

First quarter 2025 outlook

Municipal bonds: Attractive yields and solid credit create opportunities



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The municipal yield curve flattened during the fourth quarter, reflecting stubborn inflation and shifting U.S. Federal Reserve policy expectations. Despite outsized high grade municipal bond supply, municipals outperformed both Treasury bonds and corporate bonds. With favorable near-term valuations, municipal bonds should continue to outperform as attractive yields generate strong demand. We think this makes current valuations an attractive entry point for long-term investors.

KEY TAKEAWAYS

- Municipal yields start 2025 at the highest level in 15 years – 122 basis points higher than the trailing 19-year average – due to outsized supply.
- Investors look to high yield municipals to drive additional yield and total return because of strong fundamentals, attractive after-tax yields and potential further spread compression.
- With the Fed having cut interest rates and cash rates expected to decline further, investors should explore extending duration.

OUTLOOK: SEASONAL STRENGTH SHOULD SUPPORT MUNICIPALS

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

Supply increased meaningfully in 2024, with issuance growing more than 31% year-over-year. Levels are expected to remain robust in 2025 as additional infrastructure and capital improvement plans come to the market. The annual technical dynamic of the January effect may act as a catalyst for momentum during the first quarter. Abundant coupons, calls and maturities signal strong

reinvestment demand, while issuance tends to be light for the first few weeks of the year.

Credit spreads remain attractive, at 181 basis points (bps) above the AAA municipal yield for high yield municipal bonds. Other credit markets have grinded toward post-global financial crisis tights. But the municipal market remains inefficiently priced with spreads above post-Covid tights, continuing to offer investors an attractive entry point. Given the strong credit backdrop, high yield municipal bonds remain an area of focus.

The municipal yield curve should continue favoring investors through absolute yield and relative value. Despite shifting interest rate policy expectations last quarter, the municipal curve provides a haven for investors looking to increase duration and yield while moving out of cash and cash equivalents. This opportunity is particularly attractive on an after-tax basis, even more pronounced at today's elevated yields. The steepness of the curve provides investors with higher income typically associated with longer-dated bonds while earning additional total return through a combination of stable or declining rates and rolling down the yield curve. In addition, as the municipal curve steepens, the use of leverage through tender option bond trusts within portfolios is transitioning from a headwind to a tailwind.

Municipal credit is in a strong position to weather potential economic uncertainty. Statutory reserves remain high, despite excess reserves being drawn down. Muni bonds have been resilient during past economic downturns, so we would 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 look for spread compression to continue.



High yield muni spreads remain above post-Covid tights, offering investors an attractive entry point.

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

Economic activity has 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 act as a counterbalance. We expect inflation to remain somewhat sticky as these forces compete. Core goods and core services inflation have already returned to target, while housing remains elevated.

A resilient economy and inflation moving slower than expected to 2% makes the Fed's long-term policy path less clear. However, we expect the Fed will continue to cut rates in the first quarter, making its way to a terminal rate of 3.75%-4.00%.

TAXES TAKE THE SPOTLIGHT

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). In addition, alternative minimum tax (AMT) provisions are likely to remain in place, which have reduced the number of individuals subject to that tax from about 5 million to 200,000. We expect the tax landscape to remain status quo for muni investors.

Discussion about tax reform usually leads to questions about the muni tax exemption, specifically whether the exemption will be eliminated to fund broader tax cuts. While meaningful headlines will likely be generated, we believe the importance of the muni tax exemption in financing local infrastructure should argue for its retention well into the future.

FUNDAMENTAL STRENGTH STABILIZES THE MARKET

Supply

Total issuance for the fourth quarter was \$122 billion, 18% higher than in the same period last year and 13% more than in the third quarter. 2024 issuance topped \$507 billion, pressuring the high grade municipal market. The market absorbed most of the much-needed supply after two consecutive years of lower overall volume.

New money issuance exceeded \$260 billion in 2024 but slowed slightly in the fourth quarter. Refunding issuance, which had been meaningfully higher through the third quarter, was down 37% quarter-over-quarter, and advanced refundings declined 56%.

We expect issuance to remain relatively elevated in 2025, although it should return to a more consistent and traditional pattern as we move away from the election cycle and toward a likely more stable interest rate environment.

Demand

Municipal fund inflows slowed in December after a strong third quarter, totaling just over \$42 billion for the year. Flows continue to be directed toward income-oriented strategies such as high yield or longer duration.

Higher yields continue to fuel strong demand from separately managed account programs and direct purchases, causing short-term ratios to remain anchored.

With cash rates at less than 4%, muni tax-exempt income is attracting inflows as investors take advantage of the positively sloped municipal yield

curve. For the year, investors collectively directed more than \$46.6 billion into the municipal market, focusing on intermediate and long funds to take advantage of elevated yields.

Defaults

First-time municipal bond defaults totaled \$1.8 billion in par for 2024, trending lower than the annual totals over the last five years. First time distressed debt came in 34% lower during the fourth quarter compared to the same period last year.

Defaults continue to 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 tremendous momentum in which many muni credits are reaching their ceiling.

Credit spreads

High yield municipal credit spreads narrowed meaningfully during the fourth quarter, from 198 bps to 181 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, spread dispersion among high yield issuers continues to narrow. 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, and we believe this will remain important going forward.

High yield municipal spreads remain near historical averages, spending longer periods below average separated by short bursts wider. This presents relative opportunity, as other credit markets are trading at historically tight spreads, and we believe municipals have more room to run.

While the outflow cycle of 2022 and 2023 has reversed, assets have not meaningfully been

recaptured. This relative spread, combined with fundamental strength and attractive taxable-equivalent yields, should continue generating demand for munis.

As fund flows pick up, high yield technicals should improve further. This should prompt further spread tightening, particularly in more alpha driven exposure where credit selection and research determine 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 toward fair value.

CREDIT SELECTION IS KEY IN CERTAIN SECTORS

PREPA's bankruptcy has broad implications

The long bankruptcy continues for the Puerto Rico Electric Power Authority (PREPA). The First Circuit affirmed its ruling that PREPA's bonds are secured by a lien on the utility's current and future net revenue. In response, the Puerto Rico Oversight Board said it would propose a modified plan of adjustment that respects the bonds' security interest. We anticipate the new plan will incorporate Nuveen's agreement to provide exit financing. But we also expect that if Judge Swain confirms this plan, it will be appealed by the non-consenting bondholders, further extending the bankruptcy proceeding absent a negotiated settlement.

The PREPA bankruptcy has broad implications for understanding special revenue municipal bonds. Special revenue bonds are issued for utilities, transportation and other services and benefit from special treatment under Section 928 of Chapter 9 of the bankruptcy code. Investors have generally believed that liens on special revenue survive bankruptcy. But because municipal bankruptcies are infrequent, precisely what happens to special revenue bonds during and after a bankruptcy proceeding has never been fully adjudicated.

Before a PREPA plan can be confirmed, the issue of whether bondholders' lien can be discharged must be litigated. Can the Oversight Board establish a value of the bondholders' lien on net revenue and give bondholders a recovery equal to that value, thus eliminating or discharging bondholders' lien? Or does the lien "ride through" bankruptcy, such that bondholders will continue to have an interest in net revenue after PREPA's exit? This decision should give investors greater understanding of the special revenue pledge in the municipal market.

The education sector splits between the haves and have-nots

Certain sectors remain bifurcated among the haves and have-nots. 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 are wide compared to their historical averages. Careful credit selection is key to determining which entities are poised to succeed.

In the charter school sector, large networks comprised of multiple schools tend to be more stable operators given scale and management sophistication. Though not always the case, these larger networks tend to have higher credit ratings than smaller, single site entities. Charter school covenant violations have increased in FY23 and FY24, as federal aid rolls off, enrollment trends differ from pre-pandemic and competition increases. More school choice options are emerging, such as universal vouchers for private schools in states such as Florida and Arizona.

Even so, credit spreads for charter schools are historically tight compared to their three-year average, making credit selection paramount to investors capturing relative value.

Under the Trump administration, we anticipate school choice policies could 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. Perhaps taxable endowments could emerge as a new buyer in the municipal market.

Senior living occupancy is recovering

The senior living sector suffered most during Covid, as occupancy declined sharply in all levels of care. Reduced revenue made it difficult to absorb higher expenses brought on by a nursing shortage, as well as inflation on supplies, food and other items. Some markets were hit harder than others, but overall occupancy is nearing pre-pandemic levels.

Margins are improving as inflation moderates, and some facilities have stabilized their workforce to rely less on costly temporary staff. The nursing shortage continues, but the regulations requiring increased staffing levels now appear less likely after the U.S. election. The real clog in the system

is caused by the lack of sufficient qualified nursing school faculty.

We expect the large number of distressed projects and covenant violations to continue, but at a declining rate. The M&A market is quite active after seizing up during the pandemic, with multiple bidders in most situations driving up valuations. Interestingly, demand for distressed skilled nursing facilities is especially strong, and we expect this trend to continue as rates decline.

We continue to favor projects in strong markets with high occupancy rates, along with entrance fees and monthly fees in line with market housing values. Demographics are on the side of the industry as more seniors desire the feeling of community they gain by becoming residents, and more and more baby boomers have a medical need to enter a senior facility.

Credit selection remains key, as some investors continue to be spooked by the challenges of the past several years, selling bonds at sometimes attractive deep discounts.



Investor demand for distressed skilled nursing facilities is especially strong, and we expect this trend to continue as rates decline.

2025 THEMES

Economic environment

- Inflation trended lower in 2024. The Fed expects that trend 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.
- Governments are adjusting for normalization of revenue collections.
- We expect municipal defaults will remain low, rare and idiosyncratic.
- We anticipate another year of heavy supply in 2025, approaching \$500 billion. Taxable muni supply has become more muted in the elevated rate environment, making up roughly 10% of the overall market.
- Demand for owning duration continues, driven by higher-for-longer yields.
- High yield credit spreads have tightened below historical averages, supported by inflows.
- Despite tight ratios, municipal bonds may generate attractive returns based on elevated income.
- The municipal yield curve has begun to normalize, showing more positive steepness as fewer Fed rate cuts appear likely.

For more information, please visit nuveen.com.

Endnotes

Sources

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