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Second quarter 2024 outlook

Taxable municipal bonds: building momentum

Daniel J. Close, CFA
Head of Municipals

Kristen M. DeJong,
Portfolio Manager

Philip C. Traven, CFA
Portfolio Manager

In the first quarter, the taxable municipal bond market displayed relative strength in the face of rising Treasury yields. The U.S. economy remains strong, and municipal credit fundamentals are benefiting from a resilient consumer and strong labor market. Limited new issue supply and strong demand for high-quality, long duration assets led to relative outperformance for taxable municipal bonds. We believe demand could strengthen as investors consider shifting to longer duration municipals ahead of U.S. Federal Reserve (Fed) rate cuts.

KEY TAKEAWAYS

- Higher income generation and credit spread narrowing helped taxable municipal bonds absorb an increase in long-term Treasury yields.
- Investors recognize that lengthening duration may benefit portfolios in the short-term should yields move lower.
- The taxable municipal bond market enters the second quarter with relative strength, supported by above average yields and positive technical and fundamental factors.

OUTLOOK: 2024 STARTS OFF RIGHT

The municipal bond market started in a great place to begin 2024.

Yields began 2024 at their highest levels since 2011, thanks to aggressive Fed policy and a strong economy. Investors may enjoy attractive total returns from income alone, a dynamic absent for nearly a decade.

Real yields, a bond's stated yield minus inflation rate, sit at the highest levels since 2009. While inflation has been moderating, it remains considerably less than the current short-term fed funds rate of 5.25%.

We expect Fed cuts to begin in the second half of 2024. Such an environment has historically steepened the yield curve. A steepening yield curve should be positive for longer-duration bonds, allowing investors to receive the higher income associated with longer-dated bonds while earning additional total return through a combination of declining rates and rolling down the curve. The municipal market continues to await a trigger to accelerate fund flows, and Fed cuts might be that catalyst.

A supply/demand disparity should keep yields and spreads contained, as expected net negative supply would create scarcity among a shrinking pool of outstanding bonds. Declining rates may result in additional supply later in 2024, but consecutive years of low supply should allow for any uptick in supply to be readily absorbed. 2024 should create a unique dynamic with the U.S. presidential election causing some supply to move forward with issuers attempting to issue bonds before the election.

Municipal credit is in a strong position to weather potential economic uncertainty. Statutory reserves remain very high, despite excess reserves being drawn down. Though the economy remains on strong footing, we expect taxable municipals to perform well if markets move to a risk-off tone due to their resilience during past economic downturns. In recent years, credit upgrades have outpaced downgrades by a factor of 4:1. Taxable municipal bonds remain well placed to capitalize on solid credit fundamentals, and option-adjusted spreads could tighten further, providing total return potential.

THE FED SEES COOLING INFLATION AS THE PATH TO RATE CUTS

Coming into 2024, investors expected the Fed to begin cutting interest rates as early as March due to cooling inflation and weaker economic growth. While the Fed projected three rate cuts in 2024 at its December meeting, the market priced in as many as six cuts as of January. Economic data released throughout the first quarter showed continued economic strength and stickier than expected inflation to begin 2024, leading to fewer expected rate cuts and higher Treasury yield forecasts.

While the economy remains resilient, inflation is cooling. The core PCE deflator, the Fed's preferred measure of inflation, sits at 0.3% month-over-month (2.8% year-over-year). Importantly, core services ex-housing number fell from 0.7% in January to 0.2% in February. As inflation falls, conventional monetary policy rules call for an equal reduction in the policy rate. With the Fed's projections for core PCE to reach 2.4%, at least three rate cuts will be required to keep real policy rates steady.

Inflation is tracking with the Fed's criteria to begin cutting rates in the second half of the year. However, should the labor market weaken beyond what current trends suggest, the Fed could cut more than the consensus view.

2024 THEMES

Economic environment

- Inflation trajectory remains favorable year-over-year. The Fed projects marginally lower core PCE Inflation by year-end. Core services inflation excluding housing remains sticky but is trending down.
- After increasing the Fed Funds rate by 525 bps during this cycle, the Fed has been on hold since July 2023. Fed policy remains data dependent. We expect rate cuts in 2024 with the timing dependent on inflation, wages and employment data.
- U.S. growth has been resilient and recession risks have declined. Key factors include employment data, consumer spending and levels of excess household savings. Capital markets are leaning towards a 'no landing' scenario, but recession risks remain.
- Uncertainty regarding the beginning of Fed rate cuts and balance sheet contraction will continue to cause rate volatility. Rates could decline if a slowdown or recession develops.

Municipal market environment

- Credit remains strong, with robust levels of rainy day and reserve funds.
- While revenue collections are below peaks witnessed in 2022, they remain above pre-pandemic levels.
- We expect municipal defaults will remain low, rare and idiosyncratic.
- Taxable supply has remained suppressed to start the year but could be more robust in the months leading up to the election.
- Demand has favored owning duration with U.S. municipal mutual fund inflows favoring the long-end of the curve.
- As yields remain higher-for-longer, investor demand has begun to return due to prevailing market sentiment of anticipated Fed rate cuts.
- Municipals have displayed strong relative performance to begin the year.
- Taxable municipal credit spreads have tightened but remain attractive relative to other credit markets.
- Absent a meaningful rate rally or spread contraction, municipals can still post attractive returns based on elevated income generation.

TAXABLE MUNICIPAL BONDS REMAIN FIRM AMID TREASURY MARKET VOLATILITY

First quarter taxable municipal bond performance did not replicate the strong returns that closed out 2023. However, we have seen the power of higher income from above average yields. Municipal bonds readily absorbed more than a 30 basis points (bps) increase in 10- and 30-year Treasury yields as the Bloomberg Taxable Municipal Bond Index returned 0.10% during the first quarter. Income alone can provide a meaningful ballast against Treasury volatility.

Additional cushion can be garnered from credit spread tightening. Spreads for the taxable municipal bonds continue to move tighter due to the strong technical backdrop, which includes net negative supply and meaningful demand on the long end of the curve. These factors helped produce marginally positive returns for the quarter despite U.S. Treasury bond volatility.

Option-adjusted spreads across credit markets are trending toward post-global financial crisis levels. At the same time, recession risks remain due to elevated policy rates. The strength in municipal fundamentals remains an important tailwind for portfolios going forward. Should the economy weaken, we expect municipals to offer credit stability and resiliency. While taxable municipals continue to offer additional spread relative to corporate bonds for equally rated securities, it remains important to focus on essential service providers that have inelastic demand profiles. Through analysis of credit, security structure and the yield curve, portfolios may be built to generate attractive income relative to the index without sacrificing the essential service nature of the underlying projects included.

THE TECHNICAL ENVIRONMENT REMAINS SUPPORTIVE

Supply

Total municipal bond issuance for the first quarter was $99 billion, a 24% increase compared to the first quarter of 2023. New money issuance was up 2%, to $66.6 billion, while refunding issuance increased 17% versus the same period last year. Total volume was predominantly tax-exempt issuance, as tax-exempt yields remain historically low on a ratio basis compared to taxable yields. Taxable municipal issuance during the quarter was $1.9 billion, representing an 80% decline compared to the first quarter of 2023.

In addition to low taxable municipal supply, redemption activity is outpacing supply. According to Bloomberg, approximately $9 billion in taxable municipal bonds have matured or been called year-to-date. The disparity between redemption and issuance is causing a strong technical tailwind.

Going forward, issuance should remain suppressed until yields decline. If the Fed begins to cut rates this year, we may see an uptick in taxable municipal issuance. Additionally, issuers may look to pull supply forward ahead of the presidential election. In previous cycles, this has provided investors with a buying opportunity in September and October preceding the election. We expect a similar environment this year.

Figure 1: Year-to-date returns

Index	Yield to worst (%)	Spread (bps)	Effective duration (years)	Q1 2024	2023
Taxable municipal (AA-)	5.02	64	7.63	0.10	8.82
U.S. Treasury (AA+)	4.44	—	5.99	-0.96	4.05
U.S. aggregate bond (AA)	4.85	39	6.14	-0.78	5.53
U.S. corporate investment grade (BBB+)	5.30	89	6.90	-0.40	8.52
Global aggregate (unhedged) (A+)	3.74	39	6.56	-2.08	5.72

Data source: Data as of 31 March 2024. Source: Bloomberg, L.P., March 2024. All returns in USD, unhedged: Bloomberg Municipal Index Taxable Bonds Total Return Index Value, Bloomberg US Corporate Total Return Value Unhedged USD, Bloomberg US Treasury Total Return Unhedged USD, Bloomberg GlobalAggregate Total Return Index Value Unhedged USD, Bloomberg US Agg Total Return Value Unhedged USD, Bloomberg Global Agg Corporate Total Return Index Value Unhedged USD, Bloomberg US Agg ABS Total Return Value Unhedged USD, Bloomberg US MBS Index Total Return Value Unhedged USD. Disclaimer: Past performance does not predict or guarantee future results. The format and content of this report may not be modified or altered (including, but not limited to, via deletion or addition) in any way. The BLOOMBERG PROFESSIONAL service, BLOOMBERG Data and BLOOMBERG Reporting (the "Services") are owned and distributed locally by Bloomberg Finance L.P. ("BFLP") and its subsidiaries in all jurisdictions other than Argentina, Bermuda, China, India, Japan and Korea (the "BLP Countries"). BFLP is a wholly-owned subsidiary of Bloomberg L.P. ("BLP"). BLP Provides BFLP with global marketing and operational support and service for the Services and distributes the Services either directly or through a non-BFLP subsidiary in the BLP Countries. BFLP, BLP and their affiliates do not provide investment advice or guarantee the accuracy of prices or information in the Services. Nothing on the Services shall constitute an offering of financial instruments by BFLP, BLP or their affiliates.

Demand

Following U.S. Treasury volatility in 2022 and a strengthening U.S. dollar, demand weakened from a combination of currency hedging losses and investors' desires to wait out the Fed's rate hike cycle. In 2023, we saw some improvement. Demand for long duration remained a bright spot. Liability-driven investors with an objective of hedging long duration liabilities exhibited strong demand during 2023. The 2023 trends have accelerated thus far in 2024. Long duration buyers continue to show robust demand, leading to a steeper inversion of the taxable municipal spread curve.

Total return investors also exhibited more demand, as the Fed's rate hike program appears concluded with a shift toward potential rate cuts. Now with more clarity from the Fed and continued moderation in inflation, we expect demand from total return focused investors to increase in 2024.

Defaults

First-time municipal bond defaults totaled $362 million in par during the first quarter of 2024, trending with historical averages. Defaults remain concentrated in nursing homes and project finance.

Widespread issues are not expected in 2024, as record balance sheets should provide ample protection from economic uncertainty for most issuers. We expect municipal bond defaults to remain low, rare and idiosyncratic, reflecting the resiliency of the asset class even in economic downturns.

The credit backdrop overall has been robust. Upgrades outpaced downgrades by a 4:1 ratio for three years in a row. However, given the pace of upgrades since 2020, this momentum is much less likely to continue. We expect closer to a 1:1 ratio for upgrades versus downgrades going forward.

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Credit spreads

Taxable municipal credit spreads narrowed during the first quarter from 82 bps to 64 bps on an option-adjusted spread basis. In a period where U.S. Treasuries displayed volatility, taxable municipal spread tightening provided meaningful support to relative returns.

With market participants feeling enthusiastic over the possibility of a soft landing, lower quality areas of the market tightened more. A rated option-adjusted spreads tightened by -21 bps and BBB rated bonds saw -28 bps in spread tightening.

Credit spreads overall reached all-time tight levels, completely reversing the widening that occurred during the extreme volatility of 2022. While spreads overall are tight, taxable municipal bonds remain attractive on a relative value basis compared with corporate bonds. More specifically, AA rated taxable municipals ended 2023 with 16 bps spread advantage over AA rated corporate bonds. Given the resiliency offered from municipal credit, the spread advantage remains meaningful.

CREDIT

Baltimore bridge collapse triggers economic fallout

Baltimore's Francis Scott Key Bridge collapsed recently after being struck by a large cargo ship. The accident left massive destruction and the loss of human life, with significant short- and long-term impacts on the city, state and national economies.

The Port of Baltimore complex (five public and 12 private terminals) has been closed to almost all marine traffic since the incident occurred. As of the time of writing, the U.S. Coast Guard has opened a temporary channel in the harbor at a depth of 11 feet. Officials report they may soon clear an alternate channel, with a depth of 25 feet. The largest container ships require a depth of 50 feet for passage, a task that could require weeks to complete.

The Key Bridge is one of eight toll facilities owned and operated by the Maryland State Transportation Authority (MDTA). Toll revenue from the Key Bridge represented 7% of the MDTA's total toll revenue of $755 million in 2023. As noted by Moody's, the greater credit risk to the Authority's Project Revenue Bonds lies in the uncertainty of the bridge replacement costs and timing. Experts say the cost to rebuild the collapsed bridge could be at least $400 million or double that, depending on the design.

MDTA has property and business interruption insurance and may also receive third-party insurance proceeds, including from the ship owner responsible for the crash. Traffic from the Key Bridge will largely shift to the Fort McHenry (I-95) and Baltimore Harbor (I-895) tunnels, also owned and tolled by MDTA. MDTA has unrestricted cash reserves of $400 million and $431 million in its Capital Account for near-term reconstruction costs.

President Biden stated he intends for the federal government to pay for the full cost of the bridge replacement. MDTA is likely to receive some level of federal financial support, as Maryland is receiving an initial $60 million in emergency funding from the federal government.

> *As noted by Moody's, the greater credit risk to the Authority's Project Revenue Bonds lies in the* ***uncertainty of the bridge replacement costs and timing.***

Municipal bond credit fundamentals remain strong

As policy rates remain elevated, economic uncertainty remains. Municipal credit continues to be in a strong position to weather potential weaknesses in the broader economy. State and local governments maintain high cash balances, and we expect municipals to perform well in a conservative environment due to their resilience during past economic downturns.

As expected for 2024, many state and local governments are planning for revenue collections to decline from peaks. Total state and local tax revenues were down 4.4% in 2023, driven by a 13.6% decline in individual income tax collections compared to 2022. Peak revenues in 2022 were boosted by an influx of federal aid, strong stock market returns and sales taxes boosted by higher inflation and accelerated consumer spending.

Tax collections are unsurprisingly lower in 2024 as some of these factors wane — most notably federal aid distributed during the pandemic. Despite this decline, total tax collections remain above pre-pandemic nominal levels. Total tax revenues are nearly 28% higher than 2019 and 26% higher than 2020. Income tax collections are also strong compared to pre-pandemic levels.

Revenue normalization will not necessarily cause pressure on credit ratings as state and local governments prepare for these revenue declines. Given conservative budgeting, most states ended FY23 with budget surpluses, adding to historically high reserves. High reserve balances, or savings, offer a significant buffer against revenue declines.

Municipal bond defaults also remain low in 2024 year-to-date, at $362 million compared to $9.2 billion in corporate defaults. Municipal defaults are concentrated in nursing homes and industrial development bond sectors, as well as select names in health care. The most stable sectors would be considered state and local government, water and sewer utilities, land secured, higher education and health care. Default rates in these sectors remain low and close to historical averages.

Notably, for the first time since the 2008 recession, we see limited headline credit risk in the municipal market. The past decade has witnessed numerous examples of deteriorating credits that created headwinds for the market such as Jefferson County, Detroit, Puerto Rico, Illinois and Chicago. And while idiosyncratic credit events may occur, we do not expect any individual event to create spillover effects into the broader market.

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: Seibert 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.invtools.com/. Flow of Funds, The Federal Reserve Board: http://www.federalreserve.gov/releases.pdf. 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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