

Fourth quarter 2025 outlook

The municipal bond rally has room to run



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The long-awaited municipal bond rally finally materialized in the third quarter, and we believe the market has reached an inflection point. Municipals have underperformed broader fixed income markets year to date, creating an attractive entry point for additional gains. Three key factors support this outlook: the U.S. Federal Reserve's shift toward rate cuts, continued fundamental credit strength in the municipal sector and historically attractive yields.

KEY TAKEAWAYS

- Market dynamics: The return of shareholder inflows — one of the most important technical factors for municipals — helped the sector to rally and outperform other fixed income sectors in the third quarter.
- Attractive entry point remains: The Federal Reserve's rate cuts, combined with strong credit fundamentals and potentially improving technical conditions, may create a compelling opportunity for the remainder of 2025.
- **Credit resiliency:** Tax revenue collections and reserves remain at all-time highs despite economic headwinds, with state and local government revenues up year-over-year through mid-2025.

BEST IDEAS FOR Q4: DON'T MISS THE MUNI RALLY

Strong market momentum and robust credit fundamentals have created compelling relative value opportunities in the municipal market. As we look ahead, our best ideas for portfolio positioning include:

Consider investment grade exposure in 10- to 20-year bonds.

10- and 20-year bonds currently offer 62 and 170 basis points (bps) of additional yield compared to 2-year bonds, respectively. For investors concerned about duration risk, 10-year call features provide a hedge by shortening the effective duration of longer-maturity bonds to the call date.

Shift from cash into short- or longduration high yield.

Short-duration high yield municipals offer attractive risk-adjusted returns, currently yielding 4.64% tax-exempt, or 7.84% on a taxable-equivalent basis. This presents a compelling alternative for investors looking to move out of cash, which yields only 3.94%, and 2.07% after accounting for taxes and inflation.

For investors seeking enhanced total return potential and willing to extend duration, longer-duration high yield strategies that use tender option bonds (TOBs) have proven beneficial. Fed rate cuts combined with improved market technicals helped this strategy deliver positive returns in the third quarter. We expect this outperformance to continue as markets increasingly favor duration exposure and the municipal yield curve remains steep.

Explore pressured sectors such as higher education and health care.

Muni sectors caught in political crosshairs, such as higher education and health care, are trading at attractive levels relative to historical norms.

Higher education institutions faced pressure from Washington early in the year. As a result, spreads for bellwether credits widened dramatically and weighed on the sector as a whole. Similarly, health care spreads have widened due to uncertainty about future Medicaid spending. 10-year sector spreads remain attractively priced compared to start-of-year levels in higher education and health care. In the 30-year maturity space, spreads for AA and A rated securities are 30 to 54 bps wider across most sectors. As headline risk subsides, spreads should compress.

THE FED CUTS RATES AND OPENS THE DOOR TO MORE

The Fed cut rates 25 bps in September, which was largely anticipated by the market. The Fed further updated its forward guidance from 25 bps of additional rate cuts to 50 bps for the balance of the year, despite inflation running marginally above expectations.

The bigger surprise for the quarter was a weakening labor market, with jobless claims hitting a new post-Covid high of 263,000 in August alongside a general trend of slowing job creation. The Fed's emphasis on employment downside risks despite "somewhat elevated" inflation supports expectations for continued easing, with markets currently pricing in 100 bps of additional cuts by year-end 2026.

Given this backdrop of declining interest rates for short maturity paper, investors can capture meaningful yield increases by moving out of cash — which is likely to continue to experience lower yields as the Fed pursues additional rate cuts — and rotating into higher yielding municipal bonds.

MUNICIPAL RALLY CONTINUES, BUT BARGAINS STILL EXIST

Municipal bonds outperformed during the third quarter, with the Bloomberg Municipal Bond Index returning 3.00% compared to 2.03% for the Bloomberg U.S. Aggregate Index — 97 bps of outperformance. Despite this rally, municipals have still underperformed by 3.49% year-to-date, as 10-year municipal yields declined 14 bps compared to 10-year Treasuries, which fell 41 bps.

Municipal-to-Treasury yield ratios have historically served as a key barometer of relative value in the municipal market. The benchmark 5-, 10- and 30-year weekly ratios have averaged 65%, 68% and 87%, respectively, since the interest rate sell-off bottom on 31 Oct 2023. Current ratios of 60%, 70% and 90% are slightly richer than last quarter's start but remain well below year-beginning levels and meaningfully cheaper than recent history (Figure 1). Notably, while the front end has gotten richer, significant value persists at longer maturities.

The municipal yield curve is the steepest it's been in more than ten years and is nearly twice as steep as the U.S. Treasury curve. During the third quarter, investors began capitalizing on this exceptionally steep muni yield curve by rotating from 5-year municipal bonds into 20-year maturities, thereby capturing 168 bps of additional yield. This rotation drove long-maturity outperformance, with the 22+-year index returning 3.82% versus 2.19% for the 5-year index.

Even after a quarter of improving performance, municipals present significant relative value for investors deploying cash now. Municipal-to-Treasury yield ratios are 3.5 points cheaper at 10 years and 8 points cheaper at 30 years when compared to 2024 year-end (Figure 2). Absolute yields sit in the 87th percentile compared to the previous decade, while taxable-equivalent yields for highest-income earners reach compelling 7.82% levels.

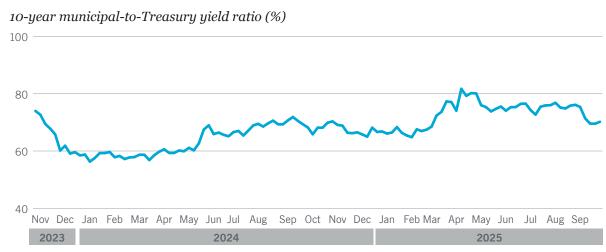
TECHNICAL TAILWINDS GATHER STRENGTH FROM INCREASING DEMAND AND WANING SUPPLY

Fund flows trump all other municipal technicals and are usually the single most important determinant of performance over short to intermediate timeframes. Importantly, investor demand surged during the third quarter with inflows of \$8.8 billion, which brought flows to \$31.6 billion year-to-date, including \$20.2 billion into long and intermediate funds. Separately managed account interest remains robust, with flows tilting toward intermediate strategies as duration becomes a tailwind. Finally, recognizing strong municipal market fundamentals, investors have allocated \$8.6 billion into high yield municipal funds.

On the supply side, total municipal bond supply in 2025 is projected to exceed last year's record \$500 billion, though issuance should slow in the fourth quarter. Year-to-date, \$428 billion has been issued – 14% higher than last year but down from the 17% increase through the second quarter. Supply cooled in the third quarter and is expected to taper further.

Issuers that accelerated deals in the first half of the year, presumably anticipating potential tax exemption changes through tax reform, are unlikely to issue again in the fourth quarter. We think this should bring supply back into equilibrium and create buying opportunities.

Figure 1: Municipal-to-Treasury yield ratios represent compelling relative value



Data source: Bloomberg, L.P., 31 Oct 2023 – 30 Sep 2025. **Performance data shown represents past performance and does not predict or guarantee future results.** Data represent the AAA municipal bond yield as a percentage of the U.S. Treasury yield for 10-year maturities.

Supply patterns vary significantly across sectors. Year-to-date, higher education, gas prepay and industrial development bonds have seen issuance more than double that of their five-year averages. Conversely, state general obligation, appropriation debt and sales tax bonds have experienced meaningfully less issuance growth when compared to the broad industry, and electric utility issuance remains lower than last year. This disconnection drives valuation dispersion and creates deployment opportunities.

The combination of strengthening demand and moderating supply creates favorable technical conditions heading into the fourth quarter.

MUNICIPAL DURATION IS BACK IN FAVOR

The steep municipal yield curve presents compelling opportunities for investors. Moving from 5-year to 20-year maturities provides an additional 168 bps of yield pickup — steepness that is nearly three standard deviations cheaper than the 10-year average.

Looking back at our records, this extreme yield curve configuration has occurred less than 1% of the time since September 2015. Comparatively, the 5-year/20-year Treasury curve offers only 96 bps of pickup, creating an 72 bps steepness advantage for municipals. This relative attractiveness across the 10- to 20-year segment requires active curve strategies and flexible portfolio management — strategies we highlighted earlier in our quarterly review.

Figure 2: Municipals are attractive on an after-tax basis





¹ The 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). Individual tax rates may vary.

Data source: Barclays Live, 30 Sep 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: short term taxable bonds: Bloomberg U.S. Government/Credit 1-5 Year Index; short term municipal bonds: Bloomberg Municipal Short Index; intermediate term taxable bonds: Bloomberg U.S. Government/Credit 5-10 Year Index; intermediate term municipal bonds: Bloomberg Municipal Intermediate Index; high yield taxable bonds: Bloomberg Corporate High Yield 2% Issuer Capped Index; high yield municipal bonds: Bloomberg High Yield Municipal Bond Index. Different benchmarks, economic periods, methodologies and market conditions will produce different results.

² Some income may be subject to state and local taxes and the federal alternative minimum tax.

5-year AAA-rated municipal bonds finished the third quarter yielding 2.32% — equal to the trailing 10-year average. In contrast, 30-year bonds finished at 4.24%, which is 45 bps above the 10-year average. For top-bracket investors, the longer duration represents an additional 0.76% in taxable-equivalent yield.

While the long end of the curve bull-flattened into quarter end, the duration opportunity remains attractive. The after-tax yield of the 1-3 month T-bill index stands at just 2.38%. In a rate cutting environment, investors should expect this yield to fall alongside policy rates. When one further factors in inflation, we believe money market returns likely won't cover cost-of-living increases over the next year.

A recent analysis we conducted shows that yield provides 85.3% of the total return for high grade municipals and 98.2% for high yield municipals. Looking back over the past decade, current yield levels sit in the 87th percentile, making this an excellent entry point for investing in intermediate-to long-maturity municipal vehicles while providing meaningful downside protection against potential volatility.

Consider: The Bloomberg Municipal 20-Year Index currently yields 4.47%. If long rates were to rise 50 bps, one could reasonably expect a modest 1-year return of -0.15%. However, if rates fall 50 bps, that could generate a return of +9.08%. Given current valuations, we find this asymmetric return profile compelling.

Money markets hold record assets exceeding \$7 trillion. We expect investors to begin extending duration to make up for lost income as rate cuts materialize. In our estimation, now is the time to position ahead of this rotation.



Investing in an intermediate- to long-maturity municipal vehicle may provide a meaningful downside cushion against further volatility.

MUNI FUNDAMENTALS REMAIN STRONG DESPITE IDIOSYNCRATIC HIGH YIELD CHALLENGES

Municipal credit fundamentals remain steady, with state and local tax revenue collections up 5.1% through the first half of 2025 compared to last year. All major tax revenue categories increased — income, sales and property — with individual income tax collections leading at 10.9% year-over-year growth. Demonstrating municipal credit resilience, tax revenues remain at all-time highs despite slowing economic growth, positioning the sector well even if growth decelerates.

The high yield market faced headwinds during the third quarter from Brightline rail project developments in Florida. A deferred interest payment on third lien bonds for the 15 July coupon caused valuation declines across all liens associated with the Florida project. Bonds funding Brightline West, connecting Los Angeles to Las Vegas, also experienced negative price action stemming from the deferred payment. Combined, all Brightline bonds for East and West projects resulted in a -0.33% total return impact on the high yield index.

Conversely, Puerto Rico Electric Power Authority (PREPA) bonds moved higher after the White House removed six of seven Puerto Rico Oversight Board members. This action was viewed as a positive credit event for PREPA, with the market viewing increased potential for the utility to exit bankruptcy with a new Board, contributing 0.05% to the high yield index total return.

POLICY CLARITY SUPPORTS THE MUNICIPAL MARKET OUTLOOK

The passage of the One Big Beautiful Bill on 4 Jul 2025 brought relief to the municipal market by preserving the municipal tax exemption. While broader federal policy changes may still impact certain sectors, individual securities will be positioned differently based on their fundamentals. This environment makes rigorous credit selection critical for generating outperformance.

The muni sector scorecard shows our views on credit fundamentals, momentum and valuations for major municipal sectors (Figure 3).

Figure 3: Muni sector score card

+ Positive	Neutral -	- Negative		
SECTOR	CREDIT FUNDAMENTALS	CREDIT MOMENTUM	VALUATIONS	KEY TAKEAWAY
State & local governments	+	=	+	Tax collections up and reserves at all time highs – provides cushion against economic slowdown
Education	=	_	+	Pressure due to increased competition for students and affordability coupled with federal policy changes. Large universities will be able to navigate, smaller colleges likely to struggle
Transportation	=	=	+	Large capital projects coupled with slowdown in air travel and shipping to ports, against backdrop of strong credit fundamentals
Housing	+	=	+	Need for affordable housing bolsters credit
Water & sewer utilities	+	=	+	Essential service, monopolistic providers with strong reserves and cash flow
Health care	=	=	+	Haves and have-nots (largely smaller rural hospitals). Stronger hospitals will likely weather Medicaid changes, while weaker providers will seek partners or struggle

Data source: Nuveen, 31 Aug 2025. Certain statements may be deemed forward-looking statements. Please note that any such statements are not guarantees or intended to constitute a prediction of any future performance; actual results or developments may differ materially from those projected.

Credit fundamentals across all major municipal sectors are solid, reflecting robust revenue collections and strong liquidity. For education and health care — both with neutral scores — we see a strong versus weak dynamic where larger, wealthier institutions will likely maintain credit quality while smaller, less robust organizations may struggle. For transportation, while fundamentals are generally strong, large capital investment needs may weigh on some credits.

The credit momentum score reflects our view of likely credit quality direction. Education is the only sector with negative momentum, as federal policy pressure and challenging demographics may impact some credits. However, we still see value in education institutions our credit team identifies as better equipped to manage current challenges.

We see value potential across all municipal sectors, as the asset class has underperformed other fixed income year-to-date. Harvard University's bonds exemplify this dynamic, with 5% bonds due in 2030 seeing spreads widen from 29 bps in January to 82 bps in late April when the administration threatened to revoke Harvard's tax-exempt status.² Nuveen's research team identified this as a compelling buying opportunity for a AAA-rated institution with a \$53 billion endowment.

Within health care, well-managed hospital systems like CommonSpirit retain flexibility to reduce expenses and absorb potential Medicaid pressures. Rigorous credit selection remains essential.

Given strong fundamental credit conditions, we believe value exists across the municipal spectrum.

MUNICIPALS ARE POSITIONED FOR A STRONG FINISH

Following unprecedented supply pressure, challenging fund flows and a higher-for-longer rate environment, we believe the municipal market has reached a critical inflection point, as demonstrated by the third quarter's long-anticipated rally.

Historically high yields, attractive valuations and strong credit fundamentals are driving investor recognition that municipals have turned the corner. While 18 months of underperformance created doubt, our conviction remains unchanged.

The current environment presents a compelling entry point. With Fed rate cuts expected, fund flows turning positive and seasonal supply/demand dynamics likely favoring performance, municipal headwinds appear to have reversed course. This convergence provides multiple performance opportunities heading into 2026.

For more information, please visit nuveen.com.

Endnotes

1 Bloomberg, L.P., 30 Sep 2025, as measured by the ICE BofA U.S. Municipal Securities Index.

2 Nuveen portfolios may or may not be invested in the Harvard bond referenced in this paper. However, no particular endorsement of any company, product or service is being made, nor does Nuveen have any other conflicts of interest in presenting this analysis. We are not recommending the Harvard bond, only referencing it as a case study in how market dislocation creates compelling value opportunities.

Sources

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Taxable-equivalent yields 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. Inflation rate used is the PCE Deflator, which is removed from the after tax income of the 3 month T-bill yield, resulting in an after tax and after inflation rate for cash. CFA- and Chartered Financial Analyst- are registered trademarks owned by CFA Institute.

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