

Third quarter 2023 outlook

Municipal bonds: Technical tailwinds persist and credit remains strong



Daniel J. Close, CFA
Head of Nuveen Municipals

The municipal bond market eked out a positive quarterly return owing to strong performance in June. With the U.S. debt ceiling drama and a large FDIC liquidation behind us, investors can focus on a market offering attractive income, supportive technicals and resilient credit. We believe portfolios should be rewarded by assuming a modestly longer duration profile while adding credit risk.



Positive technicals are expected to linger through the summer doldrums.

KEY TAKEAWAYS

- Municipal bonds ended the quarter essentially unchanged, with income offsetting a negative market return.
- Uncertainty regarding the U.S. debt ceiling, coupled with a nearly \$7 billion FDIC liquidation list, dominated market discussions.
- Positive technical factors should continue. First half issuance was 15% lower than the same period last year, and we expect net negative supply for the balance of the summer.

MUNICIPAL MARKET IS SUPPORTED BY STRONG TECHNICALS

We expect munis to remain well bid for the near future for several reasons:

Net negative supply is expected throughout the summer months, with \$124 billion of calls, maturities and coupon payments versus an estimated \$90 billion in supply. These positive technicals are expected to linger through the summer doldrums.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE

The FDIC liquidation concluded in late June, with the market absorbing nearly \$7 billion of securities the FDIC acquired from failed Silicon Valley Bank. Initial concerns regarding the impact proved to be short lived, as the additional supply was warmly received by the market.

Absolute yield levels remain elevated and have risen 85 basis points (bps) since the beginning of 2023. Absent a meaningful catalyst, we believe municipal bonds can still post attractive returns based on elevated income generation from adjusted rates.

Positive flows supported high yield and longer-duration funds. Investors continued to add duration to their municipal portfolios year-to-date through May, with intermediate and long portfolios experiencing inflows while short portfolios experienced outflows. High yield has also benefited from positive flows year-to-date.

TREASURY YIELDS SHOWED VOLATILITY WITHIN A RANGE

The 10-year U.S. Treasury yield began the second quarter at 3.46%, remaining fairly range bound until rates broke upward in May due to uncertainty regarding the U.S. debt ceiling. We saw a relief rally when the U.S. debt ceiling deal was struck at the end of the month, before rates crept upward due to uncertainty surrounding Fed policy and inflation.

Supply should pick up once rates show signs of stability, as issuers are reluctant to issue in an uncertain rate environment. Rangebound U.S. Treasury yields provide for a more predictable primary issuance calendar.

THE FED CONTINUES WATCHING INFLATION

The U.S. Federal Reserve has hiked interest rates 500 bps in the current cycle, and we anticipate it is nearing the end of its inflation fighting campaign. The goods portion of inflation has returned to pre-pandemic levels, while core services inflation (excluding medical and shelter) has remained persistent. While policy going forward will depend

on employment and inflation data, we believe the Fed will continue to keep short rates elevated for the balance of 2023.

THE TECHNICAL ENVIRONMENT REMAINS SUPPORTIVE

The U.S. Treasury yield curve remains inverted, with rates elevated at the front end. The municipal yield curve has experienced some inversion on the front end but has maintained its traditional upward slope from the intermediate part of the curve and out. Broadly speaking, both Treasury and municipal yields moved higher, with the front ends of each curve experiencing the steepest increases. As a result, longer-maturity bonds generally outperformed during the quarter.

Demand from individual investors strengthened to start the year — both directly and through separately managed accounts — keeping municipal-to-Treasury yield ratios near historical lows. The 10-year ratio varied during the quarter as Treasury volatility did not directly correlate to municipals. It widened during the quarter from 65% to 67%, which is still relatively rich compared to the long-term historical average of 85%. Conversely, the 30-year ratio was more stable and ended the quarter in line with historical averages at 90%, roughly the same level where it started the year.

Supply

Issuance has remained muted, down 15% versus the first half of 2023. A combination of record tax receipts and several large federal aid programs left municipalities flush with cash and not needing access to the municipal bond market. As noted above, rate volatility and market uncertainty continue to give issuers pause as they assess the new issue market. Further, we have entered the summer months where the municipal market sees historically large amounts of reinvestment from outsized bonds maturing and coupon payments, resulting in net negative supply.

With borrowing costs elevated due to Fed policy, net present value savings from refundings have decreased meaningfully. This has resulted in

reduced refunding issuance, down 14% year-over-year through the end of the quarter.

New money issuance remains depressed, down 20%, as higher borrowing costs and rate volatility leave some issuers remaining on the sidelines. Issuance sits at \$178.1 billion year-to-date.

Demand

After seeing all-time record outflows in 2022, 2023 has been more positive with net inflows of \$555 million through May 2023. The second quarter experienced net outflows during April and May, but preliminary flow numbers show a positive trend for June, with inflows of \$713 million.

Looking forward, we anticipate net inflows to grow as concern over inflation and Fed policy begins to dissipate and investors view municipal bonds as an asset class to provide income with strong fundamentals.

Defaults

First-time municipal bond defaults totaled \$993 million in par value year-to-date, up 44% year-over-year, representing a small percentage of the overall \$4.2 trillion market. While defaults increased, first time distress levels were down 40% from June 2022.

Defaults were exclusively concentrated in three sectors: hospitals comprised 31%, not-for-profits at 30% and nursing homes/senior living at 33%. While defaults were elevated in the first half of the year, widespread issues are not expected to occur in 2023, as record balance sheets should provide ample protection for most issuers. We expect municipal defaults will remain low, rare and idiosyncratic, reflecting the resiliency of the asset class, even in economic downturns.

Credit spreads

High yield credit spreads remained stable during the second quarter, tightening from 258 bps to 246 bps over equivalent-maturity AAA bonds. This is precisely where credit spreads began the year. Despite unchanged spreads, the Bloomberg High Yield Municipal Bond Index returned 1.65% for the quarter and 4.43% year-to-date,

as duration benefited performance. Lower investment grade spreads were also stable, with BBB spreads remaining at 99 bps to equivalent-maturity AAA bonds.

In the wake of significant revenue collection and strong balance sheets, many large issuers within the high yield municipal market have adjusted key indentures to provide additional protection to municipal investors. This includes Puerto Rico general obligation and COFINA bonds adjusting their outstanding debt to better align with revenues during economic downturns. Tobacco issuers have also adjusted their decline tolerance ratios to help position for slower sales. This type of flexibility by high yield municipal issuers should allow investors to weather uncertain economic conditions.

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.

American Dream continues adding new tenants

Regarding the grant revenue bonds, the project cost statement is still going through its approval process, which is expected to finally occur in the third quarter of 2023 after a nearly three-year delay. Once approved, revenues pledged to the debt (essentially sales taxes collected on gross sales at the project) can be appropriated and deposited annually into the trust estate. Current gross sales activity is not expected to generate sufficient revenues to fully support annual debt service. However, continued progress in opening new tenants is expected to produce increased cash flows in future years.

As of 31 Mar 2023, the project reported 84% of the mall under executed lease, plus 5% out for signing. The advancement of lease-up is positive, with tenant openings occurring on a delayed schedule as buildouts are completed by individual tenants. Current and announced tenants include strong retail brands and attractive boutiques, which is

favorable in making the project a major shopping/tourism destination. Given the 3.45 million square feet of leasable area, continued build-out of tenants remains critical to supporting project debt.



*Chicago Board of Education's **credit quality** stabilized in recent years with the help of new state and federal aid.*

The PILOT bonds receive a lot of headlines regarding the assessment challenges and court proceedings, which are expected to be ruled on/settled through the natural course of the courts. Developments involving subordinate lenders suing for breach of contract (and filing for judgement/repayment) and the owner's failure to pay PILOTs on parcels adjacent to the mall (parcels have building rights for a hotel, minor league baseball stadium and offices) are not expected to prime PILOT bond holders or impair receipt of payments pledged to PILOT bonds.

Longer term, the credit risk for the PILOT bonds relies primarily on two inputs: (1) annual assessed value of the mall parcels and (2) the applicable tax rate. The tax rate has declined in recent years, which has contributed to the bonds relying on draws from reserves to pay debt service. For reference, the most recent reported billing results in second quarter tax bill estimates show 93% of revenues needed to pay debt service came from the PILOT bonds. The bonds will require increases in one or both of the two inputs to generate PILOT payments sufficient to fully support the bonds.

Chicago Board of Education faces future funding challenges

Chicago Board of Education's (CBOE) credit quality stabilized in recent years with the help of new state and federal aid. School funding reform enacted in 2017 increased state funding and approved a dedicated property tax levy specifically to support pension obligations. At the time, changes in state law netted the district nearly \$1 billion in new, annual revenues.

However, growing salary costs, underfunded pensions and reduced subsidies from the City of Chicago continue to present funding challenges. Prior to the pandemic, rising salary costs stemming from the district's 2019 teachers' contract threatened to significantly pressure the budget. Instead, the district received \$2.8 billion in pandemic-related federal aid, pushing budget stress off for a few years.

The fiscal gap is still a few years away. The district's recently adopted FY24 budget is balanced, but highlights future structural budget challenges. The \$9.4 billion spending plan increases the district's property tax levy by the max allowed under state imposed caps and relies on \$670 million of federal pandemic-relief aid. All pandemic-related federal aid will be spent by the end of FY25, leaving a funding gap in future years. The budget gap projected for FY26 is estimated between \$600 and \$700 million, or about 8% of the FY24 budget.

The district has limited options for raising revenue locally and is likely to seek additional state support. State aid currently falls about \$1.4 billion short of the Illinois' own evidenced-based funding standard, making the state a likely target. A long-term plan to address the projected shortfall is not yet in place, though this is understandable given governance changes.

Nearly the entire school board was recently replaced with new mayoral appointees, and additional changes are imminent. Pursuant to 2021 legislation, the board will transition from 7 members appointed by the mayor to an all-elected, 21-member board by 2027. Next year will be the first with a partially elected school board. One of the new administration's first tasks will be formulating a plan to address the budget gap.

Court ruling issued for PREPA

Most of Puerto Rico's debt obligations have been restructured in recent years. However the Puerto Rico Electric Power Authority (PREPA), the primary provider of electricity, remains in bankruptcy. PREPA has failed to make debt service payments since it declared bankruptcy in 2017.

PREPA entered into a series of agreements with bondholders, most recently with the 2019 Restructuring Support Agreement. In March 2022, the Commonwealth of Puerto Rico repudiated the 2019 RSA. Bondholders immediately requested mediation. Protracted mediations and restructuring negotiations extended throughout 2022 but ended in December when the PR Oversight Board filed a bankruptcy Plan of Adjustment and began litigation challenging the security backing the bonds.

In March 2023, the Title III court ruled that bondholders had a security interest only in a few accounts held at the Trustee rather than a security interest in the ongoing revenue of the utility, as bondholders believed. Judge Swain ruled that bondholders did have an unsecured claim over and above the amount in the accounts, but surprisingly said that that claim had to be estimated based on the value of the net revenue that would be available under a receiver.

And then on 26 June, the U.S. District Court issued a decision valuing the bondholders' claim at \$2.388 billion, approximately 28% of the amount of bondholders' prepetition claim of \$8.5 billion. The claim value was well short of consensus repayment estimates, which caused bond prices to fall significantly. In addition, the Puerto Rico oversight board filed a new 2023 PREPA fiscal plan that concurrently stated the utility could only afford to give creditors \$2.4 billion in newly restructured bonds.

Bondholders will likely appeal these rulings unless they are able to reach a consensual agreement to restructure the debt. The bankruptcy confirmation hearing is expected to occur in November or December.



*Bondholders will likely appeal the PREPA rulings unless they are able to **reach a consensual agreement** to restructure the debt.*

OUTLOOK

We see a few main factors driving third quarter performance. First, municipals should continue to be buoyed by strong coupon and reinvestment dollars and slower issuance. While issuance is likely to increase compared to the first half, we do not anticipate it will outpace these reinvestment dollars. Higher borrowing costs and record reserves should keep borrowing needs muted.

Second, inflation appears to be normalizing and should provide more stability for investors. As clarity emerges regarding the end of Fed rate hikes, investors look toward the municipal yield curve's positive slope to add portfolio duration while providing additional income.

Further, credit fundamentals remain strong due to historic revenue collections in the wake of the pandemic. While municipal revenue collection has peaked from

post-Covid highs, strong reserves make municipal bonds well positioned to weather an economic slowdown driven by higher interest rates. Despite this, we believe credit selection will continue to grow in importance as tighter economic conditions put pressure on specific names.

Finally, the positively sloped yield curve and strong fundamentals should provide a positive investment experience for intermediate to long-term credit, including high yield, during the third quarter and beyond. After a painful 2022 and volatile yet positive start to the year, we expect bonds to act like bonds for the remainder of the year, with income and strong balance sheets driving the investor experience.

We believe our bottom-up, fundamental credit research process is well-positioned to take advantage of the opportunities we are seeing in the market today.

2023 THEMES

Economic environment

- Inflation has come down sharply in recent months, and the trajectory is favorable due to lower energy prices, housing costs and rents.
- However, core services inflation excluding housing remains sticky and elevated,
- The Fed Funds rate has risen by 500 bps during this cycle.
- Federal Reserve policy remains dependent on employment and inflation data.
- We do not expect rate cuts for the balance of 2023 as the Fed contends with elevated core services inflation.
- U.S. growth should trend lower as the impact of Fed policy is absorbed. Key factors include interest rate hikes, headwinds in the banking sector and declining money supply.
- Recession is a concern, though the timing continues to be pushed.
- Uncertainty regarding the end of Fed rate tightening continues to cause rate volatility. Anticipate a return to range bound trading once stable conditions return.

Municipal market environment

- We expect municipal defaults will remain low, rare and idiosyncratic.
- Credit remains strong, with historic levels of rainy day funds.
- Revenue collections are expected to normalize from covid peaks, but still remain solid.
- Supply remains muted due to higher interest rates.
- Net negative tax-exempt supply will likely persist through the summer, providing technical support.
- Demand is returning for both intermediate/long duration and high yield, which offer attractive yields.
- Municipal performance is expected to improve 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

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.invttools.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.

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals.

The views and opinions expressed are for informational and educational purposes only as of the date of production/writing and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections, forecasts, estimates of market returns, and proposed or expected portfolio composition. Any changes to assumptions that may have been made in preparing this material could have a material impact on the information presented herein by way of example. **Performance data shown represents past performance and does not predict or guarantee future results.** Investing involves risk; principal loss is possible.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. For term definitions and index descriptions, please access the glossary on nuveen.com. **Please note, it is not possible to invest directly in an index.**

Important information on risk

Investing involves risk; principal loss is possible. All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments. This information should not replace an investor's consultation with a financial professional regarding their tax situation. Nuveen is not a tax advisor. Investors should contact a tax professional regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

Nuveen, LLC provides investment solutions through its investment specialists.

This information does not constitute investment research as defined under MiFID.

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE

nuveen

A TIAA Company