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Fourth quarter 2023 outlook

Taxable municipal bonds: yields moving higher

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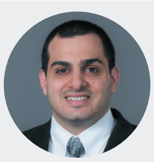

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The taxable municipal bond market experienced negative third quarter returns in sympathy with U.S. Treasuries. With the U.S. Federal Reserve (Fed) nearing the end of its rate hike cycle, higher yields have increased future expected returns, given yields are now at levels not seen over the last decade. We believe portfolios should be rewarded by assuming a modestly longer duration profile while adding credit risk.

KEY TAKEAWAYS

- The surge in Treasury yields contributed to negative taxable municipal market performance for the quarter.
- The Fed's higher-for-longer stance provides the most attractive entry point for taxable municipal investors in more than a decade.
- A positively sloped taxable municipal credit spread curve and strong fundamentals provide an opportunity to drive income.

OUTLOOK

Clip the coupon through near-term uncertainty

We see several main factors driving fourth quarter taxable municipal bond performance. Most important is the surge in U.S. Treasury yields that has not been supported by fundamentals. Ultimately, we think softening inflation should lead to a more range-bound interest rate environment, and technical shocks may offer attractive entry points for investors willing to absorb near-term volatility.

Second, taxable municipal market technical factors continue to be buoyed by strong demand and slower issuance.

Further, municipal credit fundamentals remain strong. Plentiful reserves mean municipalities are generally well positioned to weather an economic slowdown driven by higher interest rates. Despite this, credit selection continues to grow in importance as tighter economic conditions pressure specific names.

Finally, the Fed has affirmed its commitment to defeating inflation. 30-year Treasury real yields are their highest in the last decade, and a positively sloped municipal yield curve and strong fundamentals provide an opportunity to drive income. After a painful 2022 and challenges in 2023, income investors assuming the Fed would have paused already in 2023 have not experienced the price returns they expected. But higher yields have increased future expected returns.

Going forward, income investors do not require declining yields to have a positive experience. With Treasury market stabilization, taxable municipal bond investors may enjoy more than 5.5% annualized returns through income alone for high quality, essential service investments.

2023 THEMES

Economic environment

- Inflation has come down sharply in recent months, and the trajectory is favorable due to goods and the rollover of housing costs.
- Core services inflation excluding housing remains sticky and elevated.
- The fed funds rate has risen by 525 basis points (bps) during this cycle. Fed policy remains data dependent, with a focus on core services inflation.
- Another rate hike is possible before year-end; we do not expect rate cuts until the second half of 2024.
- U.S. growth should trend lower as the impact of Fed policy is fully absorbed. Key factors include interest rates, continued headwinds in the banking sector and declining money supply.
- While the economic slowdown may be milder than expected, we remain unconvinced the Fed can engineer a soft landing.
- Uncertainty regarding the end of Fed rate tightening continues to cause elevated rates. Anticipate a return to range bound trading once the Fed is done with rate hike campaign.

Municipal market environment

- Credit remains strong, with historic levels of rainy day funds.
- While revenue collections are solid and above 2021 levels, they have slipped below the peaks witnessed in 2022.
- We expect municipal defaults will remain low, rare and idiosyncratic.
- Supply should return in the fourth quarter but remains depressed compared to the prior year.
- Demand through the third quarter has focused on intermediate, long duration and high yield.
- Absolute yields are now at levels last seen in 2007, which might spur investor demand heading into 2024, particularly when investors have conviction the Fed is done hiking.
- Municipal performance is expected to rebound as interest rates stabilize and inflows return.
- Absent a meaningful catalyst, municipals can still post attractive returns based on elevated income generation from adjusted rates.
- Long-term tax-exempt and taxable municipal valuations are attractive on a spread basis, compared to similar maturity U.S. Treasuries and corporate bonds.

DEFEATING INFLATION CONTINUES AS A SLOW GRIND

As the Fed seemingly approaches the end of its rate hike cycle, Treasury yield volatility has surged as market dynamics shifted.

The Fed raised the fed funds rate by 25 bps at its July meeting, holding rates steady in September. The Fed's dot plot of rate expectations shows a higher-for-longer period as the central bank commits to bring inflation down to its 2% target. Chair Jerome Powell also gave an indication that a soft landing was likely.

The market interpreted this combination to mean a long, slow grind to defeating inflation. Treasury yields increased rapidly, and the yield curve steepened during the final days of the quarter. The 10-year Treasury yield rose 73 bps during the quarter, while the 30-year yield rose 84 bps.

Additionally, U.S. Treasury market technicals weakened substantially. Issuance increased dramatically following the resolution of the U.S. debt ceiling debate in June. At the same time, demand declined from non-U.S. buyers due to the strength of the U.S. dollar.

VOLATILE U.S. TREASURIES APPLY PRESSURE

The surge in Treasury yields did not allow municipal bond cash flows time to provide the performance cushion typically experienced during periods of interest rate volatility. The Bloomberg Taxable Municipal Index returned -3.71%. Yields for the index rose from 5.07% to 5.62% for the quarter, which far surpassed any cushion provided by spread tightening. While spreads for the index narrowed by -11.5 bps during the quarter, the main theme was the sudden increase in U.S. Treasury yields during the final weeks of September.

Relative to other fixed income asset classes, taxable municipals generally underperformed due to their longer average duration and maturity structures during a period when the yield curve steepened. Taxable municipal specific factors are reasonably healthy, displayed by narrowing credit spreads and steady improvement in credit quality from 10 consecutive quarters of upgrades outpacing downgrades. However, in a quarter where U.S. Treasury yield movements had an outsized impact on performance, asset class duration disproportionately impacted relative returns.

Figure 1: Year-to-date returns

	Yield to worst (%)	Spread (bps)	Effective duration (years)	Returns (%) 3Q 2023	Returns (%) YTD 2023
Taxable municipal (AA-)	5.62	84	7.7	-3.71	0.87
US Treasury (AA+)	4.86	—	5.79	-3.06	-1.52
US aggregate bond (AA)	5.39	52	6.08	-3.23	-1.21
US corporate investment grade (BBB+)	6.04	120	6.68	-3.09	0.02
Global aggregate (unhedged, A+)	4.21	50	6.47	-3.59	-2.21

Data as of 30 September 2023. Source: Bloomberg, L.P., September 2023. 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 Global-Aggregate 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.

THE FED GAINS CREDIBILITY IN FIGHTING INFLATION

The Fed's higher-for-longer stance is feeding a sustained environment of elevated yields. We think this provides the most attractive entry point for municipal investors in more than a decade.

Long-term investors are now able to lock in higher yields from municipal bonds. But short-term price fluctuations are keeping investors with cash on the sidelines, since it is impossible to predict the peak in interest rates.

Market strategists generally expect a soft landing, given the resiliency of the economy and continued strength in the labor market. These tailwinds have supported credit sensitive markets, but we believe investors should remain cautious.

The lagging effects of rate hikes may take longer to appear in this cycle. Consumer cash balances were higher going into Fed tightening, many corporations locked in longer-dated financing at low interest rates, residential mortgages were re-financed broadly at low interest rates, and fiscal expansion was greater ahead of this tightening cycle.

These factors continue to aid economic expansion. But if the economy shows signs of weakness due to lagged impacts, the interest rate environment could abruptly shift to a declining trend.

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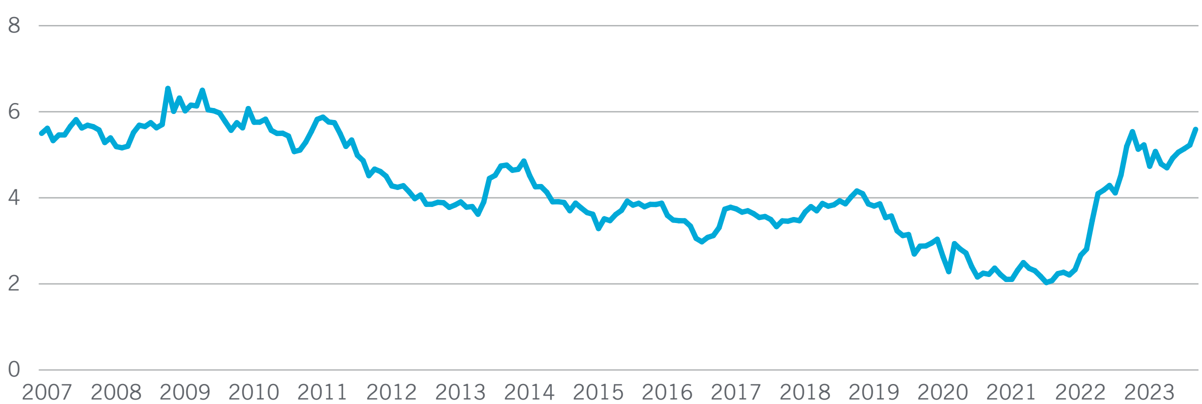
TAXABLE MUNICIPAL BOND VALUATIONS ARE INCREASINGLY FAVORABLE

With the Bloomberg Taxable Municipal Bond Index yielding 5.62% at quarter end, elevated yield levels match those rarely seen since the Build America Bond Program of 2009/2010. In previous periods of elevated yields, the market sharply corrected, creating a positive total return environment. Market consensus currently points to a period of elevated-for-longer interest rates, creating longer-term opportunity for investors to capture yield that may drive portfolio income for years to come.

Generally, it is critical that fixed income returns are greater than the rate of inflation, as this represents investors' real rate of return. From 2020 to early 2022, inflation outpaced most high-quality fixed income bond yields, creating negative real rates. Today, municipal yields have adjusted higher while inflation is declining, boding well for real returns moving forward.

Figure 2: Yield to worst for taxable municipal bonds



Source: Bloomberg, Taxable Municipal Index Dec 2006 – 30 September 2023. Bloomberg Municipal Index Taxable Bonds Total Return Index Value, Bloomberg US Corporate Total Return Value Unhedged USD

The essential service nature of the municipal market has historically afforded resiliency in the face of economic uncertainty. Enthusiasm around higher yields continues to build, especially as they offer more cushion against Treasury volatility.

THE TECHNICAL ENVIRONMENT REMAINS SUPPORTIVE

Supply

Total Issuance declined 13% this year versus the first three quarters of 2022. A combination of record tax receipts and large federal aid programs left municipalities flush with cash.

New money issuance is down 15%, to $274.7 billion year-to-date, due to higher borrowing costs and rate volatility. Refunding issuance was down 15% year-over-year through the end of the quarter. Net present value savings from refunding deals have decreased meaningfully with borrowing costs elevated due to Fed policy.

Taxable municipal issuance has been impacted the most, with issuance down 43% compared to 2022. Advance refunding volume, a large source of taxable municipal issuance, has fallen considerably given the interest rate environment.

Fourth quarter issuance trends are typically robust, but issuers may seek better timing to place deals with yields at their cycle peak. Nevertheless, we expect issuance to increase from summer lows but remain muted.

Demand

Demand has shown signs of strengthening as Fed rate hikes are nearing an end and investors see the value in high embedded yields to support returns over the next few years. However, headwinds in Treasury market volatility and currency markets are causing cross currents in demand from certain regions of the world.

Despite this, demand is far outpacing supply, which has supported spread tightening over the past quarter. If the Fed were to pause, we expect demand to strengthen further.

Defaults

First-time municipal bond defaults totaled $1.5 billion in par value year-to-date, trending with historical averages. While defaults increased, first-time distress levels remain muted. Defaults have been concentrated in three sectors, with 62% coming from senior living, project finance and non-profits.

While economic uncertainty remains, widespread issues are not expected in 2023 and 2024, as record balance sheets should provide ample protection 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. Taxable municipal defaults are extremely rare, as much of the default experience is in tax-exempt paper.

Credit spreads

Credit spreads narrowed during the third quarter, with option-adjusted spreads decreasing from 96 bps to 84 bps for the Bloomberg Taxable Municipal Index. The fundamental backdrop for municipal credit remains strong. Upgrades have outpaced downgrades since the end of 2020, and local government reserves are robust. Spreads have tightened because of strong fundamental credit momentum combined with supportive technical conditions due to suppressed supply.

We believe further taxable municipal tightening is justified for several reasons. Taxable municipal credit spreads remain wide relative to corporate bonds of similar quality, as AA rated taxable municipals have a 20 bps spread advantage over AA rated corporate bonds. Elevated rates from the Fed keep recession risks in place, with municipals being a relative safe haven during periods of economic softness. And record levels of cash and cash alternatives should begin rotating back into long-term assets when the Fed pauses as investors anticipate a decline in cash yields.

As the Fed nears the end of its rate hike cycle and interest rates stabilize, investors may look to balance their elevated cash positions with capturing higher long-term yields. Positive momentum in demand for taxable municipal bonds may push spreads tighter and support total returns going forward.

CREDIT REMAINS STRONG OVERALL

Credit remains strong overall, with historic levels of rainy day funds and unspent transfers from covid relief bills. And while revenue growth has declined from 2021 and 2022 highs, collections generally remain solid, outside of California.

Maui wildfires destroy a highly developed area

Multiple wildfires broke out on the Island of Maui in early August that devastated the communities of Lahaina, Kula and Olinda. The wildfires burned a relatively small yet highly developed land area that was popular with residents and tourists. The property destruction will result in a future drop in the taxable assessed valuation (AV), which is used to calculate the property tax levy. Maui County relies heavily on property tax revenue for operations and for paying debt service on its general obligation bonds.

While tourism is important to the local economy, taxes derived from discretionary sources such as hotel stays account for a small percentage of the county's operating revenue. Maui residents whose homes or businesses were destroyed by the wildfires are exempt from paying property taxes for fiscal year 2023-2024 and owners who have already paid will receive refunds. It is too early to know how significant the decline in property tax revenues will be, but the county has a strong financial position, with ample liquidity, that will help address these costs. In addition, the county's tax base is large and better able to absorb the potential AV reduction. President Biden declared the wildfires a major disaster, which makes federal funding available to the local government and affected individuals.

Much of the highly desirable Lahaina region is expected to be rebuilt. The new properties would be assessed at market value upon completion, which would likely result in higher assessed values and an eventual increase in property tax revenue. Both Maui County and the state of Hawaii have been sued for gross negligence and wrongful conduct leading to the fires. The total legal costs and claims liabilities, if any, will not be known for years.

Hawaiian Electric faces substantial financial challenges

Hawaiian Electric Company (HECO) is under extreme scrutiny for potentially causing the Maui wildfires in August. While the cause is being investigated and liabilities are being determined, HECO looks like it could be at least partially responsible for damages. HECO conceded that their downed power line ignited the initial fire, but claims firefighters extinguished that blaze. It believes a secondary fire ignited after HECO had deenergized power lines, destroying much of Lahaina.

Estimated damages range from $5 billion to $7 billion, with the potential for assigned damages to outstrip the enterprise value of HECO. Additionally, several lawsuits have been filed against HECO, including from Maui County, increasing the overall costs for HECO if it is found to be responsible.

Cost recovery for HECO to fund potential damages or lawsuits could be extremely difficult, as utility rates are already high, the total number of ratepayers is relatively small and ratepayers' income levels are generally below average. For the utility to continue to exist and provide power, HECO will likely require support beyond the $95 million pledge from the federal government for rebuilding efforts. Although HECO has indicated its goal is not to restructure, the utility is facing the possibility of substantial financial liabilities and likely constrained capital markets access, making bankruptcy a continued risk.

Governments maintain extraordinary financial flexibility

Following years of double-digit growth in revenue collections, many municipalities are preparing for budgetary deficits as federal pandemic funds expire and investment returns decline.

Through second quarter 2023, state tax revenue collections are down -10.7% at $398 billion compared to the first half of 2022. However, quarterly collections are still more than the historical average of $296 billion. State pension returns weakened in 2022, with average funded ratios declining to 77.3% from 83.9% in 2021. Investment returns are expected to be 5.3% in 2023, less than the assumed rate of return of 6.8%.

Governments maintain extraordinary financial flexibility, and fundamentals remain strong. They are prepared to balance budget deficits by reducing targeted expenditures. Average state spending increased by an elevated 16.8% in 2022, due mostly to one-time covid-related spending. States are estimating just a 2.5% increase in expenditures in FY24. Governments also have the flexibility to reduce other expenditures and increase revenues.

Municipal governments' rainy day funds, or savings/reserves, sit at historical highs. State governments are entering FY24 with $159 billion in rainy day funds, totaling more than double pre-pandemic levels, which offers significant budgetary flexibility.

As municipal credit quality remains strong, Moody's upgrades are outpacing downgrades by a 4:1 ratio. Upgrades are outpacing downgrades for the tenth consecutive quarter through second quarter 2023.

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Governments maintain extraordinary ***financial flexibility, and fundamentals remain strong.***

Hospitals slowly recover from the pandemic

Hospitals and health systems continue their slow recovery from the pandemic and particularly the post-pandemic environment. While the onset of the pandemic made 2020 a difficult year for hospitals, volumes and revenue had largely returned by late 2021. Margins recovered, and financials were looking much stronger.

However, 2022 turned out to be one of the worst for hospitals in recent memory as the combined impact of unexpected industry-wide cost spikes and the expiration of most pandemic aid programs took their toll on margins.

The cost surges were driven mostly by staffing shortages, forcing hospitals to rely heavily on extremely expensive contract labor, particularly agency nurses. This significantly increased staffing costs in the short-run and resulted in smaller increases in ongoing staffing costs, as the normal wage rates for in-house nurses increased as well. This was exacerbated by the expiration of the federal funding hospitals received during the pandemic to offset pandemic-related losses.

Operating stresses accelerated hospital mergers and acquisition activity, as hospitals and health systems sought to address these challenges through greater efficiencies and increased contracting leverage.

Overall, it is clearly taking longer than expected for hospitals to recover from pandemic-related changes to volumes, revenues and cost structures. However, many providers are finally showing material improvement. As usual, some hospitals and health systems are better positioned to adapt to the changing environment than others, and not all will recover at the same pace. And some may never fully recover.

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. 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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