# nuveen
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# Potential tax changes highlight municipal market opportunities

## INSIGHTS FROM THE NUVEEN MUNICIPAL CREDIT RESEARCH TEAM

*As tax policy discussions gain momentum, the long-standing tax-exempt status of municipal bonds is up for review. And a potential increase in the top marginal tax rate is on the table. While this introduces a degree of uncertainty, it also creates potential opportunities for investors. Shifts in policy expectations have led to market dislocations, offering attractive entry points for those positioned to navigate the evolving landscape with a focus on credit quality and valuation.*

## A BUDGET COMPROMISE WILL LIKELY INCLUDE PAY-FORS

Congress is developing a budget reconciliation bill that contemplates both extending the tax cuts passed under the Tax Cuts and Jobs Act (TCJA) and providing additional tax relief. News reports indicate that a budget bill will likely cross the president's desk as soon as July and as late as the fourth quarter.

As part of this process, Congress is seeking pay-fors, or offsets, to generate revenue to defray the costs associated with the tax cut extensions and any new tax relief. In January, the House Budget Committee compiled a list of approximately 200 line items that could potentially generate revenue offsets, including the tax exemption on municipal bonds. On 12 May, the House released a draft of its reconciliation bill, and the muni bond tax exemption was not included in the list of pay-fors. While the topic may resurface later during budget negotiations, it is a positive sign that it was not included initially. Recent reports also discuss increasing the top marginal tax rate to 39.6% from the current 37%, though this proposal was also not included in the first reconciliation bill from the House.

## CHANGES TO THE MUNICIPAL TAX EXEMPTION ARE UNLIKELY

Nuveen believes it is unlikely that outstanding municipal bonds would be impacted by changes in tax policy. Furthermore, any changes to the ability to issue tax-exempt bonds would more likely target the approximately $900 billion private activity bond (PAB) segment of the market.[1] This includes bonds issued for entities such as private universities, hospitals, stadiums and airports, and comprises approximately 27% of the $3.3 trillion tax-exempt outstanding municipal bond market (Figure 1).[1]

In the face of any changes, we believe existing tax-exempt bonds would likely be grandfathered in and retain their tax exemption. Thus, only bonds issued on a go forward basis would be taxable. In addition, we believe threats to individual entities losing their organizational tax-exempt status are idiosyncratic and should remain rare or non-existent given the existing legal framework.

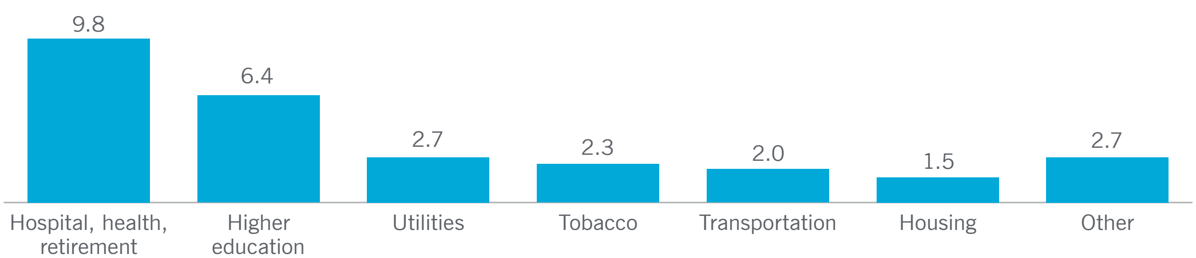
## TAX-EXEMPT BONDS WOULD BECOME SCARCE

Nuveen believes that any change in the future tax exemption for PABs would lead to scarcity of tax-exempt bonds for entities, namely private universities, transportation and not-for-profit hospitals (Figure 2). Under this scenario, the amount of outstanding tax-exempt PABs at the time of the tax policy change would be finite, as future debt issued by borrowers in these sectors would be taxable.

The potential for change in tax policy has contributed to elevated municipal bond issuance year-to-date, as municipal issuers seek market access ahead of any potential changes. This elevated issuance has pushed municipal-to-Treasury yield ratios meaningfully cheaper, as 10- and 30-year ratios have widened 14% and 13%, respectively. For the first four months of the year, tax-exempt municipal bond issuance was up 12% from the same period last year, led by borrowers in the education, general purpose and transportation sectors.

### Figure 1: Changes to tax exemption would likely target private activity bonds

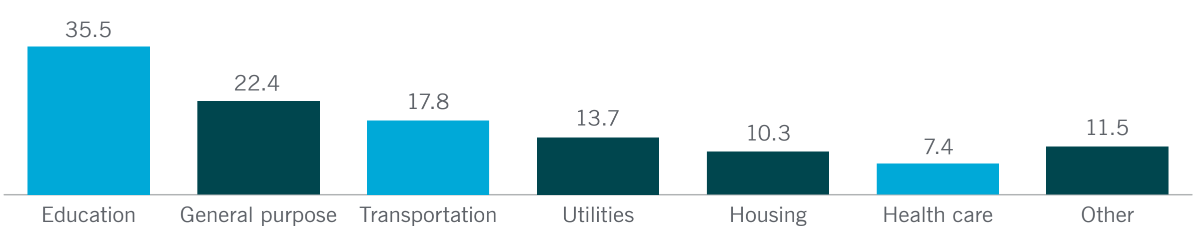
*Private activity bonds as a percent of the tax-exempt municipal market (%)*




Data source: Bloomberg, L.P., 28 Apr 2025. The Other category includes K-12 education, economic development & corporate obligors, and charities & other non-profits.

### Figure 2: Education, transportation and health care may particularly be impacted

*Issuance, first quarter 2025 ($ billions)*




Data source: Bloomberg, L.P., 28 Apr 2025. The Other category includes electric power, development, public facilities and environmental facilities.



OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

A similar pattern occurred in December 2017, prior to passage of the TCJA, as issuers rushed to market ahead of feared shifts to the treatment of municipal bonds. Similar issues were discussed then, including changes to the tax status of stadium financing bonds, tax-exempt refunding and broader tax treatment of municipals.

When the House proposed the initial version of the budget bill in early November 2017, the municipal market promptly sold off by nearly -1.5%. It wasn't until the Senate proposed a competing bill that the market rallied, recouping prior losses by year end and eventually outperforming Treasuries by more than 50 basis points (bps).

That year, fourth quarter issuance was up 66% compared to the trailing five-year average, and in December alone it was 270% higher than the same month in the prior year. Despite the significant pick up in issuance at the end of 2017, once the market received certainty on tax policy, municipals provided positive total returns on an absolute and relative basis.

Considering this historical fact pattern, the underperformance of the municipal asset class so far this year, as well as the recent significant increase in yields, we firmly believe this may be an opportune time for investors seeking to capitalize on market uncertainty and invest in the municipal market (Figure 3).

## MUNIS, AND PABS IN PARTICULAR, MAY BE UNDERVALUED

It stands to reason that outstanding tax-exempt PABs would become more valuable if tax policy changes limit the ability of borrowers to issue tax-exempt PABs going forward. Despite this, the market is currently treating tax policy uncertainty with avoidance, and potentially impacted sectors are underperforming year-to-date (Figure 4). This may present a unique opportunity for investors to purchase undervalued bonds that are misunderstood by the market.

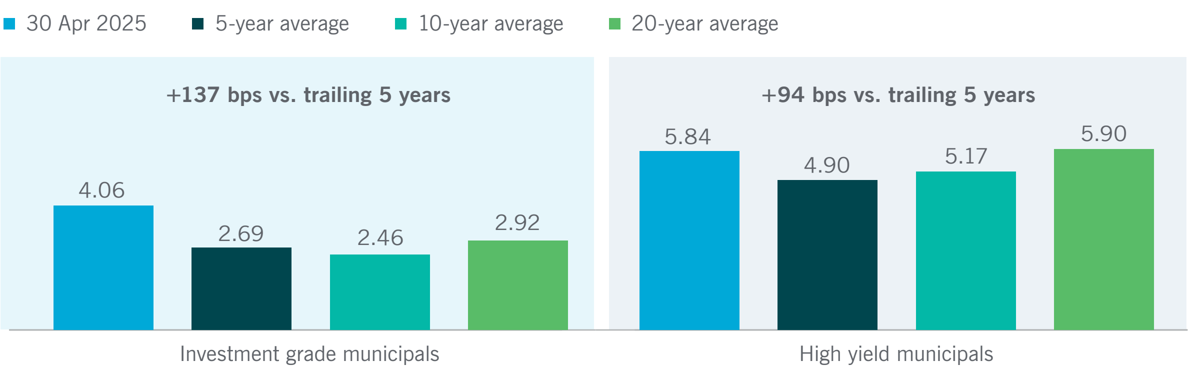
### Figure 4: Potentially impacted sectors are underperforming so far this year

| | Total return (%) | Relative return (%) | Yield-to-worst (%) | Relative yield (%) |
|---|---|---|---|---|
| **Education** | -1.67 | -0.42 | 4.33 | 0.16 |
| **Health care** | -1.73 | -0.48 | 4.69 | 0.52 |
| **Transportation** | -1.38 | -0.13 | 4.42 | 0.09 |
| **Utilities** | -1.53 | -0.28 | 4.05 | -0.13 |
| **Broad municipal market** | -1.25 | — | 4.17 | — |

Data source: Investortools, 28 Apr 2025. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: education:** S&P Muni Education Index; **health care:** S&P Muni Health Care Index; **transportation:** S&P Muni Transportation Index; **utilities:** S&P Muni Utilities Index; **broad municipal market:** S&P Broad Municipal Index.

### Figure 3: Current municipal yields are attractive compared to history

*Yield to worst (%)*




Data source: Bloomberg, L.P., 30 Apr 2025. **Performance data shown represents past performance and does not predict or guarantee future results.** Yields are yield to worst. Yield to worst is the lowest potential yield that can be received on a bond without the issuer defaulting. **Representative indexes: investment grade municipals:** Bloomberg Municipal Bond Index; **high yield municipals:** Bloomberg High Yield Municipal Bond Index.

## TAX RATE CHANGES COULD INCREASE THE VALUE OF THE MUNI TAX EXEMPTION

If the top federal marginal tax rate increases from the current level of 37% to the recently floated 39.6%, the demand for tax-exempt muni bonds would certainly increase, as the tax exemption would become even more valuable to taxpayers in the highest tax bracket.

For example, the taxable-equivalent yield (TEY) on a 4.17% investment grade municipal bond is 7.04% (measured by the S&P Municipal Bond Index) for taxpayers in the current highest marginal tax bracket of 37% (and the 3.8% ACA tax). If the top marginal tax rate increased to 39.6%, this TEY would increase 33 bps to 7.37% (Figure 5).

## MUNI BONDS OFFER ATTRACTIVE RISK-ADJUSTED RETURNS AND HISTORICALLY HIGH YIELDS

Muni bonds presently offer attractive risk-adjusted yields and may become even more attractive if tax-exempt paper becomes scarce and higher tax rates emerge for top earners. Unlike past shocks, when municipal yields spiked due to potential credit concerns — such as the pandemic or the Great Financial Crisis — the recent move higher in yields is unrelated to credit concerns.

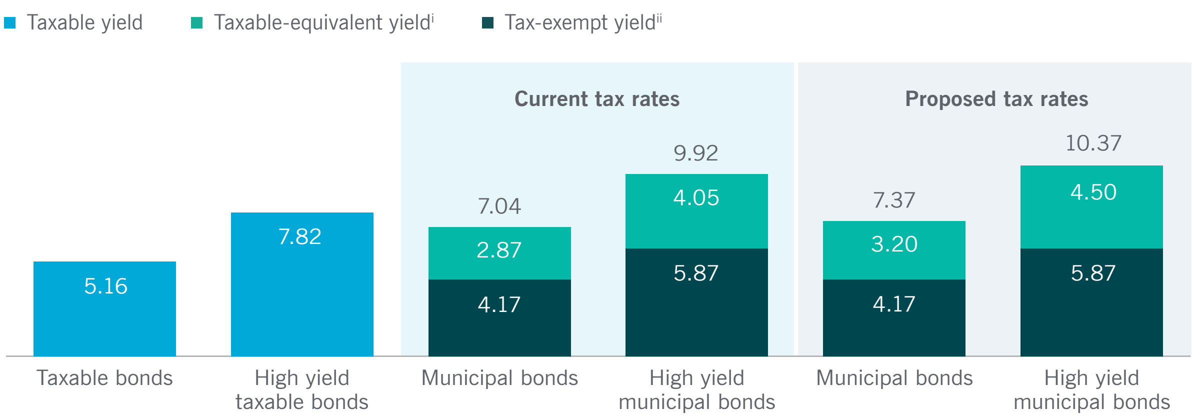
Indeed, the 41 bps spike in yields can best be ascribed to technical factors, namely record supply and meaningfully diminished liquidity. Consider that municipal yields are currently in the 97th percentile when looking over the past 10 years.[2] Since yield has driven historical returns in fixed income, municipals appear poised to deliver attractive returns moving forward.

Municipal credit remains resilient, particularly in times of economic stress. With past recessions and economic slowdowns as a guide, the municipal market historically has not experienced a spike in defaults due to the prevalence of essential service monopolies and tax-backed credits (Figure 6).

In addition, state and local governments are heading into this period of economic uncertainty with record levels of rainy day funds at 15% of 2025 spending levels, a dramatic increase compared

### Figure 5: Municipals are attractive on an after-tax basis

*39.6% tax rate*




i The current taxable-equivalent yield is based on the highest individual marginal federal tax rate of 37.0%, plus the 3.8% Medicare tax on investment income (the Net Investment Income Tax). The proposed taxable-equivalent yield is based on a rate of 39.6% plus the 3.8% Medicare tax. Individual tax rates may vary.

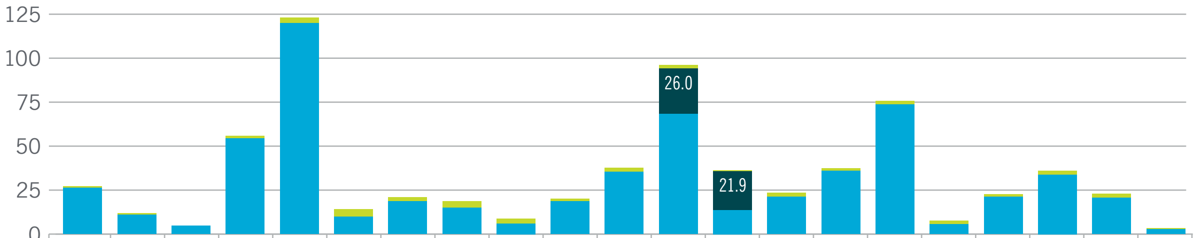
ii Some income may be subject to state and local taxes and the federal alternative minimum tax.

Data source: Bloomberg L.P., 28 Apr 2025. **Performance data shown represents past performance and does not predict or guarantee future results.** Yields are yield to worst. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer defaulting. **Taxable-equivalent yield** is the yield a taxable investment needs to possess (before taxes) for its yield to be equal to that of a tax-free municipal investment. The yields shown are based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income. Individual tax rates may vary. They do not take into account the effects of the federal alternative minimum tax (AMT) or capital gains taxes. **Representative indexes: municipal bonds:** Bloomberg Municipal Bond Index Total Return Index Value Unhedged USD; **taxable bonds:** Bloomberg U.S. Corporate Total Return Value Unhedged USD; **high yield taxable bonds:** Bloomberg U.S. Corporate High Yield Total Return Index Value Unhedged USD; **high yield municipal bonds:** Bloomberg Muni High Yield Total Return Index Value Unhedged USD. Different benchmarks, economic periods, methodologies and market conditions will produce different results.

## Figure 6: Defaults remain in line with historical trends

*Municipal payment defaults ($ billions)*

■ Corporate defaults ■ Municipal defaults – Puerto Rico ■ Municipal defaults




| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ■ (Municipal defaults) | 0.9 | 0.9 | 0.2 | 1.6 | 3.4 | 4.3 | 2.4 | 3.8 | 2.8 | 1.5 | 2.3 | 27.8* | 22.7* | 2.3 | 1.3 | 2.2 | 2.1 | 1.6 | 2.0 | 2.1 | 0.7 |
| ■ (Corporate defaults) | 26.3 | 11.0 | 4.7 | 54.4 | 119.8 | 9.9 | 18.7 | 15.0 | 6.0 | 18.7 | 35.3 | 68.3 | 13.7 | 21.2 | 36.0 | 73.6 | 5.6 | 21.1 | 33.8 | 20.7 | 2.8 |

Data sources: Bank of America/Merrill Lynch Research, 03 Apr 2025, municipal default data as of 31 Mar 2025. Bank of America/Merrill Lynch Research HY Credit Chart book, corporate default data as of 31 Mar 2025. Data represents defaults on the entire universe of bonds, both rated and unrated, and includes Puerto Rico defaults. *For 2016 and 2017, the figures shown for municipal defaults were primarily from Puerto Rico defaults; $26.0B (2016) and $21.9B (2017).

to 8% in 2019. This rainy day cushion is further supported by growing tax revenues, which were up nearly 5% in 2024, as income taxes, sales taxes and property taxes are elevated as compared to the same period in 2023. Municipals are in a position of strength and offer attractive risk-adjusted investment opportunities.

## CURRENT CONDITIONS FAVOR MUNICIPAL BOND INVESTMENT

The municipal tax exemption will certainly remain in the headlines. But Nuveen remains confident that there will be little to no change to the tax-exemption for municipal bonds given the important role of the tax-exemption in helping to provide affordable financing for critical infrastructure on behalf of states, local governments and other essential service providers across the country.

However, with high levels of uncertainty in the current environment, investors should plan for all scenarios — including one in which the tax exemption changes for munis. Given elevated yield levels, resilient credit fundamentals and our expectation that municipals will retain their tax-exempt status, we believe this is a compelling opportunity to invest in the asset class and capitalize on the current market dislocation.

**Endnotes**

**Sources**

1 Data source: Bloomberg, L.P., 28 Apr 2025.

2 Data source: Bloomberg, L.P., 28 Apr 2025, as measured by the ICE BofA U.S. Municipal Securities Index.

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