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2025 MUNICIPAL CREDIT OUTLOOK

Stable credit, smart choices

Five credit dynamics driving the muni market

Muni bonds adapt and remain strong

Nuveen has a favorable view of municipal credit in 2025. We support investors' confidence in generating stable income from this public purpose asset class that finances essential infrastructure in the U.S. We base this strong conviction on five key credit dynamics that span across sectors.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

FIVE KEY CREDIT DYNAMICS

- ***Municipal bonds finance essential infrastructure projects*** across the U.S. at the local level. These bonds are secured by taxes or dedicated revenue streams, and they are backed by a strong security pledge.
- ***Reserve levels for state and local governments remain at all-time highs,*** and leaders have budgeted conservatively for more normalized future revenues.
- ***Republican control in Washington should not materially affect most municipal issuers,*** though some sectors such as health care, education and utilities may experience more impacts.
- ***Have and have-not stratification persists in certain sectors*** such as higher education and health care, requiring discerning credit research to identify the best opportunities.
- ***Real estate remains compelling when deals are structured effectively;*** spotlight on strong collateral coverage and shorter development timelines.

Key credit dynamics

1. Municipals finance essential infrastructure projects

Municipal bonds fund essential infrastructure for state and local government, K-12 schools, colleges and universities, roads and airports, hospitals, water and sewer utilities, housing and more. Many entities that issue these bonds have a monopolistic market position and provide essential services to the communities in which they are located. For this reason, they tend to have broad political support.

In addition, they crucially can levy taxes or fees on their residents or users, and these revenues are typically pledged to repayment of the bonds that they use to finance infrastructure projects. As such, municipal bonds not only finance essential projects, but their repayment tends to be largely insulated from the operating performance of the entities that back them. In other words, the taxes they levy or the rates they charge tend to be pledged to pay debt service first and are cordoned off from paying other operating expenses.

Recently, the future prospect of the municipal bond tax exemption has come back into discussion. Whenever tax reform is debated in Washington, the tax exemption is discussed as a potential way to pay for aspects of the tax policy changes. This time is no different. In Nuveen's view, the municipal bond tax exemption is unlikely to be eliminated given the severity of the infrastructure needs in this country, coupled with the anticipated increased cost to municipalities from having to borrow in the taxable bond market. Estimates of infrastructure needs in the U.S. vary, with one source, the American Society of Civil Engineers, estimating that "nearly $7.4 trillion is needed across 11 infrastructure areas: highways, bridges, rail, transit, drinking water, stormwater, wastewater, electricity, airports, seaports and inland waterways."

The municipal bond market will be instrumental in financing these projects at the local, rather than the federal, level. Some estimates indicate that removing the municipal bond tax exemption would increase municipalities' borrowing costs in the range of 25%. This is a significant burden for small municipalities and would ultimately result in higher local taxes and fees, and less local control over infrastructure, as smaller issuers will be forced to pool financings or issue through state programs.

This unattractive alternative and municipals' essential role in financing infrastructure ensure that the asset class should remain compelling as a tax-exempt income option for investors going forward. In our view, any changes to the municipal tax-exemption would be targeted (private activity bonds such as higher education and health care being more likely impacted) and limited to bonds issued on a go-forward basis.

2. Reserve levels for state and local governments remain at all-time highs

The recent period of state and local budgetary ease has come to an end, as most one-time federal pandemic aid has been spent or allocated, prospects for continued strong revenue growth have dimmed and expense pressures remain elevated. Many states enacted personal income tax rate cuts over the last two years, and these tax policy changes, combined with an expected slowdown in sales taxes, kept FY25 budgeting in check.

The FY26 budget cycle, which begins early this year, is expected to be more challenging due to expectations for slower revenue growth. However, we expect states will be well positioned for the return to normal given strong reserve levels. Planned reserve draws in some states are expected, but fund balances should remain higher than pre-pandemic levels. The median state rainy day fund balance is projected to reach 15% of FY25 spending as compared to just 8% in 2019.

Careful credit selection will become more important over the next year for local governments. They face many of the same revenue and expenditure pressures as states, but with fewer options. Locals rely primarily on stable property taxes and have predominantly residential tax bases. City spending increased by an average of 6.7% in FY23, but spending was only up an average of 1.3% for FY24, indicating they are reining in budgets to meet revenue expectations.

Positively, declines in commercial real estate valuations are not expected to have an outsized impact on revenues. This is due to relatively low dependence on property taxes generated by commercial properties coupled with lags in assessed values and smoothing mechanisms to stabilize property tax revenues.

Labor costs are expected to pressure expenditures at all levels of government. Public sector position vacancy rates remain higher than pre-pandemic levels, and labor shortages for public safety and corrections workers are particularly acute in some places. Higher wages needed to attract workers have a multiyear impact, as many union contracts get locked in with annual increases over several years.

Public K-12 school districts used about half of their federal pandemic aid to fund salaries. Many districts must now adjust their budgets to account for revenue declines, though many will opt to spend down reserves to maintain staffing levels, potentially pressuring ratings and credit quality.

Increased debt issuance is likely as states and locals transition away from financing capital plans with excess revenues and federal dollars. Concern over potential tax policy changes at the federal level may also motivate issuers to come to market in 2025.

3. Republican control in Washington should not materially affect most municipal issuers

Through the third quarter of 2024, the number of upgrades continued to outpace downgrades by a 3 to 1 margin. Nuveen believes that most credit upside has been captured in the ratings, meaning the pace of upgrades should slow.

Even amid this stable credit environment, robust credit research is key to portfolio performance. Identifying opportunities for relative value and credit upside is important among large numbers of issuers that have recently been upgraded. As we look forward, robust revenues and record funding of reserves for state and local governments put municipal credit in a strong position to manage through any economic downturns.

We do not expect essential service providers, especially those funded with local tax revenues, to be materially affected by policy changes at the federal level. Many municipal issuers benefit from broad autonomy and local control, providing relative stability regarding revenues pledged to debt service. Municipal bonds backed by property taxes, dedicated state and local taxes, transportation revenues, tolls or project-specific revenues should remain relatively insulated from federal policy changes.

Figure 1: Select sectors may be influenced by the Republican sweep

HEALTH CARE

- M&A may be easier due to less focus on regulation, which could support smaller, struggling hospitals
- Medicaid may shift toward privatization, which may challenge profitability for hospitals
- State funding may shift toward block grants, pressuring state budgets

EDUCATION

- School choice policies could gain momentum, which could support charter schools over public K-12 schools and states
- Pro-union policies may see reduced support, which could help public K-12 schools
- Student loan forgiveness could be rolled back, and private higher education endowments may be taxed, potentially impacting higher ed

UTILITIES

- Environmental regulations enforcement may be relaxed, supporting the sector
- Fewer mandated capital upgrades could benefit balance sheets but impair water quality

Health care

Health systems continue to pursue M&A at an increasing rate to diversify service areas, strengthen bargaining power and pursue economies of scale. Cross-market mergers are becoming more prominent, with regulators increasingly challenging transactions in similar geographic regions. Between 2000 and 2020, the Federal Trade Commission (FTC) challenged only 13 hospital mergers (roughly 1%). Since 2020, the FTC challenged and prevented at least seven such planned transactions.

We believe the Republican sweep may signal an easier path for M&A due to less focus on regulation. This could support smaller, struggling hospitals seeking partners to gain leverage with commercial payors. But it could also mean a shift toward more privatization of government funding, with insurers playing a larger role in administering Medicare and Medicaid. This may challenge some hospital profitability, as it may mean less negotiating power and lower reimbursement rates.

Larger health systems have been more resilient to changes in health care regulations and policies and have more leverage to negotiate with commercial payors than small, independent hospitals.

Education

We anticipate school choice policies could gain momentum under the Trump administration, 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.

Utilities

Republican control makes a looser regulatory environment more likely. This could mean lower mandated capital costs for electric utilities and water and sewer systems. Fewer mandated capital investments could benefit system balance sheets and lead to lower rate increases, but could also mean less investment in ensuring water quality.

4. Have and have-not stratification persists in certain sectors

Certain sectors remain bifurcated among the haves and have-nots. Investors may be familiar with this concept in higher education and health care. The strong get stronger and the weak get weaker. We are seeing a similar dynamic emerge in other sectors such as charter schools and tobacco bonds.

In higher education, greater numbers of small colleges are struggling, while larger and wealthier institutions have seemingly inelastic demand. In health care, larger systems with robust liquidity and strong market positions were mostly better able to weather the pandemic and labor inflation challenges than many of their smaller, single-site counterparts with limited balance sheets.

As such, some of the high-grade higher education and health care 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.

Tobacco bonds also contain haves and have-nots. Recent tobacco bond restructurings have resulted in high grade senior bonds that are better able to withstand significant tobacco consumption declines compared to lower-rated bonds that are more sensitive.

Current tobacco bond spreads have widened with persisting consumption declines. Spreads on low-grade tobacco bonds have widened much more dramatically than for high grades, reflecting the bifurcated nature of this sector.

5. Real estate remains compelling when deals are structured effectively

Credit quality of land-secured deals issued in the municipal market correlates to the health of the housing market, given the residential nature of most land districts. Strong housing demand from new buyers and depressed selling of existing inventory due to persistently high mortgage rates have pushed buyers into new housing communities. This dynamic has supported credit quality.

We favor deals in locations with proven demand, where meaningful infrastructure development has already occurred and home construction momentum is expected to lead to short build-out timelines. We prefer deals with solid collateral coverage (underlying land value significantly exceeds the amount of land-secured debt issued), and with known developers and builders that have robust balance sheets.

Land-secured bonds remain an important source of municipal high yield supply. New issuance reached an all-time high in 2024, exceeding $7 billion through late November. Issuance is concentrated in states with population growth and accommodative legislation, such as California, Colorado and Florida. We believe there will be increased issuance in states like Texas and Utah as well.

Bonds in the land-secured sector have experienced very few losses in recent years. Only four issues totaling $52.2 million in par are in default for all land-secured bonds issued since 2015 (less than a 0.25% default rate based on par issued during this period, through 21 Nov 2024).

> **“We do not expect the majority of muni issuers to be materially impacted by federal policy shifts.”**

Outlook

Municipal credit is expected to adapt to changing conditions

We expect strong credit fundamentals to continue supporting municipal bonds in 2025, offering investors the opportunity to generate stable income while supporting U.S. local infrastructure. Municipal bond proceeds generally fund essential projects and benefit from strong security packages, repaid by pledged taxes or project revenues.

Tax revenues for state and local governments have returned to historical growth trends while expenditure pressures for many have not lessened and federal pandemic aid has been spent down. As issuers experience additional budget stress, careful credit selection becomes more important. The trend of the haves and have-nots in health care and higher education also highlights the need to incorporate fundamental credit evaluation into investment decisions.

Questions are expected about how the new administration in Washington will impact issuers and how federal tax reform will be funded. However, we do not expect the majority of municipal issuers to be materially impacted by federal policy shifts or by drastic changes to the long-standing tax exemption on municipal bonds. The year ahead may present new challenges for many credit sectors, but overall municipal credit is expected to adapt to changing conditions and remain strong.

*Nuveen is honored to be named the **#1 team** in the 2024 Smith's All-Star Municipal Analysts Awards.*

For more information, please visit nuveen.com.

Endnotes

Sources

"Continued federal infrastructure investments will save jobs and grow the economy over the next decade: economic study," *Civil Engineering Source*, American Society of Civil Engineers, 13 May 2024; Moody's Ratings, Rating Revisions: Upgrades exceeded downgrades in Q3 2024, 15 Nov 2024; JPM-2025 outlook-spread data.

About the Smith's awards: Smith's All-Star Municipal Analyst Awards Program is the only program that consistently and prominently provides recognition in the municipal space. Smith's Research & Gradings announced the annual awards on 04 December 2024. The program starts with the formation of Smith's Blue Ribbon Ballot Committee of Portfolio Managers. Members of the committee nominate the nation's leading municipal analysts to the ballot. Once the ballot nominations for the 29 different categories are compiled and verified, the final ballot is sent to 1,000 institutional investors for voting. The entire process is transparent, and the voting increases the democratization of the municipal bond market. Please see https://www.smithsresearch.net/events/smiths-municipal-all-star-awards for more information. Used with permission.

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