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Municipal market: Bonds are acting like bonds again

2023 saw continued market volatility as investors assessed the impact of U.S. Federal Reserve rate increases. With the Fed signaling the end to rate hikes and possible cuts, investors can focus on municipal bonds behaving like bonds again: offering tax-exempt income and providing portfolio diversification.

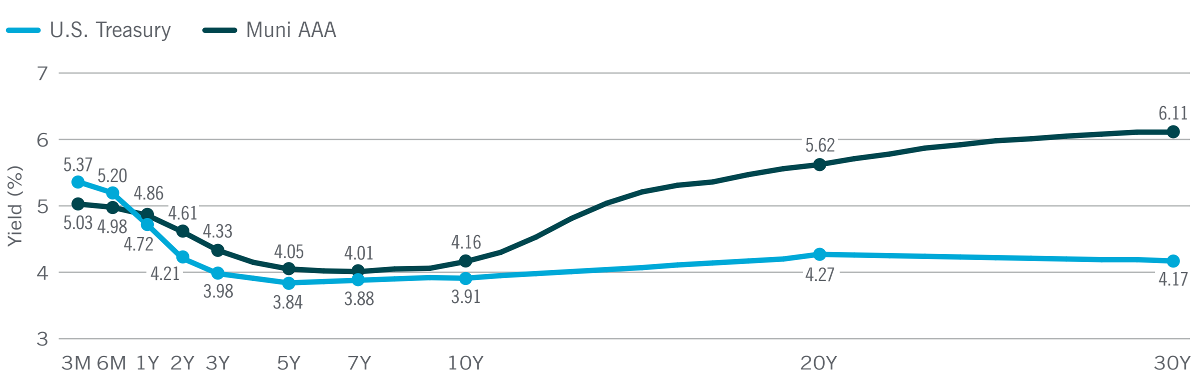
LONGER DURATION IS COMING INTO FAVOR

The Fed appears to be finished raising interest rates, with the median of the dot plot of individual expectations indicating cuts of 100 basis points (bps) in 2024 and a total of 300 bps longer term. Such an environment has historically steepened the yield curve.

A steepening yield curve should be positive for longer-duration bonds, allowing investors to receive higher income associated with longer-duration bonds while earning additional total return through a combination of declining rates and rolling down the curve.

Figure 1: By extending duration, investors may achieve higher tax-efficient yields

U.S. Treasuries versus AAA municipal yield curve (taxable-equivalent yield)

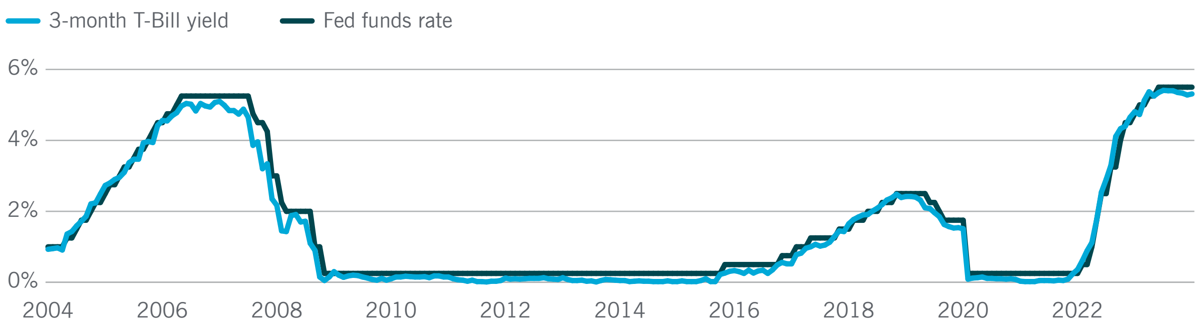


Data source: Bloomberg, L.P., Nuveen Portfolio Strategy & Solutions, 31 Jan 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Taxable-equivalent yield (TEY)** is the yield a taxable investment needs to possess (before taxes) for its yield to be equal to that of a tax-free municipal investment. The yields shown are based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income. Individual tax rates may vary. They do not take into account the effects of the federal alternative minimum tax (AMT) or capital gains taxes.

SHORT-TERM YIELDS WILL NOT LAST

The conclusion of the hiking cycle likely means the end for these attractive short-term yields. Bond yields have historically fallen by about 1 percentage point on average in the year following the last Fed rate hike, and rates have already declined from their recent peak on 31 Oct 2023.

Figure 2: Yields have fallen quickly when the Fed stops hiking



Data source: Bloomberg, L.P., Federal Reserve Projection Materials, 27 Feb 2004 – 08 Feb 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Fed tightening cycles: 30 Jun 2004 to 29 Jun 2006; 15 Dec 2015 to 19 Dec 2018; current cycle began 16 Mar 2022.

> *The conclusion of the hiking cycle likely means the end for these attractive short-term yields.*

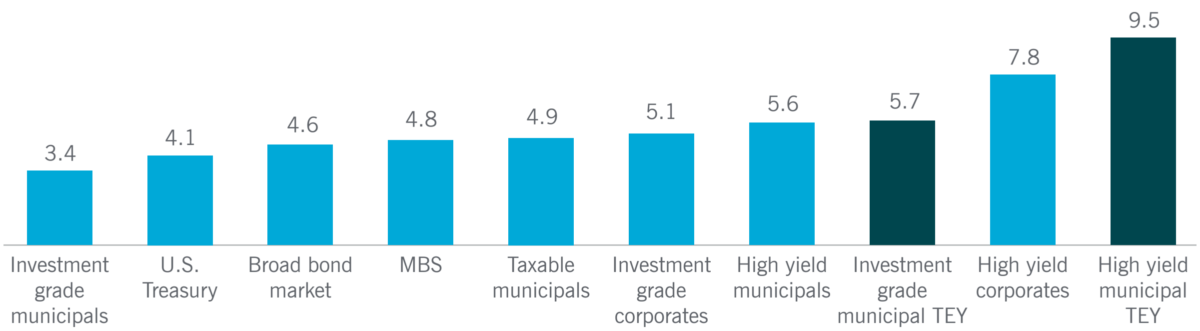
MUNICIPAL BONDS OFFER ATTRACTIVE YIELDS

Aggressive Fed policy and a strong economy have boosted market yields to the highest levels in more than a decade. This means investors may maximize income at more attractive rates than in previous years.

Municipal bonds also offer an attractive taxable-equivalent yield (TEY) opportunity, as the interest earned is exempt from regular federal taxation and in some cases state and local taxes. For investors residing in high-tax locations such as California, New York State and New York City, TEY will be even more attractive.

Figure 3: Muni yields are attractive vs. other broad fixed income sectors

Yield to worst (%)



Data source: Bloomberg, L.P., trailing 12 month returns from 31 Jan 2023 – 31 Jan 2024; yield to worst as of 31 Jan 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Yields are yield to worst. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer defaulting. **Representative indexes: Broad bond market:** Bloomberg U.S. Aggregate Bond Index; **High yield corporates:** Bloomberg U.S. Corporate High Yield Index; **High yield municipals:** Bloomberg High Yield Municipal Bond Index; **Investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index; **Investment grade municipals:** Bloomberg Municipal Bond Index; **Mortgage-backed securities (MBS):** Bloomberg MBS (fixed rate) Index; **Taxable municipals:** Bloomberg Taxable Municipal Bond Index; **U.S. Treasury:** Bloomberg U.S. Treasury Index; The taxable-equivalent yield is based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income (the net investment income tax). Individual tax rates may vary.

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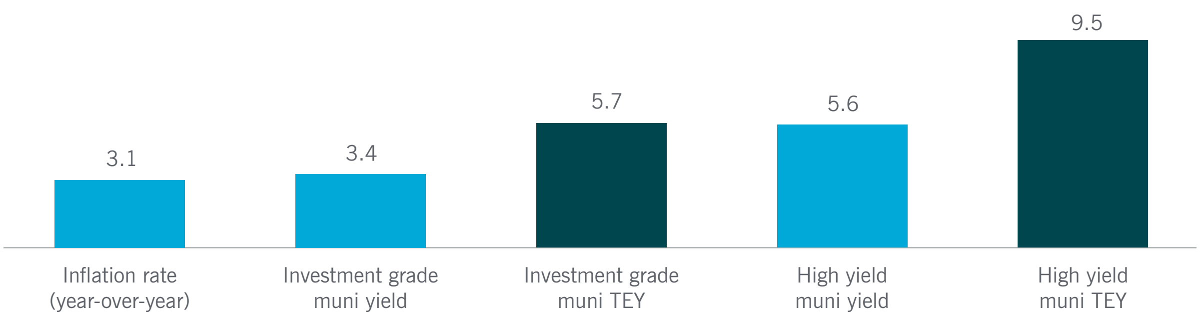
REAL YIELDS ARE POSITIVE

Real yields — a bond's stated yield minus the inflation rate — sit at the highest levels since 2009. While inflation remains above central bank targets, it has moderated significantly. Real yields should remain attractive as central banks maintain higher interest rates while inflation continues to decline.

Municipal bond yields started 2024 at their highest level since 2011. In this environment, investors may enjoy attractive total returns from income alone, a dynamic absent for almost 10 years. Municipals do not need a meaningful rate rally or dramatic spread compression to offer outsized, equity-like returns.

Figure 4: Municipal bond yields exceed inflation

Yield to worst (%)



Data source: Bloomberg, L.P., Bureau of Labor Statistics, 31 Jan 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: inflation:** U.S. Consumer Price Index; **investment grade municipals:** Bloomberg Municipal Bond Index; **high yield municipals:** Bloomberg High Yield Municipal Bond Index. Yields are yield-to-worst. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer defaulting. The taxable-equivalent yield is based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income (the net investment income tax). Individual tax rates may vary.

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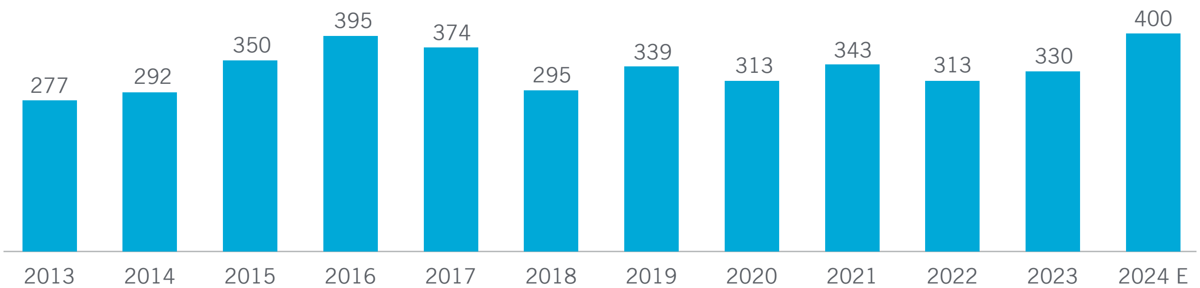
TECHNICAL IMBALANCES FAVOR MUNIS

Municipal bond gross supply is expected to total $350 billion to $450 billion in 2024, up slightly from $330 billion in 2023. However, with approximately $400 billion of bonds maturing in 2024, supply will likely be net negative. Demand should exceed supply, as proceeds from matured bonds will require investments in new bonds. And declining rates may result in other bonds being called early, with these additional reinvestment needs further increasing demand.

This supply/demand disparity should keep yields and spreads contained, as net negative supply creates scarcity among a shrinking pool of outstanding bonds.

Figure 5: Gross municipal bond supply is expected to be higher in 2024

Municipal bond issuance ($ billions)



Data source: Securities Industry and Financial Markets Association (SIFMA.org), *U.S. Bond Market Issuance and Outstanding,* 31 Dec 2023. AMT municipal issuance is part of the tax-exempt municipal market. 2024 data is estimated, as of 31 Jan 2024.

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

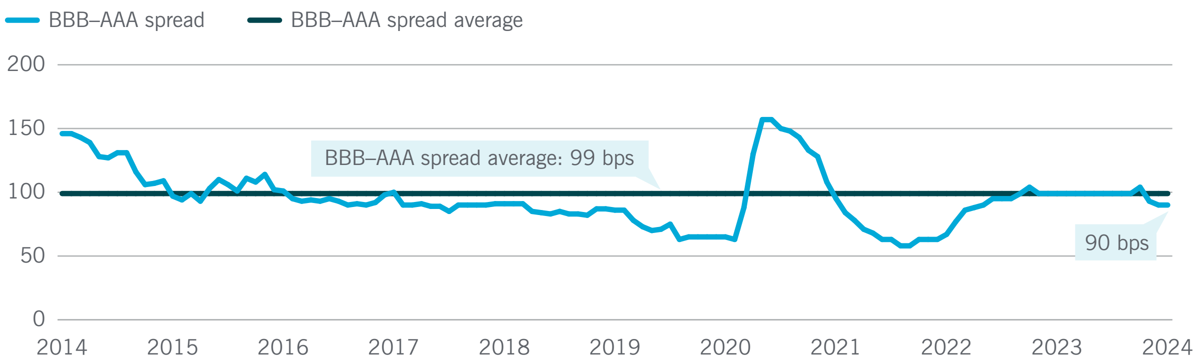
MUNICIPAL BOND FUNDAMENTALS ARE STRONG

Municipal credit is in a strong position to weather potential economic uncertainty. State and local governments have high cash balances, and we expect munis to perform well in a risk-off environment due to their resilience during past economic downturns. In recent years, credit upgrades have outpaced downgrades by a factor of 4:1.

Municipal bonds should be well placed to capitalize on these solid fundamentals, and we think spreads can tighten further and provide total return potential.

Figure 6: Muni credit spreads have been stable, reflecting supportive fundamentals

20-year BBB municipal yields versus AAA municipal yields (bps)



Data source: Bloomberg, L.P., Refinitiv MMD, 01 Jan 2014 – 31 Jan 2024, shown monthly. AAA and BBB rated municipal yields represented by Refinitiv Municipal Market Data (MMD) yields for AAA rated and BBB rated 20-year bonds, respectively. **Performance data shown represents past performance and does not predict or guarantee future results.** Ratings shown are from S&P and are subject to change. AAA,AA,A, and BBB are investment grade ratings; BB,B, CCC/CC/C and D are below-investment grade ratings. Different benchmarks, economic periods, methodologies and market conditions will produce different results.

2024 MUNICIPAL BOND MARKET OUTLOOK

We believe the municipal market is poised for improvement in 2024. The Fed's anticipated easing this year should bolster demand for municipal bonds. If investor sentiment shifts positively, as we expect, strengthening demand could absorb secondary market supply and act as a catalyst for spread tightening. We see favorable conditions for municipal bonds, with attractive yields to start the year and solid credit fundamentals for state and local governments. In this environment, we think municipal bonds have attractive potential in diversified, long-term portfolios.

For more information, please visit nuveen.com.

Endnotes

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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.

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