

Second quarter 2025 outlook

Taxable municipal bonds: silver linings

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The fallout from the U.S. administration's tariff regime continues to send shockwaves through markets. Uncertainty around policy will likely continue to drive market and geopolitical volatility and has complicated the U.S. Federal Reserve (Fed) rate cutting path. While uncertainty and volatility impact several asset classes, we see opportunities in taxable municipal bonds to play an important role in diversified portfolios.

KEY TAKEAWAYS

- Credit strength helped taxable municipal bonds outperform most fixed income indexes during the first quarter.
- Credit spreads widened throughout the quarter and gained further momentum in March as tariff related volatility raised concerns of a slowing economy.
- Municipal credit should remain resilient in a slowing economy and outperform corporates, bolstered by fundamental strength and a favorable technicals.



Investors have an opportunity to capitalize on elevated yields, supportive market technicals and strong credit profile of municipals

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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OUTLOOK: VOLATILITY MAKES THE CASE FOR TAXABLE MUNIS

Given the volatility and credit concerns across markets, investors could benefit from adding taxable municipal bonds to diversified portfolios. Investors have an opportunity to capitalize on elevated yields, supportive market technicals and strong credit profile. Below are our best ideas to consider, as we believe taxable municipal bonds are well-positioned to navigate extended volatility.

- Taxable new issue spreads have become more attractive with recent new issue deals offering spreads greater than +120 basis points (bps) to benchmark Treasuries and greater than 6% yields for investment grade credits.
- Build America Bond (BAB) spreads compete with BBB corporate spreads offering an opportunity for investors to move up in quality with significantly less risk of default. (Figure 1)
- Tactful exposure in pressured sectors such as health care, higher education and infrastructure programs may offer benefits with careful credit selection.

STRONG PERFORMANCE

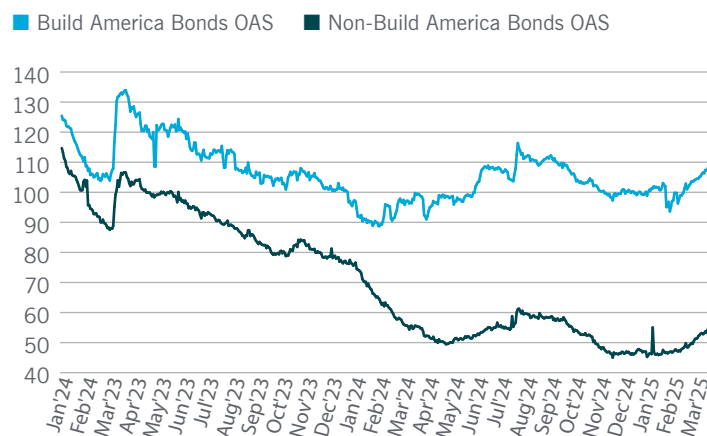
Taxable municipal bond market outperformed most fixed income indices during the first quarter, cushioned by suppressed issuance. The Bloomberg Taxable Municipal Bond Index returned 2.99%, outperforming the Bloomberg U.S. Taxable Aggregate Index at 2.83% and U.S. Corporate Investment Grade Index at 2.31%. Meanwhile, 10-year U.S. Treasury yields declined 37 bps, 10-year taxable general obligation AAA municipal yields declined a more modest 29 bps.

Although 10-year Treasury yields declined in the first quarter, absolute yields for taxable municipals remain elevated. The Bloomberg Taxable Municipal Index yielded 4.98% and provides stable risk adjusted yield opportunities compared to other fixed income indices.

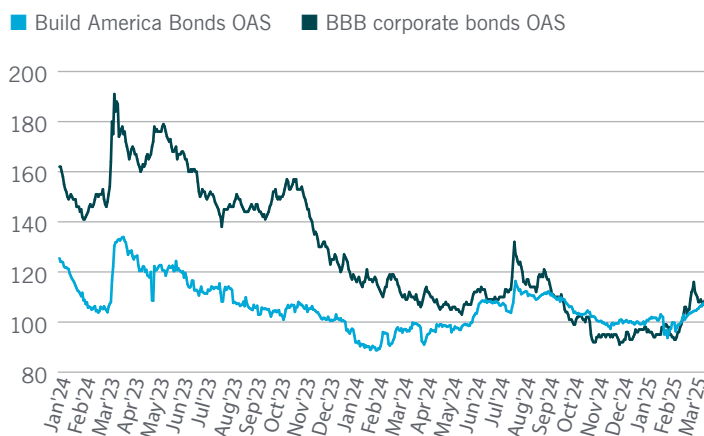
In March, spreads gained momentum and widened further as investors began favoring stronger credit given a risk-off sentiment. Taxable credit spreads widened marginally in the first quarter, with overall index spreads increasing 8 bps to 67 OAS by quarter end. As investors flocked to high quality areas of the market, AAA bonds saw the least widening at 6 bps, while BBB rated bonds widened the most at 14 bps.

Figure 1: Build America Bonds offer opportunity

BABs vs non-BABs



BABs vs BBB corporates



Data source: Bloomberg L.P., 31 Dec 2023 – 31 March 2025. Performance data shown represents past performance and does not predict or guarantee future results.

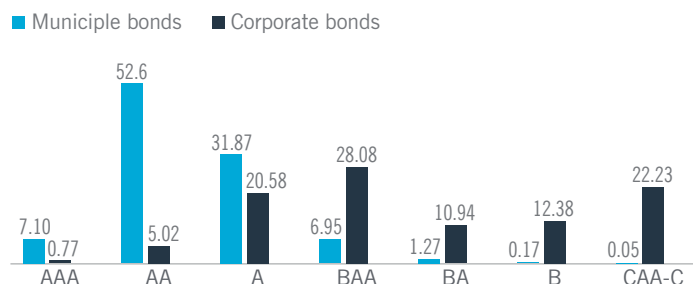
TECHNICAL FACTORS SUPPORT TAXABLE MUNIS

Overall municipal issuance was up 15% in the first quarter, compared to the same period in 2024, which was a record-breaking year. However, issuance was inconsistent across the municipal market. Tax-exempt issuance is up 10% year-over-year, pressuring these bonds and driving first quarter underperformance. Taxable issuance jumped 19% and alternative minimum tax (AMT) eligible bond issuance increased 757%. Taxable municipal issuance, although higher for the quarter, remains suppressed as it has for the past three consecutive years. This trend has supported total return performance.

Following the interest rate volatility in early April, taxable new issue deals have seen increased spread opportunities with recent transactions offering spreads between 120-140 bps over benchmark treasuries, compared to 85-105 bps earlier in the quarter. These recent new issue deals offer attractive entry points for institutional investors with longer dated investment grade bonds offering yields near or above 6%.

High quality fixed income is defensive due to the Fed maintaining higher policy rates, and overall yield remaining near historically elevated levels. Negative correlation to higher risk asset classes should continue, offering more diversification benefits to municipal bonds compared to the period of persistent low interest rates of the 2010s. More return coming from income could provide investors with greater cushion amid economic and policy uncertainty. Municipal bonds higher average rating profile than corporate debt should attract investors looking to avoid volatility in corporate markets (Figure 2).

Figure 2: Municipal bonds carry higher ratings than corporate bonds



Data source: Moody's Investors Service, U.S. Municipal Bond Defaults and Recoveries, 1970-2023, 24 October 2024, with data as of 31 December 2023, updated annually. Performance data shown represents past performance and does not predict or guarantee future results.

THE FED GRAPPLES DIFFICULT ECONOMIC BACKDROP

The Fed's March meeting was slightly dovish, with an upgrade to the median inflation forecast but no parallel move higher in the policy interest rate outlook. The Fed lowered its forecast for annual GDP growth from 2.1% to 1.7%, while raising expectations for core inflation (excluding food and energy) from 2.5% to 2.8% by year end, compared to its 2% target. The unemployment forecast edged up to 4.4%.

Weaker growth spurred by tariff policy, coupled with lower employment readings, argues for lower rates. However, higher inflation (also due to increased tariffs) calls for tighter policy and higher rates. While conditions are fluid as we begin the second quarter, the central bank expects multiple rate cuts in 2025. As more information emerges, investors should consider municipal bonds as they move out of cash to take advantage of additional yield.



Negative correlation to higher risk asset classes should continue, offering more diversification benefits to municipal bonds

FEDERAL POLICY DEVELOPMENTS MAY AFFECT MUNICIPAL BOND ISSUERS

Ongoing discussions surrounding tax policy, federal funding initiatives and regulatory changes could introduce risks and opportunities for municipal issuers in the near term.

- Relaxed environmental regulations may alleviate cost pressures for water and sewer utilities, bolstering their balance sheets.
- Grant funding cuts and the potential for more endowments to be taxed challenge higher education institutions.
- Cuts to federal student loans could impact enrollment trends and make it harder for colleges and universities to raise tuition.
- We may see less federal support for large transportation projects already underway (airports and public transit), potentially increasing debt issuance or extending timelines for completion.
- Changes to government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac could remove the implicit government guarantee and affect ratings for the mortgage-backed securities guaranteed by these entities.

We do not expect essential service providers, especially those funded with local tax revenues, to be materially affected by federal policy changes. 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. Only 5% of local government revenues come from the federal government, and public K-12 school districts are primarily funded by states. Federal funding is typically targeted at special education and school

districts with lower-income populations, so federal funding cuts could put pressure on state budgets to back-fill lost revenues.

Tariffs could pressure tax revenue and issuer budgets

State and local tax revenues could be pressured to the extent that tariffs create a drag on economic growth and curb consumer spending. Reduced sales tax revenues could pressure credit quality, especially for issuers with tighter liquidity and slimmer reserves.

Communities dependent on cross-border trade may see declining commerce and trade flows, while ports could see lower volumes due to tariffs curtailing imports. States with a high concentration in auto and aircraft manufacturing face some supply chain disruption and higher costs. These pressures, combined with uncertainty about how tariffs will be applied and implemented, is prompting many issuers to budget conservatively for the upcoming fiscal year.

Cost cutting efforts generate uncertainty for health care

The most recent House Budget Resolution passed in late February calls for \$800 billion in cuts from the Energy and Commerce Committee, which oversees Medicaid, making Medicaid adjustments a likely target to help pay for a Tax Cuts and Jobs Act extension.

Medicaid is a long-tenured state/federal cost sharing program providing health insurance to about 21% of the U.S. population, and represents the largest expenditure for most states. Importantly, states control benefits offered and eligibility parameters and would adjust individual programs in response to any federal funding reductions. To the extent other downstream entities are impacted by state budgetary strain, we could see funding cuts to local governments and K-12 school districts.

Not-for-profit hospitals would also be impacted by Medicaid funding changes. Fewer patients covered by insurance would drive up the percentage of self-pay patients and bad debt expense. This could challenge the profitability of some health care issuers, especially small rural hospitals that rely on Medicaid.

A more relaxed merger and acquisition policy may offset this pressure. Smaller and weaker health care organizations could be absorbed into larger institutions, potentially offering better credit positioning for municipal investors. Furthermore, some states may choose to bear the cost of continuing to provide health care and education services, which may support individual credits that are more pressured.

FUNDAMENTAL STRENGTH CUSHIONS UNCERTAINTY IMPACT

The impacts of federal policy changes will vary by state. However, states are well positioned to weather a tough budget environment given historically strong reserve levels and their ability to adjust revenues and expenditures as needed.

State and local tax collections have remained resilient. Total state and local tax collections were up 4.6% in 2024 over the prior year. State individual income taxes were up 5.6% in 2024 compared to 2023, while corporate income taxes were essentially flat. Sales tax collections were up just 1.5% but remain well ahead of pre-pandemic levels.

State budgets are expected to be challenged in fiscal year (FY) 2026 due to slower revenue growth and federal funding uncertainty. Planned reserve draws are expected in some states, but fund balances should remain higher than pre-pandemic levels. The median state rainy day fund balance is projected to be 15% of FY25 spending, compared to just 8% in 2019. Higher reserves and budgetary autonomy make state budgets better positioned to adjust to federal funding cuts.

For more information, please visit nuveen.com.

Endnotes

Sources

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.invttools.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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