outflow cycle of 2022 and 2023 has reversed, assets have not meaningfully been recaptured. Investors have waited for a catalyst such as rate cuts to return to long-duration fixed income, and the growing confidence has slowly brought investors back. We expect this trend to accelerate as rates decline further.

As fund flows pick up, high yield technicals should improve further. This should be a catalyst for further spread tightening, particularly in more alpha driven exposure where credit selection and research drive price appreciation. The ability to source these deals compared to more beta driven exposure in the larger areas of the high yield market provides meaningful credit spread compression opportunity even as the broader high yield market moves closer to fair value.

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MUNICIPAL CREDIT REMAINS RESILIENT

U.S. election will affect tax policy

The outcome of the U.S. presidential election in November will impact future tax policy, with implications for the muni market. Many provisions in the 2017 Tax Cuts and Jobs Act (TCJA) are scheduled to sunset at the end of 2025. This means the current tax policy regime cannot be maintained without legislative action, making continuation of the status quo unlikely. Important potential changes include:

The top marginal tax rate could revert to 39.6%. Including the 3.8% ACA tax, the top marginal rate would increase to 43.4%. A muni bond's taxable-equivalent yield increases as tax rates rise. In other words, the tax-exemption on muni bonds is more valuable for individuals who pay higher taxes. As such, we would expect increased demand for munis in a higher tax environment.

More taxpayers could be subject to alternative minimum tax (AMT). The TCJA enacted a higher AMT exemption and increased the income level at which the exemption begins to phase out. If the TCJA sunsets, projections suggest that the number of taxpayers subject to the AMT would increase from 200,000 currently to 7.6 million taxpayers in 2026. This would lead to less favorable tax treatment for certain private activity bonds (PABs) subject to the AMT, muting the tax benefits accruing to investors subject to this tax.

The SALT deduction cap is set to expire. The TCJA capped the federal State and Local Tax (SALT) deduction at $10,000 for all income tax filers. SALT deduction limits result in higher adjusted gross income (AGI) for taxpayers who itemize their deductions. Higher AGIs increase the value of the muni tax exemption and support demand for muni bonds. Importantly, allowing the SALT cap to expire disproportionately affects taxpayers located in high-tax states.

Higher education and hospitals: the haves and have-nots

Higher education institutions and hospitals are two sectors continually in the headlines as these organizations 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 and declines of up to 15% are projected over the next ten years.

For hospitals, they 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 credit 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. On the other hand, smaller institutions with more 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 a perception that the 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 among 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 calendar year 2024.

Revenue growth is notable given that a number of states have 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 have 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 fiscal year, FY2025.

Moderate state tax collection growth so far this year signals a return to normal for state budgets. State credit quality remains strong, evidenced by broad revenue and expenditure flexibility 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.

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 general obligation (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 FEMA (Federal Emergency Management Agency). Deployment of recovery funding normally provides both 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.

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 rates 50 bps at the September meeting. We expect measured rate cuts of 25 bps 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 U.S. election and the timing of future rate cuts should 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.
- Supply has picked up meaningfully compared to 2023. We anticipate that supply will remain elevated until the first week of November, then slow to a near standstill 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.
- High yield credit spreads have tightened below historical averages due to inflows.
- Despite tight ratios, municipals should generate attractive returns based on elevated income.

For more information, please visit nuveen.com.

Endnotes

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. 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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