

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

When rates are steady, munis will be ready

Bottom line up top

What to expect when you're expecting rate cuts. As any first-time parent can attest, the reality of caring for a new baby may be a far cry from what you expected, no matter how confident you felt in your assumptions nine months earlier. Today's equity markets seem to be exhibiting similar bravado in anticipation of another "blessed event" — the delivery of U.S. Federal Reserve rate cuts by the end of 2023. Although we believe the Fed will hike once more in May before pausing, expectant investors may be overly confident about the timing of an actual pivot. Their certitude shows in stock prices that look frothy in the face of higher-for-longer interest rates and increased odds of a (mild) recession.

Munis may outperform before rate cuts become the norm.

Unlike equity markets, which are pinning hopes of a bull run on lower interest rates, municipal bond markets are poised to hit their stride once rates stabilize. In a majority of prior rate hike cycles, municipals outperformed significantly in the six months following a pause in Fed rate increases relative to the six months leading up to the pause (Figure 1). While there are no guarantees similar results will be repeated, fundamentals appear healthy and vibrant, with municipalities collecting revenues and building reserves to levels not seen in more than 40 years. What's more, with credit spreads currently exceeding long-term historical averages, high yield municipal bonds may be well positioned to deliver compelling total returns over the rest of 2023. In contrast, equities could face



Saira Malik, CFA
Chief Investment Officer

On behalf of Nuveen's Global Investment Committee

As Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's Equities Investment Council and is a portfolio manager for several key investment strategies.

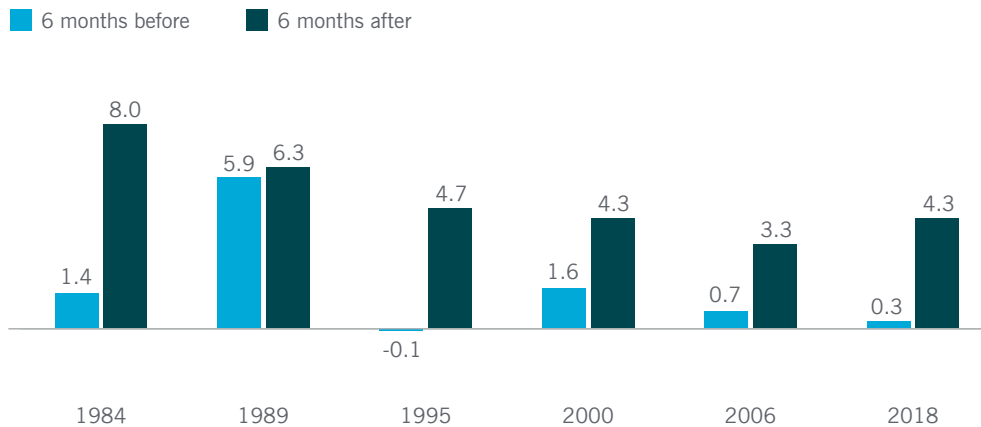
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further downside risk for the rest of the year — especially heading into a recession — if the Fed keeps interest rates steady but elevated and decides to start cutting later rather than sooner.

FIGURE 1: MUNICIPAL BOND RETURNS HAVE TYPICALLY IMPROVED AFTER THE FED STOPPED HIKING

Bloomberg Municipal Bond Index total returns before and after Fed pauses (%)



Data source: Bloomberg, L.P., 31 Dec 2022. Performance data shown represents past performance and does not predict or guarantee future results. Fed pause dates: 31 Aug 1984, 28 Feb 1989, 28 Feb 1995, 28 Apr 2000, 30 Jun 2006 and 31 Dec 2018. Index returns include reinvestment of income and do not reflect investment advisory and/or other fees that would reduce performance in an actual client account.

High yield municipal bonds may be well positioned to deliver compelling total returns over the rest of 2023.

Portfolio considerations

Across the municipal bond landscape, we prefer pairing credit risk with duration risk. Municipal credit has strengthened, and a steeper curve relative to Treasuries favors longer-duration, high yield exposure. For example, the short-to-intermediate part of the curve shows municipal-to-Treasury ratios between 60% – 65%, while longer-end ratios are around 90% (Figure 2). The asset class also offers a taxable-equivalent yield north of 9% — surpassing yields on almost all credit sectors in the taxable fixed income space.

High yield municipal credit spreads were quite resilient last quarter, rising just 12 basis points (bps) despite turmoil in the banking sector that roiled most credit markets in March. Although we expect a mild recession near the end of the year, we believe municipal credit spreads will again demonstrate resilience. Given strong underlying fundamentals and the telegraphed nature of the Fed’s policy actions, spreads should hold relatively well even if economic conditions worsen.

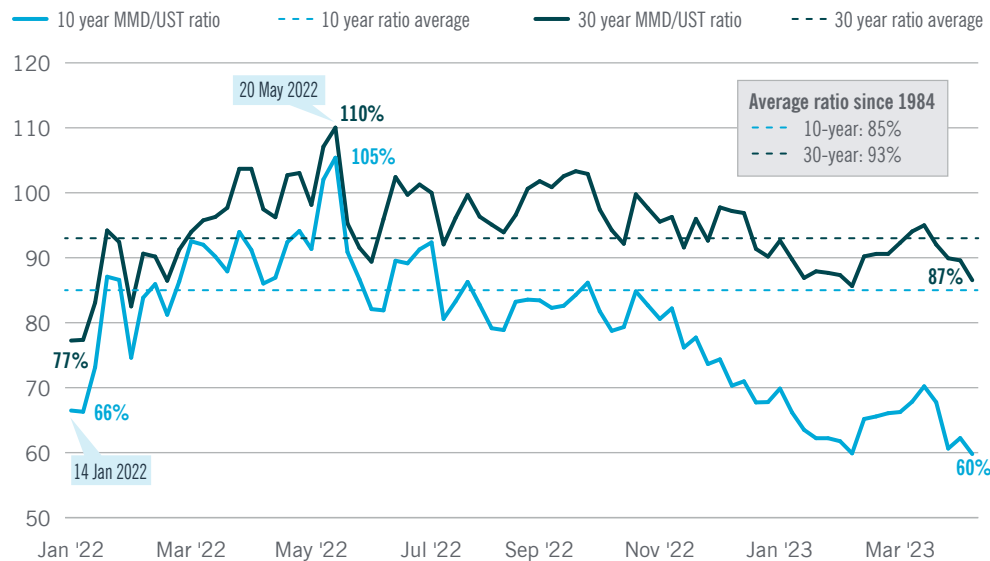
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On the technical side, municipal issuance has remained muted, falling 29% year-over-year in the first quarter. Issuance should pick up slightly as the year progresses, with interest rates stabilizing once the Fed pauses its hiking cycle. That said, issuance will likely stay somewhat muted compared to levels over the past five years. Additionally, the combined effects of record-high tax receipts and several large federal aid programs have left municipalities flush with cash.

We believe municipal credit spreads will again demonstrate resilience.

FIGURE 2: THE MUNI YIELD CURVE FAVORS LONG-END EXPOSURE

Municipal-to-Treasury ratio: AAA municipal bonds value relative to Treasuries



Data source: Bloomberg L.P., 15 Apr 2023. Performance data shown represents past performance and does not predict or guarantee future results. Fair value Municipal 10- and 30-Year Index AAA General Obligation bonds, 10- and 30-year U.S. Treasury yields. Represents the relative value of municipal yields to Treasury yields.

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Regular meetings of the GIC lead to published outlooks that offer:

- macro and asset class views that gain consensus among our investors
- insights from thematic “deep dive” discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

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Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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