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Second quarter 2025 outlook

Municipal bonds: Compelling yields in a shifting U.S. policy landscape

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Municipal bonds began the second quarter on sale, with heavy new issuance pushing absolute and relative yields higher. With U.S. tax bills coming due, U.S. municipal bond holders tend to sell muni holdings to make these payments. This dynamic may cause temporary weakness in the market early in Q2 and could reverse quickly, providing meaningful opportunities to capture yield. Looking ahead, we consider how potential changes in U.S. federal policy could affect the municipal bond market.

KEY TAKEAWAYS

- The municipal bond market underperformed other fixed income meaningfully during the first quarter, with technicals acting as a stiff headwind.
- High yield municipals continue to entice investors due to low relative credit risk, attractive taxable-equivalent yields and favorable ratios compared to high yield corporates.
- Investors may consider increasing exposures to private activity bonds and the overall municipal market ahead of opportunities presented by potential shifts in tax policy.

OUTLOOK: CURRENT MARKET CONDITIONS SUPPORT INVESTING IN MUNI BONDS

We think now is a compelling time to consider adding municipal bonds to a diversified portfolio, as investors may take advantage of elevated yields, attractive valuations and improving market technicals. Below are our best ideas to consider, as we believe the market is well-positioned in the months ahead.

- Investment grade exposure in 10- to 20-year maturities offers attractive yield pickup with a minimal increase in duration (due largely to embedded 10-year call features).
- Short-duration high yield may benefit interest rate sensitive investors due to the favorable value of yield per unit of duration.
- AMT bonds provide additional yield, with index-eligible bonds adding meaningful yield compared to broad index exposure.
- Tactful exposure in pressured sectors such as health care, higher education and infrastructure programs may offer benefits with careful credit selection.

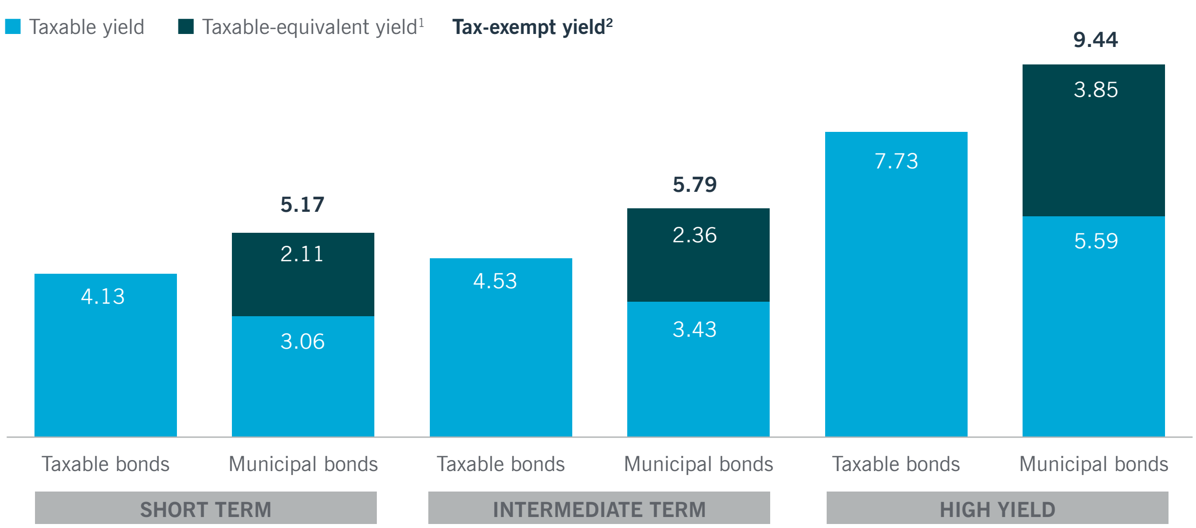
MUNICIPAL BONDS BEGIN THE SECOND QUARTER ON SALE

The municipal bond market underperformed other fixed income meaningfully during the first quarter, with technicals acting as a stiff headwind. The Bloomberg Municipal Bond Index returned -0.22%, compared to the Bloomberg U.S. Aggregate Index at 2.78%. While 10-year U.S. Treasury yields declined 37 basis points (bps), 10-year AAA municipal yields moved in the opposite direction, rising 20 bps.

With the divergence in municipal and Treasury yields, absolute yields ended the first quarter elevated. The Bloomberg Municipal Intermediate Index yielded 3.43% and the Bloomberg High Yield Municipal Bond Index yielded 5.59%. This equates to a 5.79% taxable-equivalent yield (TEY) for the highest earners on high quality bonds and 9.44% for high yield (Figure 1).

Figure 1: Municipals are attractive on an after-tax basis

Yield comparison (%)



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.

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

Data source: Barclays Live, 31 Mar 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.

TECHNICAL FACTORS CAUSE MUNICIPALS TO BE DISCOUNTED

Overall issuance was up 15% in the first quarter compared to the same period in 2024, which was a record-breaking year. Issuance was inconsistent across the muni market, with tax-exempt issuance up 10% year-over-year, taxable issuance rising 19% and alternative minimum tax (AMT) eligible bond issuance increasing 757%. This sizable increase in AMT issuance has further pressured these bonds, providing attractive relative value opportunities in many circumstances.

Issuance should remain elevated compared to both historical averages and last year's record numbers. We expect more traditional municipal market trends to emerge later in the year, with issuance slowing during the summer months.

On the demand side, fund flows have been relatively strong. Investors poured $9.7 billion into the municipal market in the first quarter, including $6.3 billion in open-end funds. High yield municipals continue to attract investors due to low relative credit risk, elevated taxable-equivalent yields and attractive ratios compared to high yield corporates. Investors have injected $4.8 billion into high yield municipal bond funds, including $3.9 billion into open-end funds.

While net flows remained positive, they could not keep pace with the heavy issuance, particularly with dealers also lightening inventory by up to nearly $2.5 billion heading into March. The sizable issuance has resulted in municipals underperforming other areas of the fixed income market, which has increased yields and created relative value for investors looking to put cash to work. While issuance is likely to remain elevated through the middle of the second quarter, technicals are beginning to shift and we anticipate better support throughout the remainder of this year.

MUNI YIELD RATIOS ARE THE CHEAPEST SINCE LATE 2023

Municipal-to-Treasury yield ratios have historically been a barometer of relative value in the municipal market. The benchmark 5-, 10- and 30-year ratios have averaged 63%, 65% and 84%, respectively, since the bottom of the interest rate selloff on 31 Oct 2023. Today's ratios of 74%, 78% and 92% are the cheapest since the recovery began (Figure 2 shows the 10-year ratio).

10-year AAA rated municipal bonds finished the quarter yielding 3.26%, which is 1.25% higher than the trailing 10-year average. This means clients in

Figure 2: Municipal-to-Treasury yield ratios represent compelling relative value

10-year municipal-to-Treasury yield ratio (%)

Data source: Bloomberg, L.P., 31 Oct 2023 – 31 Mar 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.

the highest tax bracket are receiving an additional 2.11% in taxable-equivalent yield. Over the past 15 years, yield has driven 79.2% of municipal investment grade returns and 105.5% of high yield returns, demonstrating that income is the primary driver of municipal total return over time.

Short-duration high yield municipals offer a 4.68% yield (7.91% TEY) for investors seeking to maximize yield while remaining interest rate sensitive. Short-duration high yield spreads are +167 basis points (bps), which is 20 bps cheaper than long-duration high yield spreads.

Short-duration high yield spreads and absolute yields remain attractive, but it may be accretive to extend duration within high yield using tender option bonds (TOBs) as market conditions evolve. While duration was a headwind in the first quarter, lower interest rates for the balance of 2025 would benefit strategies with longer duration. As short interest rates decline with anticipated U.S. Federal Reserve cuts, borrowing costs may decrease, which should support strategies that use TOBs. This ability to deliver additional total return and income through leverage should position long, high yield strategies attractively as market dynamics shift.

Municipal yield curve relative steepness is important as municipal-to-Treasury yield ratios increase further out on the curve. The municipal yield curve provides investors with +163 bps of additional yield by moving from the shortest to the longest part of the curve. And 80 bps of this yield pickup comes in the 10- to 20-year portion of the curve. With municipal bonds having a standard 10-year call feature, investors are not taking on significant additional duration exposure by extending longer than 10 years to gain additional yield.

High quality fixed income is behaving in a defensive manner due to the Fed remaining patient at higher policy rates and overall yields being higher than in recent history. Negative correlation to higher risk asset classes should continue, offering more diversification benefits to municipal bonds than during the period of persistent low interest rates of the 2010s. More return coming from income could provide investors with more cushion amid economic and policy uncertainty.

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THE FED GRAPPLES WITH A 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%.

Chair Jerome Powell faces a unique challenge: 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.

FEDERAL POLICY DEVELOPMENTS MAY AFFECT MUNICIPAL BOND ISSUERS

Tax exemption may again be up for debate

The topic of municipal bond interest tax exemption often surfaces during discussions of broader tax reform. We don’t see strong signs that the tax exemption will be materially revised, though outright elimination is on a long list of options being considered to help pay for extending the Tax Cuts and Jobs Act (TCJA).

Eliminating the exemption would save the federal government approximately $40 billion a year, a small portion of the more than $4 trillion in savings needed to fund the TCJA. And the change would have an outsized impact on state and local governments, potentially leading to increased borrowing costs of $82 billion a year.

Eliminating the exemption could also make it more difficult for smaller, infrequent investors to access the municipal market. Smaller borrowers may be compelled to use pooled financing structures, undermining local autonomy over capital spending.

We believe continuing the tax exemption has bipartisan support. But levels could be adjusted or limited for a subset of issuers, such as private activity bonds for issuers like private universities, not-for-profit hospitals, airports and stadiums.

Any changes would not likely be retroactive and thus not impact outstanding debt, making municipal bonds with the tax exemption far more valuable. Investors may want to consider increasing their exposures to both private activity bonds and the overall municipal market to capitalize on this potential future market opportunity.

Expect speculation on muni tax exemption to persist until the TCJA is settled.

Municipal finance navigates potential policy shifts

Ongoing discussions surrounding tax policy, federal funding initiatives and regulatory changes could introduce both 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.

> *Any changes in tax exemption would not likely be retroactive, making muni bonds with the tax exemption far more valuable.*

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 that depend on cross-border trade may see declining commerce and trade flows, while ports may see lower volumes due to tariffs curtailing imports. States with a high concentration in auto and aircraft manufacturing may see some supply chain disruption and higher costs. These pressures, combined with uncertainty about how tariffs will be applied and implemented, are 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 TCJA extension.

Medicaid is a long-tenured state/federal cost sharing program that provides 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 particularly 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.

> *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.*

FUNDAMENTAL STRENGTH CUSHIONS AGAINST UNCERTAINTY

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 more 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.

CONDITIONS FAVOR A MUNICIPAL MARKET REBOUND

Despite the municipal bond market's relative underperformance in the first quarter, driven by outsized supply, conditions are improving. With supply expected to largely normalize and investor demand likely to strengthen, we think muni bonds appear poised for improved performance. As macroeconomic factors stabilize and clarity on tax policy emerges, attractive valuations support a more favorable outlook in the coming months.

For more information, please visit nuveen.com.

Endnotes

Sources

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