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Fourth quarter 2022 outlook

Municipal bonds: Hints of recovery emerge

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The third quarter began with another false start rally, but hawkish U.S. Federal Reserve rhetoric and a disappointing inflation report stifled any sustained comeback. Overall performance was much less negative, however, indicating this historic bond selloff may be slowing. Credit fundamentals are strong and municipal bond valuations are attractive, especially for municipal-to-Treasury ratios beyond 10 years in maturity. The tax-exempt income compensation for investors willing to invest now and wait for a market shift is at the highest level in more than a decade.

KEY TAKEAWAYS

- With the bad news already priced into municipal bond prices and yields, we see hints of a recovery in demand.
- As demand strengthens, supply is falling significantly. Yields indicate that now is a better time to be an investor than a borrower.
- Municipalities are flush with cash while revenues are setting new highs, making credit quality well positioned for slow growth or a recession.

SIGNS OF MODEST COOLING IN ECONOMIC GROWTH ARE DEVELOPING

The U.S. economy has held up surprisingly well under an array of pressures: Fed policy and fiscal tightening, geopolitical risks and the global slowdown. Ironically, this has prompted the Fed to be even more hawkish in its most recent speeches and forecasts.

We see signs of modest cooling in growth, and these indicators should become more pronounced as the lagged impacts of policy are fully felt.

These factors include a decline in net new jobs, a decreasing trajectory of wage gains and surveys such as JOLTS showing a significant decline in unfilled job openings.

The Consumer Price Index dropped significantly in July, both month-over-month and year-over-year. Subsequently, markets were sorely disappointed when the price index exceeded expectations in both August and September, driven primarily by the stickiness of high rental prices. Fixed income markets remain hyper focused on inflation data, and thus sold off sharply.

Overall, growth and inflation data are declining, but more gradually than investors had hoped. M2 money supply growth is poised to enter negative territory year-over-year, the federal budget deficit has contracted by more than $3 trillion in just over a year and the U.S. dollar is up by more than 25% against a basket of other major currencies.

Policy changes and back-to-work themes work their way through the economy with uncertain lags. The Fed has been careful not to appear soft on its message of higher rates for longer, nor to shy away from the resulting market volatility.

Alongside other factors, the Fed has significantly lowered the market's inflation expectations. Perhaps relatedly, we are seeing a more robust discussion of the risks of overtightening and the importance of a pause in the 75 basis points (bps)-per-meeting trajectory.

The ultimate impact of these major policy shifts remains unknown and should be watched carefully.

VALUATIONS ARE LOOKING INCREASINGLY FAVORABLE

U.S. Treasury market yields rose across the curve, but overall the curve flattened during the quarter. The 2-year yield increased 132 bps and the 5-year yield rose 105 bps. On the long end, 10- and 30-year yields increased 82 bps and 59 bps, respectively. The municipal yield curve has actually been more positively sloped throughout this year, steepening between 10- and 30-year maturities during the third quarter.

Treasury yields declined in July, but downside volatility took hold in August and accelerated in September as markets priced in more aggressive Fed rate hikes and a longer period of tighter financial conditions. Toward the end of the quarter, volatility moved in both directions as the market responded to inflation data and foreign central bank policy. On 28 September, the 10-year Treasury yield peaked momentarily at 4.00% before declining to close the quarter at 3.83%.

Municipal-to-Treasury yield ratios also fluctuated, but remained much higher than at the beginning of the year and compared to historical averages. The 10-year ratio started the year at 67%, rose to its high of 105% on 20 May and fell to 86% to close the third quarter. The 30-year ratio, which is typically cheaper, rose from 78% to a high of 110%, then ended the quarter at 103%, compared to its long-term average of 93%.

This trend is most likely related to differing pockets of demand. Individual investors are direct purchasers of bonds 10 years and shorter, but heavy mutual fund outflows contributed to significant selling pressure on the long end. Therefore, the relative performance of municipals versus Treasuries varied based on the specific portion of the yield curve.

Although rate volatility is inevitable, we anticipate a better balance going forward. The Fed's tone has certainly been hawkish, upping its forecast for the peak in the fed funds rate to 4.6% next year. Investors can be encouraged that the futures markets and the Treasury yield curve have priced in this new guidance.

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Supply

Supply declined by -14.6% from the same period last year to $309.1 billion, primarily because refundings dropped by 51%. The market selloff appears to have stalled the ability of many issuers to refund existing issues, at least temporarily.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

Taxable municipal supply declined by 60% for the quarter compared with the third quarter of 2021. Taxable supply increased dramatically after the Tax Cuts and Jobs Act of 2017, and now regularly makes up approximately 20% of the new issue market under normal circumstances. If interest rates stabilize, we may see a catch-up period of taxable new issuance after a sluggish first half of the year.

Interestingly, tax-exempt supply was also 44% lower during September than the same period last year. This indicates the rate environment is currently much less attractive to borrowers and the scarcity value should return, which may provide technical support to the market.

Demand

After consistently positive inflows of $80 billion in 2021, outflows continue this year, despite some positive inflows during July. June outflows were -$15.8 billion, July showed inflows of $98 million, and August and September returned to outflows of -$1.6 billion and -$14.2 billion, respectively. The -$91.7 billion total year-to-date is the primary cause of cheaper valuations, such as rising municipal-to-Treasury yield ratios. Open-end mutual fund outflows (excluding exchange-traded funds) have reached an astounding -$105 billion through 30 September.

However, the open-end fund total may understate interest in the asset class overall, as municipal ETF flows are positive at $13.7 billion through September. High yield municipal funds also saw positive inflows in July, but year-to-date outflows continue. June saw outflows of -$2.5 billion, July inflows of $1.1 billion, August outflows of -$277 million and September outflows of -$3.3 billion.

Going forward, we expect mixed inflows and outflows being driven by a tug of war between attractive valuations amid solid fundamentals opposed by continued fears over inflation, interest rates and Fed policy.

Defaults

Through September 2022, first-time municipal bond defaults totaled $984.2 million, a very small percentage of the overall $4 trillion market. For the third consecutive year, defaults are mainly concentrated in nursing homes and industrial development revenue bonds, as these categories include arguably the most idiosyncratic risks. Overall, we do not anticipate municipal payment defaults becoming widespread.

Credit spreads

Credit spreads were relatively stable during the quarter, with a small increase of 4 bps from 226 bps to 230 bps over the equivalent-maturity AAA bond. The S&P Municipal High Yield Index returned -14.3% year-to-date through September, driven more by duration and higher ratios to Treasuries than credit spread movement. Lower investment grade spreads were also very stable, with BBB spreads widening slightly from 95 bps to 99 bps on average.

CREDIT SECTORS REMAIN STRONG SINCE THE PANDEMIC

Puerto Rico nears the end of debt restructuring

In mid-September, Hurricane Fiona caused major damage in Puerto Rico, highlighting the island's vulnerability to natural disasters and the slow pace of recovery from the hurricanes of 2017. Most of the island lost power and many areas saw severe flooding. Although the Commonwealth had been granted significant federal funding to rebuild after Hurricanes Irma and Maria five years ago, deployment of these funds has been slow. Estimates suggest only 30% of permanent reconstruction work had been started when Fiona hit, including much of the work to improve the electric grid.

Just as Hurricane Fiona hit, court-ordered mediation between the creditors of the electric system (known as PREPA) and the oversight

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board broke down. In response, Puerto Rico's bankruptcy judge ordered the oversight board to file a confirmable plan of adjustment to restructure the $9 billion of legacy PREPA debt by 1 December, as well as a proposed court schedule to meet a June 2023 confirmation hearing target. PREPA would exit bankruptcy by mid-2023 based on this timeline. In addition, the judge sent the parties back into mediation with a 31 December deadline.

With the exception of PREPA, nearly all of Puerto Rico's legacy debt has been restructured. General obligation bonds and COFINA sales tax bonds are actively traded and are included in municipal high yield indices. Holders of the taxable Contingent Value Instrument (CVI) will receive the first annual distribution in November.

Hurricane Fiona is not expected to impair the government's ability to make payments on newly restructured debt. The federal government continues to support allocating reconstruction funds, which will alleviate local funding pressure and be critical to support Puerto Rico's economy and tax revenues. While slow economic growth could cause further outmigration over the longer term, Puerto Rico's economy is currently fairly strong, with unemployment at a record low and solid tax collections.

State and local governments recover quickly

State and local governments recovered quickly from the pandemic, and credit quality in the tax-backed sector has remained resilient. Federal aid helped offset revenue declines and enabled states to balance their budgets, which avoided state funding cuts for schools, health care and state revenue shared with locals.

The first quarter of 2022 continued to show positive growth, with total state and local government tax revenues up 4.7% from the fourth quarter of 2021, and up 15.9% versus the first quarter of 2021. Additionally, state and local government balance sheets remain historically high.

Unlike 15 years ago, sizeable reserves now put state and local governments in a much stronger position to weather an economic downturn. Credits that historically exhibit expenditure pressures may be impacted the most by a recession, given the current inflationary environment that puts upward pressure on wages, borrowing costs and pension liabilities. Similar to the Great Recession, officials would look to raise tax rates, cut service spending and/or draw down reserves to close projected budget gaps.

Local government and school district general obligation (GO) bonds are largely secured by ad valorem property taxes, which are not expected to experience widespread decline even in a recession. If assessed values decline, property tax levy adjustments will help these governments maintain revenues. Notably, the 2009 recession produced just a 3% reduction in property tax receipts that was eventually realized in the third quarter of 2010. The 2001 recession saw no reduction.

Additionally, states are less likely to consider cuts to shared revenues given their historically stronger reserve positions. States and larger cities that tend to depend more on sales tax receipts or other economically sensitive revenue streams may be more vulnerable.

Transportation enjoys a strong recovery

Toll roads recovered relatively quickly from the pandemic. Coming into calendar year 2022, many experts forecasted that traffic levels nationwide would finally reach pre-pandemic levels. Despite rising gasoline prices during the first half of 2022, vehicle miles traveled (VMT) through the first five months of 2022 was at 99% of activity shown during the first five months of 2019. Annual traffic growth generally correlates to overall GDP, so we anticipate traffic levels and revenue generation should deteriorate somewhat during any forthcoming recessionary environment. Most seasoned toll roads have unconstrained legal capacity to raise toll rates and generally demonstrate good elasticity of demand after doing so.

The airport sector took longer than many ground transportation sectors to see passenger traffic recover from the Covid-19 lows, but most airports are now observing passenger traffic at or near pre-pandemic levels. While a recessionary environment may reduce the pace of recovery in air travel, pent-up demand should support a continued gradual recovery in passenger volumes. In typical recessionary environments, the airport sector has experienced reduced volumes and revenues. However, given the ongoing pent-up demand for air travel supporting the current recovery, we expect the airport sector should experience a level of resiliency in the near term, compared to historical recessionary environments.

The airline sector continues to recover from Covid-induced lockdowns, with capacity and revenue levels at or above pre-pandemic levels. However, high fuel prices, wages and other operational costs are negatively impacting EBITDA and margins relative to pre-pandemic levels. That said, the airline sector bolstered balance sheets with federal stimulus support. While a recession would typically lead to reduced airline volume and revenue, the pent-up demand and ongoing robust recovery from two years of significantly reduced passenger traffic continue to offset recession risk. This demand side recovery should result in a level of resiliency relative to historical recessionary environments.

Land-secured benefits from changing buyer preferences

The credit quality of the land-secured sector is generally correlated with the strength of the housing market. Since the start of the pandemic, the housing market has experienced a significant upturn, primarily due to the federal government's response and a change in buyer preferences as a result of work-from-home mandates.

The average home price in the United States increased by 41% from the fourth quarter of 2009 through the fourth quarter of 2019 (4.1% annualized rate). We believe that indirect benefits to consumers from federal fiscal stimulus and low interest rates helped spur housing demand since the beginning of the pandemic. For reference, the average home price in the United States increased by 37% from first quarter 2020 through first quarter 2022 (a 14.8% annualized rate).

While new home construction activity has experienced strong growth in recent years, it has failed to keep pace with the rapid increase in new household formations. Roughly 3.88 million new single-family homes were constructed throughout the country from 2018 through 2021, falling well short of the 7.28 million in new household formations over the same period (new construction meeting approximately 53% of demand).

Preliminary data from 2022 show improved support, with construction supporting 72% of new household formations for the year. Many developments are setting new records for construction pace to meet strong buyer demand.

Credits of more seasoned developments in strong locations should remain resilient through a recession, whereas newer developments in tertiary locations will be more at risk. Further, land-secured deals structured as limited tax bonds may be more at risk, as they depend on a certain amount of homes to be constructed at a certain price to generate a sufficient tax base to pay debt service relative to the more standard land-secured bonds that are paid from special assessments where payment is not dependent on such factors.

Health care faces spikes in operating expenses

Hospital and health system volumes have largely returned to pre-pandemic levels, with the accompanying revenues. The biggest hurdle for hospitals in the current environment are spikes in operating expenses, particularly for staffing. Staffing costs (salaries, wages and benefits) make up more than 50% of the typical hospital's cost structure. Staffing shortages had been partially addressed by the increased use of agency nurses at much greater cost than in-house staff. These higher expenses are beginning to wane, with the declining cost and use of outside agency staff.

Still, for most hospitals, operating margins for the first half of 2022 are off significantly from the prior year. Full year results will likely be well behind

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prior years as well. The combination of inflation and lingering staffing shortages may well delay full recovery from these weaker margins.

Balance sheets for most hospitals — at least those of a certain size — remain strong, with ample liquidity and manageable debt burdens. Some of this liquidity had been enhanced by favorable investment markets in past years and the receipt of significant amounts through CMS (i.e., Medicare) advances during the pandemic.

The more recent market environment has eroded some of this liquidity, as has the repayment of the CMS advances (which have mostly been repaid at this point). With strong overall liquidity heading into the pandemic, recent declines shouldn't create significant credit concerns for most hospitals.

A recessionary environment would provide headwinds, potentially slowing improvement in margins. However, strong balance sheets and robust demand for services should be more than adequate to shield most hospitals from any severe erosion in credit quality. As a sector, hospitals remain solid and well positioned to adjust to changing circumstances.

As usual, small, rural hospitals are most at risk, with weaker balance sheets and other resources, as well as less flexibility to adjust to revenue/volume disruptions and cost spikes. Those that cannot partner with larger providers are likely to struggle and face increased ratings pressure.

OUTLOOK

The municipal market may be experiencing a bottom

Over the last several years, investors pursuing a balanced portfolio approach have been frustrated by low fixed income yields. However, over the first three quarters of 2022, municipal interest rates have increased to their highest levels since 2009. And, we are seeing the highest sustained yields since 2002.

Traditional drivers of municipal performance show encouraging signs: taxes are not likely to increase, credit quality is strong and new issue supply is falling sharply. As a result, taxable-equivalent yields appear secure and relatively attractive. Yield has historically been the best forecaster of long-term municipal bond returns, and this signal seems opportunistic.

The biggest impediment to improved performance has been persistent inflation. Amid the short-term noise, the Fed has completed 300 bps of tightening and markets have priced in another 150 bps. We should soon see more cooling of economic and inflation data, with the money supply plunging, the dollar skyrocketing and mortgage rates more than doubling.

The extensive economic and market support measures implemented during the pandemic will take time to unwind. We've made much more progress than most investors recognize.

While it is always difficult to time the precise peak of interest rates, we are seeing more back-and-forth to municipal bond demand and performance. Municipal bond total returns remained negative in the third quarter, but they were significantly better than in either of the first two quarters. And the market experienced some significant periods of bounce back within the quarter.

We think all of these factors indicate that the municipal market may be experiencing a bottoming effect.

2022 THEMES

Economic environment

- Inflation remains hard to predict and has likely peaked, but may still be above the Fed's target.
- Further uncertainty has been posed by geopolitical events.
- Fed funds rate has risen by 300 bps in 2022, with more rate hikes expected.
- Fed's policy shift is fully discounted by markets.
- U.S. growth is softening due to higher interest rates and fiscal tightening.
- Rates remain volatile, and the path of rates depends on inflation.

Municipal market environment

- Long-term municipal valuations are attractive compared to similar U.S. Treasuries.
- Credit remains strong, with historic levels of revenue collections and rainy day funds.
- Attractive spreads plus sound credit conditions offer an appealing entry point for high yield municipals.
- Defaults remain rare and idiosyncratic.
- Supply is lower than last year due to less taxable municipal issuance from refunding.
- Continued fund outflows continue to pressure municipal performance.

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: Morningstar. 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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