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CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

# Why munis can thrive in 2025

## Bottom line up top

**"Higher for longer" as economy looks stronger.** Although financial markets spent most of last year continuing their rebound from inflationary, rate-driven volatility that began in 2022, investor sentiment and market expectations for the path of inflation and interest rates took a turn in the "wrong" direction as 2024 came to a close. Since September, when the Federal Reserve implemented the first rate cut of its current easing cycle, Treasury yields have risen steadily. This market weakness, reflecting concerns about sticky inflation and anticipated fiscal policy shifts from the incoming presidential administration, has recently been amplified by the return of a "good news is bad news" mantra in response to resilient U.S. economic data. Last week's employment-heavy economic calendar painted an upbeat picture of the labor market: abundant jobs, stable unemployment and healthy wage growth — enough good news to send the 10-year yield to 4.76% to end the week, its highest level since November 2023 (4.77%). And looking ahead, markets are now more hawkish about policy rates in the coming year (Figure 1), pricing in just one 25 bps Fed cut in 2025, down from four only a few weeks ago.

**Tariffs and tax cuts and deficits – oh my!** The "last mile" of the journey to bring inflation down to the Fed's 2% target has proved to be about as long and winding as the yellow brick road, with some potentially treacherous footing. Given this landscape, we're monitoring three key policy themes in the early months of 2025 amid the shift in U.S. political leadership: (1) tax cuts; (2) higher tariffs; and (3) deregulation. These priorities have the potential to reignite inflation, further complicating the Fed's ability to cut rates and possibly

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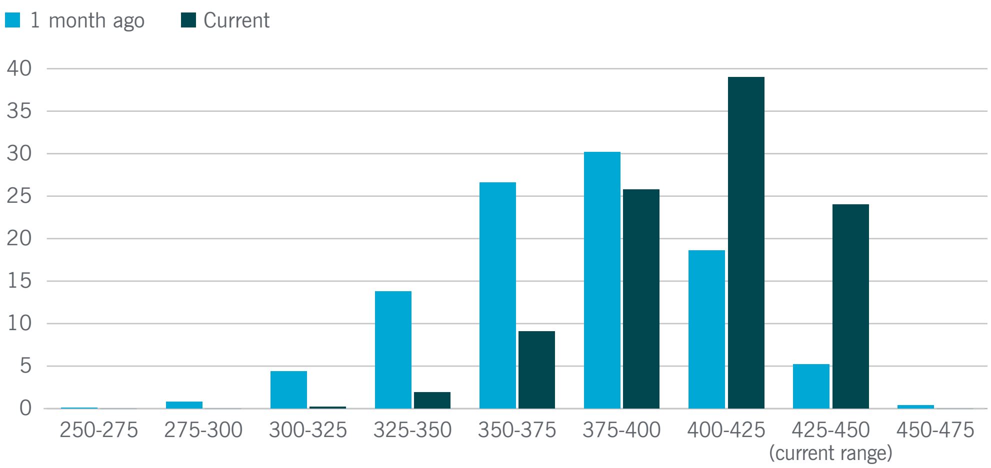
As Head of Equities and Fixed Income, Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's Equities Investment Council and is a portfolio manager for several key investment strategies.

*Ongoing inflationary pressures are likely to limit U.S. Federal Reserve rate cuts this year.*

presenting some wicked headwinds for financial markets. U.S. equities in particular, where valuations are at a premium and market leadership remains concentrated in interest rate-sensitive technology stocks, may be especially vulnerable. Despite these concerns, however, we see opportunities for investors to take advantage of the current higher-for-longer rate environment to generate attractive levels of current income from some historically reliable sources, including municipal bonds.

**FIGURE 1: RATE EXPECTATIONS RISE AS HOPES FOR FED CUTS WANE**

*Market-implied fed funds target rate upper limit probabilities for 2025 (%)*




Data source: CME FedWatch, as of 10 Dec 2024 and 10 Jan 2025. Data depicts the implied percentage probabilities of the upper range of the fed funds rate in basis points based on interest rate markets as calculated by the CME Group.

# Portfolio considerations

Municipal bonds finished 2024 in positive territory, led by high yield munis, which gained +6.6% for the year. Investment grade municipals were up +1.1%. (Returns based on respective Bloomberg municipal bond total return indexes.) Attractive income levels and tighter credit spreads drove these positive results, while rising intermediate- to long-term interest rates acted as a drag. Looking ahead, we see five key municipal market themes for 2025:

1. **Taxes remain in the spotlight.** We expect a legislative push to extend key provisions of the 2017 Tax Cuts and Jobs Act, including the current marginal tax rate levels for high-income earners and the cap on deductions for state and local taxes. Additionally, municipal bonds should retain their tax- exempt status given their importance in financing local infrastructure.

2. **Valuation tailwinds persist.** Credit spreads are a commonly used valuation metric. Over the past two decades, the risk of wider credit spreads (generally implying a deterioration in creditworthiness) has been associated with liquidity events or contagion. In contrast, current credit

conditions look sound, and contagion risks are not a pressing concern. This environment is conducive to continued spread tightening in high yield municipals, which could lead to increased capital appreciation potential.

3. **Elevated muni supply continues.** Municipal bond supply rebounded in 2024 after tepid issuance levels during the prior two years. Supply should be abundant in 2025 as well, possibly reaching $500 billion, due to ongoing infrastructure needs and refunding volume. We anticipate municipal supply to be more diversified this year, with more high yield issuance to address infrastructure needs, especially in areas of strong population growth.

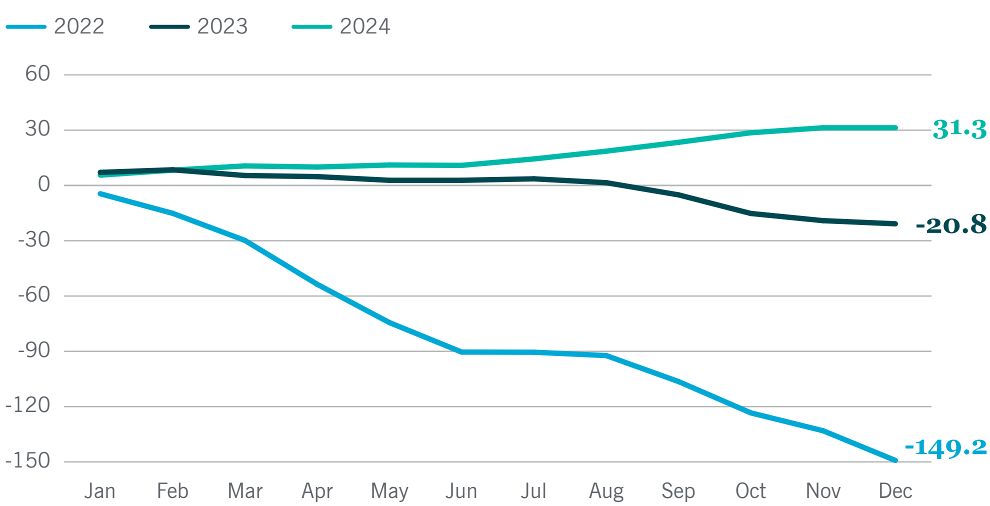
4. **Demand also remains strong.** Net flows into muni funds improved in 2024, and we see room for further acceleration. The +$31.3 billion of inflows through November 2024 haven't yet offset the combined -$170 billion in outflows in 2022 and 2023, when investors pulled out of muni funds in response to the Fed's aggressive rate hikes (Figure 2). The prospect of additional rate cuts (albeit on a slow trajectory), combined with a resilient U.S. economy, favors a steeper muni yield curve that boosts demand for long-duration municipal bonds from investors currently sitting on cash.

5. **Muni credit strength endures.** Through the second quarter of 2024, municipal credit rating upgrades continued to outpace downgrades by a 3 to 1 margin, according to Moody's Ratings. Looking forward, we expect the pace of upgrades to slow and for muni credit fundamentals to remain stable — bolstered by healthy revenues and record funding of reserves for state and local governments — making municipal credit well-positioned to weather potential economic downturns.

***Valuations, fundamentals and supply/demand dynamics all look positive for munis in 2025.***

**FIGURE 2: MUNI FLOWS HAVE STARTED TRENDING IN A POSITIVE DIRECTION**

*Cumulative annual net flows ($ billions)*




Data sources: Morningstar Direct, 01 Jan 2022 to 30 Nov 2024. Data reflects cumulative mutual fund flows for each calendar year, shown monthly.

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*Regular meetings of the GIC lead to published outlooks that offer:*

- macro and asset class views that gain consensus among our investors
- insights from thematic "deep dive" discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

**For more information, please visit nuveen.com.**

### Endnotes

#### Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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