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Fourth quarter 2020

Municipal market approaches full recovery

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Municipal bond market performance continued to recover at an accelerated pace throughout the fourth quarter. Returns for 2020 reached the mid-single digits, representing a full or nearly full price recovery for most areas. We see this trend as positive for municipals heading into 2021.

By the fourth quarter, municipals were significantly outperforming U.S. Treasuries.

KEY TAKEAWAYS

- 2020 municipal returns showed significant volatility throughout the year, but ended solidly positive.
- Performance was boosted by improving sentiment, stable credit conditions and stronger technicals.
- We believe the municipal market is well positioned to start 2021.

MUNICIPAL PERFORMANCE IS DUE TO FACTORS OTHER THAN INTEREST RATES

In the first half of the year, Treasury bonds rallied sharply in a flight to safety as the coronavirus pandemic unfolded, while most municipal bonds declined in value. These trends reversed by the fourth quarter, when the 10-year Treasury yield rose 24 basis points (bps) to 0.84% and the municipal benchmark AAA MMD yield fell 16 bps to 0.71%. This shift represented significant municipal outperformance versus Treasuries and a return to more normalized ratios to taxable bonds.

Financial markets are becoming more optimistic, as investors look to a potential post-pandemic economic boom boosted by successful vaccines, Federal Reserve (Fed) policies and additional federal stimulus. As a result, municipals have been trading as a credit driven asset class rather than being tethered to U.S. government bond interest rates.

Despite challenges, overall municipal credit conditions have held up far better than most forecasts predicted. After 11 consecutive years of robust growth, municipal government tax receipts declined only about 1% on average in 2020. Meanwhile, property tax collections increased sharply due to the strong housing market. Defaults have been lower than expected overall, with a moderate uptick in specific sectors that struggled prior to the pandemic.

Municipal markets absorbed a record supply of new issues in October.

Certain challenges could still arise, but we believe good news is on the horizon. While the most recent stimulus package does not contain direct subsidies for state and local government finances, funding for individuals, mass transit systems, airports, education and health care may indirectly benefit municipal bonds. Another major stimulus package may come as soon as February, and Democratic control of the Senate could mean at least $200 billion of municipal government relief. High yield municipals are already reacting to this possibility with narrowing credit spreads.

Looking at technicals, municipal markets absorbed a record supply of new issues in October as issuers brought deals ahead of the November elections to reduce uncertainty. This dynamic created a post-election relief rally, with supply dropping while inflows continued.

From a valuation perspective, many metrics are returning to where they started 2020, particularly for high quality. High yield valuations have not yet fully recovered, but are trending favorably. We expect high yield should continue its recent outperformance during the first half of 2021.

CENTRAL BANKS CONTINUE ACCOMMODATIVE POLICIES

Major central banks around the world cut interest rates and dramatically increased liquidity into the financial system to combat the financial impacts of the coronavirus pandemic. At its December 2020 meeting, the Fed stated it would not adjust its bond buying program of $120 billion per month until it sees “substantial further progress.” However, it did adjust its primary rationale for these purchases from fostering functioning financial conditions to promoting accommodative monetary policy. This subtle change likely indicates that quantitative easing (QE) will continue well beyond the end of the pandemic, at least until the U.S. is on track to achieving full employment or inflation seems primed to accelerate beyond 2%.

Debate continues over the likelihood of higher inflation in 2021. In the short run, the pandemic has depressed the core inflation rate to around 1.2%, below the Fed’s 2% target. In addition, the labor market contains substantial slack, productivity will likely increase as we emerge from the pandemic and the deflationary forces of technology and demographics are more powerful than ever. However, the deficit is expanding at the same time pent-up demand could be unleashed as consumers return to their normal lifestyles with stimulus funds to spend.

For now, inflation has room to overshoot to the upside to help the Fed achieve its long-term average target of 2%. The Fed does not expect inflation to average 2% until 2023, which is consistent with 12 of the 17 committee members expecting rates to be on hold at least until 2024.

The Fed's aggressive and rapid response appears to have boosted all credit markets. The benefits to the municipal market have been less direct, but municipals have certainly been helped by the healing in other fixed income markets.

Other central banks globally have been cutting rates and expanding bond purchase programs. They have added an incredible $14 trillion in monetary stimulus to the financial system, which has restored liquidity to fixed income markets around the world.

MUNICIPAL MARKET ENDS 2020 ON A HIGH NOTE

While the Bloomberg Barclays Municipal Bond Index returned -0.30% in October, it rebounded to return 1.82% for the fourth quarter and 5.21% for the year.

The yield curve flattened during the fourth quarter after steepening in the third quarter. Despite this flattening, the municipal AAA yield curve ended the year steeper than one year ago. The flattening of the curve and the general decline in interest rates during the fourth quarter gave bonds with longer maturities an advantage over those with shorter maturities.

Municipal-to-U.S. Treasury yield ratios declined dramatically during the quarter. The 10-year ratio dropped from 126% to 76% and the 30-year moved from 110% to 84%. Historically, the 10- and 30-year ratios are 85% and 93%, respectively.

For the year, municipal-to-Treasury ratios declined from record highs in March and April to end 2020 almost exactly where they began. These ratios remain somewhat rich relative to historical norms, and they may fall even further. With Democrats controlling the Senate, the Biden administration may likely push for at least the return of the 39.6% top tax bracket for individuals and increases to the corporate tax rate and the tax on dividends and capital gains. Under these scenarios, municipal bonds could remain very attractive to individuals and even corporations at today's lower ratios.

The return of the 39.6% tax rate will likely be coupled with the reinstatement of the ability to deduct state and local taxes (SALT), currently capped at just $10,000. This could benefit higher-tax states. Approximately 60% of municipal bonds come from four high-tax states: California, New York, New Jersey and Illinois. Therefore, these states' bond performance can significantly impact the broader municipal market.

> *Fund flows were very constructive for the year, despite record outflows in March.*

Supply

Total issuance was up 12% year-over-year as of mid-December, for a record high $465 billion. Growth has been driven by a 31% increase in refundings, while new money issuance was flat year-over-year. Taxable municipal bond issuance grew 104% to $142 billion as of mid-December, which is six times the historical average. The correlation continues between increased taxable municipal bond issuance and the growth of refunding issues, as today's tax laws dictate that pre-refunding can only be done on a taxable basis. While this restriction could also change under the Biden administration, it is currently depressing tax-exempt supply, which was down -4% in a year of record issuance.

Demand

Municipal bond fund flows were very constructive for the year as a whole, despite record outflows of -$43 billion in March. In retrospect, the environment in the spring of 2020 represented an historic opportunity. Municipal fund flows reversed in May and remained positive through the end of the year. Flows for October and November were $5 billion and $6 billion, respectively.

High yield municipal fund flows were slower to recover, turning positive in June. Flows for October and November were $260 million and $1.4 billion respectively.

Credit spreads

Despite the acceleration in coronavirus cases, optimistic investors were willing to assume more credit risk in order to enhance tax-exempt yields. Investment grade spreads narrowed during the fourth quarter, with BBB-AAA spreads moving from 143 to 108 bps. This level remains wider than when the year began, but is approaching more normal levels.

High yield credit spreads also remain wider than the long-term historical average, representing opportunity for enhanced income plus the potential for total return as spreads continue to grind tighter. At the end of the third quarter, high yield municipal credit spreads were 313 bps on average above the AAA scale. They narrowed at an accelerating rate to 265 bps by year end.

Defaults

Payment defaults totaled roughly $1.9 billion for the year through November. This represents a very small percentage of the overall market, and a relatively modest uptick from $1.3 billion in 2019. Nursing homes and industrial development revenue bonds represented 70% of all municipal defaults.

Defaults in 2020 were generally caused by idiosyncratic risks among smaller, stand-alone projects without government backstops – typical for the municipal market. While the pandemic may have pushed certain weaker and more economically sensitive projects into default, the crisis does not appear to be affecting larger issuers in the major sectors. Given the Fed's liquidity, federal fiscal stimulus programs and effective vaccines, we do not anticipate municipal payment defaults to become larger or more widespread. Reserve fund draws, tighter budgets, rate covenant violations and potentially more downgrades are much more common and more likely going forward.

MUNICIPAL CREDIT HAS BEEN RESILIENT

Brightline continues its expansion

Brightline, Florida's passenger rail, received two boosts during the fourth quarter. In November, Brightline and Walt Disney World publicly announced that they had entered into a formal agreement to construct a new train station at Disney Springs. Upon opening in 2023, this station will directly connect the most visited theme park in the world with the 20 million domestic and international visitors arriving into South Florida each year. Shortly after that favorable announcement, Brightline successfully issued $950 million of new bonds during December, constituting the final piece of long-term financing necessary to complete construction to Orlando International Airport scheduled to open in 2022. The new bonds were sold to more than 30 different investors and immediately traded up a few points in the secondary market.

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Since the beginning of the coronavirus pandemic, Brightline has invested significant time and focus on three new inline train stations currently under construction in SE Florida: Aventura, Boca Raton and PortMiami. These stations are scheduled to open over the next 12 months and significantly benefit future operations, given the incremental ridership each is expected to generate. While it is uncertain how quickly mass transit will recover post pandemic, prefunded interest along with available ramp-up liquidity reserves fully cover interest due on the bonds a full 12 months after the extension to Orlando International Airport is completed, and well beyond when most of the worldwide population is expected to be vaccinated. Longer term, we continue to believe Florida's population growth, along with its massive tourism and hospitality industries, provide Brightline with attractive potential to succeed.

Puerto Rico

Puerto Rico achieved a few important milestones in the fourth quarter of 2020, and a new political administration brings potential for further progress in 2021. Mediation with creditor groups resumed last fall based on a revised debt adjustment plan from the board. In December, the Puerto Rico Aqueduct and Sewer Authority successfully refunded approximately $1.4 billion in outstanding callable revenue bond debt, lowering the utility's debt service costs by an estimated $350 million. Although the offering was limited to qualified institutional buyers and was non-rated, the strong demand demonstrated the potential for market access for future Puerto Rico transactions post-bankruptcy.

> *New leadership and court deadlines may create a path for Puerto Rico to exit bankruptcy in 2021.*

Puerto Rico's new governor, Pedro Pierluisi took office on January 2 and immediately enacted a series of executive orders addressing COVID-19 management, public corruption and the Commonwealth's finances. One order declared a fiscal emergency, enacting new spending controls and cuts to the number of political appointees. In his inauguration address, Pierluisi stated he's committed to the concluding bankruptcy process and accelerating Puerto Rico's reconstruction and recovery fueled by federal funding that has already been approved, but has not yet been deployed.

These goals will likely be influenced by the changing composition of Puerto Rico's Oversight and Management Board. Four new members were appointed before year-end, only one of which was a holdover from the last board. Several slots in the seven-member slate remain in flux, but the make-up of the board has changed significantly. Board members have expressed new urgency to reach the consensual the creditor agreements still needed to exit bankruptcy, and creditor negotiations are ongoing.

The board plans to submit a term sheet and the "contours" of a revised plan of adjustment for the Commonwealth general obligation and related debt to the bankruptcy court by February 10. The board's latest offer increases the cash concession, but jettisons previously proposed sales tax bonds in favor of a Contingent Value Instrument (CVI) that allows holders to share in a portion of the outperformance of future sales tax collections. Legislative approval will be necessary before the Title III court can approve a settlement and Puerto Rico's divided legislature means the governor will have to work to build political support for any deals reached.

The board has also said that Puerto Rico Electric Power Authority (PREPA) is expected to exit bankruptcy in 2021. The oversight board has indicated that it is working with creditors to implement its 2019 restructuring support agreement, despite not having the support of the Puerto Rican legislature. This plan contemplates the exchange of existing bonds for new bonds backed by a surcharge on PREPA bills. Over the past year, Puerto Rico has made progress in transforming PREPA, including bringing on LUMA Energy to operate the system, and soliciting interest from outside parties to operate PREPA generation. In addition, the Biden administration is expected to speed up access to federal disaster funding, over $10 billion of which is slated for PREPA.

New leadership and court deadlines may create a path for Puerto Rico to exit bankruptcy in 2021. The Commonwealth first declared its debt unpayable in 2015 and filed for Title III/bankruptcy protection in 2017. Since then, unanticipated natural disasters and political disruptions have prolonged the process far longer than initially anticipated. Favorably, 2021 may finally provide enough runway to conclude debt restructuring and allow Puerto Rico to move forward.

Tobacco sector outperformed in 2020

The tobacco sector performed best in the Standard & Poor's Municipal Bond Index in 2020, returning 15.6% versus the 4.95% for the Index as a whole. The sector benefited from its generally long duration, and credit factors concerning tobacco settlement bonds were mostly positive. Declines in cigarette consumption moderated, narrowing from a decline of 4.98% in 2019 to a projected 1.5% decline for 2020. This improvement is attributed to a number of factors, including a return to combustible cigarettes following some high profile negative incidents involving vaping, home confinement due to the pandemic (less smoking restrictions) and low gas prices (a large portion of cigarettes are purchased at gas station convenience stores). The level of cigarette consumption is one of the key determinants of the revenue stream supporting tobacco settlement bonds.

The land-secured sector appears well positioned in the near term.

Several tobacco issues were refunded/restructured in 2020, including Ohio's troubled Buckeye program. These new, restructured issues were generally better credits with less leverage and higher decline tolerances. Also, portions of some of these new deals came as taxable bonds, removing supply from the tax-exempt market.

Looking forward, a possible cloud on the horizon for 2021 is potential cigarette tax hikes as local governments contend with pandemic-related revenue shortfalls. Increases in cigarette taxes usually lead to decreases in cigarette consumption.

Land-secured sector appears well positioned

The onset of the coronavirus pandemic initially caused concerns about the outlook for the housing market, which is meaningfully correlated with the credit quality of the land-secured sector. However, the resilience and strength of the housing market quickly became apparent, and recent data continues to show market strength. Home prices in the 20-city S&P CoreLogic Case-Shiller Index rose 7.95% year-over-year in October, the largest such increase since 2014, and new home construction reached a nine-month high in November. As the housing market proved its strength, land-secured sector issuance returned robustly, providing a healthy source of supply to the high yield municipal market in the second half of the year.

As the year ends, the sector appears well positioned in the near term, as housing market fundamentals are sound. Recent housing demand has been driven primarily by supply shortfalls unable to keep pace with population growth and demographic changes. This is in sharp contrast to housing demand prior to the Great Recession, which was largely driven by excess credit. In addition, persistently low mortgage interest rates and a demand for larger homes should provide for supportive conditions to the housing market and to this sector. We expect a continued steady level of new issue supply in this sector in 2021.

OUTLOOK

The municipal market has positive momentum for 2021

Entering 2021, high grade bond valuations have returned to pre-pandemic levels and high yield is trending in a favorable direction. We believe this leaves room for spreads to contract in the first half of the year.

Municipal performance over the past year was driven less by interest rates and more by credit quality and technicals, with a fair bit of politics mixed in. This trend should continue in 2021.

Fundamental strength will depend on how long the economy takes to recover from the pandemic. In the meantime, global central banks will continue to be highly accommodative and another federal stimulus program, including state and local fiscal relief, should come in February.

We expect strong economic growth in the second half of 2021 as more people return to normal life and begin spending again. A U.S. infrastructure initiative could also help municipal economies recover from the pandemic. Such a proposal appears to have bipartisan interest after years of being perpetually delayed.

Municipal defaults should remain steady in 2021, as the major issuers are likely to be the focus of federal support as needed.

Technically, gross supply should remain high. Growth should come mainly from refunding and taxable issuance, rather than tax-exempt supply. Net new issue supply could be slightly negative, as tax-exempt bonds are called away and replaced with taxables. We expect strong demand to continue or accelerate, especially for tax-exempt municipals as the chances improve for Congress to pass more elements of the proposed Biden tax plan.

What about headwinds? Record amounts of deficit spending mean a risk of higher inflation in the second half of 2021, and interest rates may rise in anticipation. The growing role of technology, aging demographics and the slack in the economy may mitigate this inflation scare, but rising interest rates could challenge municipal performance.

We still believe the most likely scenarios for 2021 favor municipal bond performance, and we are specifically looking at the attributes of municipal bonds that are more resistant to interest rate volatility and create performance cushion from rate moves. Even with some prospects of moderately higher interest rates, credit spreads should narrow, which benefits total returns, particularly for high yield municipals.

2021 THEMES

- 2021 will be a transition year. The path to normalization will be long but ultimately successful.
- The Federal Reserve and U.S. Treasury will support the markets, benefiting municipals.
- Monetary stimulus and low rates should boost economic activity as conditions stabilize. Inflation will remain low as labor productivity increases.
- Treasury yields will increase moderately, but the effect on municipals will be cushioned by yield spreads and the scarcity of tax-exempt bonds.
- The importance of the underlying municipal projects typically stabilizes the credit.
- Downgrades and defaults will be lower than expected, and clarity on credit health will lift investor confidence.
- As we look to the future, the market will focus on the potential for rising tax rates, which should boost demand for municipals.

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. **ICI Fund Flows:** http://www.ici.org/research/stats. **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:** Bureau of Labor Statistics, National Association of State Budget Officers. Chicago: City of Chicago 2021 Budget Forecast.

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