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Fourth quarter 2021 outlook

Municipal market offers better value

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The big questions for the municipal bond market in the fourth quarter relate to federal monetary and fiscal policies.

KEY TAKEAWAYS

- Municipal performance softened moderately and underperformed U.S. Treasuries for the first time this year.
- The backup in municipal interest rates is understandable, after a strong run pushed the tax-exempt market to relatively rich valuations.
- Credit continued to outperform, but at a slower pace. Credit spreads narrowed slightly due to surging municipal revenues.

GROWTH IS PAST ITS PEAK, BUT EXPANSION CONTINUES

The U.S. economy experienced its peak growth rate in the second quarter, when reopenings across the country coincided with another round of huge fiscal stimulus amid a highly accommodative Federal Reserve (Fed). A more normalized pace of expansion can be expected going forward, which remains positive for investors.

Even if the bipartisan infrastructure bill is passed alongside a scaled-down version of the Build Back Better reconciliation bill, the new spending will be spread over the next several years and have a moderate impact. This lies in contrast to the emergency spending programs enacted starting in April 2020 in which the money was spent right away.

On the monetary policy front, the Fed has indicated its intention to start tapering the pace of quantitative easing (QE) before the end of this year. Other reasons to expect a slowdown in the torrid pace of GDP growth include labor shortages, continued supply chain disruptions and the spread of the Delta variant.

Even with these headwinds, several important strengths should continue to propel U.S. economic growth forward. Workers are gradually being enticed back to work with higher wages and the end of enhanced unemployment benefits. The labor force participation rate is improving, although it remains far below pre-pandemic levels. U.S. job openings have spiked to more than 10 million, which is higher than the total number of unemployed. This trend is contributing to wage growth and starting to pull people off the sidelines. Since the worst of the lockdowns, the unemployment rate has dropped from nearly 15% to 4.8%.

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The Delta variant is declining, and most areas of the country responded to this recent wave with masking, distancing and vaccines, rather than lockdowns. The more tempered policy responses generally helped the economy continue to push forward throughout the third quarter, and we expect this dynamic to continue.

Household net worth has accelerated with rising home prices, asset prices and savings. Wage growth continues to be robust, and there is substantial pent-up demand in the economy.

Thus, economic performance in the fourth quarter should remain strong even in the face of slightly less robust fiscal and monetary stimulus. We view even a moderated growth rate for the U.S. economy positively, as it is based less on government stimulus measures and should prove more sustainable.

THE FED MARCHES TOWARD TAPERING

Shortages have resulted from the widespread global lockdowns, followed by the reopenings, as pent-up demand was unleashed much faster than supply could rebuild. Housing construction cannot keep up with demand. Similarly, automobile production has slowed, with used car prices rising by more than 27% in the last year. Many key commodities have experienced price spikes, most recently the natural gas and electricity markets.

The Fed correctly predicted this period of higher-than-normal inflation, and is more tolerant of exceeding its 2% long-term target. The components of the price indexes that are boosting inflation above the 2% target are a small sliver of overall CPI. Supply chain issues and work force shortages in certain sectors have contributed to inflationary spikes, but these instances should be temporary.

With a disruption this severe, the Fed's definition of transitory might be longer than previously perceived as supplies rebuild. Looking longer term, the secular disinflationary forces of technology, aging demographics and global competition remain prevalent and likely to be more impactful over time.

In addition to these temporary supply and demand imbalances, concerns are growing that monetary and fiscal stimulus programs are playing a role in today's inflationary environment.

Although the Fed warned of shortages causing unusually volatile price swings, it is also sensitive to overheating demand in the near term with too much stimulus. The Fed continues to pound the drumbeat of tapering QE beginning in November or December 2021 and ending by mid-2022.

Although this decision could soften U.S. Treasury bond prices (and increase yields) in the near term, less QE is ultimately an important step toward a healthy normalization of policy and avoiding new asset bubbles.

Importantly, the Fed also indicated there would likely be a significant gap between the end of tapering and the first rate hike. Most Fed officials do not expect rates to increase until 2023. For comparison, after the global financial crisis, QE tapering ended in 2013 and interest rates rose for the first time in 2016.

Fixed income markets are anticipating a period of lighter Fed purchases of longer-term Treasury bonds, while the fed funds rate continues to be anchored near zero. As a result, the Treasury and municipal yield curves steepened slightly during the third quarter.

MODEST SELLOFF RESTORES BETTER VALUATIONS

After flattening during the second quarter, the yield curve steepened during the third quarter due to solid economic data, inflation concerns and anticipation of Fed tapering.

Credit spreads continued to narrow in the third quarter as the economy continued its return to normal and state and local tax receipts surged higher. High yield spreads narrowed from +177 bps to +164 bps over AAA municipals. Investment grade spreads have also declined, with BBB spreads declining slightly from +63 bps to +58 bps over AAA.

Municipal-to-Treasury yield ratios measure high quality municipal bond valuations relative to the U.S. Treasury bond curve. These ratios touched historical highs in 2020 as pandemic-related credit fears dominated investor psychology, only to plummet to historic lows at the end of the second quarter of 2021.

Municipals underperformed Treasury bonds in the third quarter for the first time since their recovery began in spring 2020. This backup in rates and ratios helps to normalize the relationship, and enables municipals to offer investors a better value.

The 10-year municipal-to-Treasury yield ratio rose from 66% to 75% during the third quarter, versus a long-term average of 85%. The 30-year ratio also increased from 73% to a little more than 80%. This is still lower than the long-term historical average, and may indicate that investors are anticipating higher individual income tax rates in the near future.

Supply

New issue supply set a record at approximately $450 billion in 2020. The pace is virtually identical through the first three quarters of this year, while the composition is different. Taxable municipals accounted for a record 30% of 2020 supply, and refunding volume was an impressive $150 billion as many taxable deals were used for refunding tax-exempt bonds.

Taxable municipals have accounted for 23% of issuance so far in 2021, which equates to more than $80 billion in par value. This remains a historically high figure, but down 38% from last year's pace. Similarly, refunding volumes remain very strong at $121 billion year-to-date, but this is 26% lower than last year.

In sum, taxable deals and refunding deals remain very significant components of new issue supply, but they are less dominant than in 2020. At the same time, traditional tax-exempt bonds issued for new capital purposes are up 19% year-over-year through the end of September. As a result of slightly less refunding volume amid robust new issue volume, the municipal bond market has recently grown to more than $4 trillion in total par value of bonds outstanding.

Demand

Municipal fund flows have been consistently positive this year. Open-end mutual funds saw positive flows of $10.5 billion, $9.6 billion and $5.5 billion in July, August and September, respectively. High yield municipal fund flows were $2.6 billion, $2.3 billion and $740 million, respectively.

Investors are encouraged by the strength of the credit recovery in municipals, and new tax hike proposals are likely coming next year. Toward the end of the quarter, caution increased around interest rate volatility, but demand and fund flows were consistently positive.

Defaults and credit

As of the end of September, payment defaults have totaled roughly $1.74 billion for the year, a very small percentage of the overall market. Nursing homes and industrial development revenue bonds represent around 76% of all municipal defaults in 2021. We do not anticipate widespread municipal payment defaults.

Most municipal governments end their fiscal years on 30 June, and the tax receipts for fiscal year-end have just become available. Trailing 12-month results show an impressive upswing, taking state and local revenues to new record highs:

- Personal income taxes: +37.3%
- Corporate income taxes: +79.2%
- Sales taxes: +11.5%
- Property taxes: +13.4%

The average state now has more than 15% of its top-line budget in cash on hand for rainy day funds, also a record. Not surprisingly, credit rating upgrades are running at two times the pace of downgrades. Historically, most defaults come in credits without a backstop of government support. Nevertheless, we still believe these indicators bode well for credit strength going forward.

MUNICIPAL CREDIT IMPROVES ALONG WITH ECONOMIC GROWTH

Infrastructure and reconciliation bills plod along

While its fate seems inextricably tied to that of the reconciliation bill that Democrats seek to pass on a party-line vote, the Bipartisan Infrastructure Investment and Jobs Act (HR 3684) would affect state and local issuers primarily in two ways: through grants for transportation, water and broadband projects, and by expanding the authority to issue private activity bonds.

Altogether, the bill increases federal spending by $550 billion over five years. The largest amount of grants to state governments would come from $110 billion authorized for roads and bridges. In addition, airports would receive $20 billion for runways, taxiways and terminals. Public transit systems would receive subsidies totaling $39 billion. Another $65 billion would be allocated to provide broadband internet service to unserved or underserved areas. Water projects would receive $55 billion, which includes $23 billion authorized by the Drinking Water and Wastewater Infrastructure Act, and $8 billion for western water projects that provide for groundwater storage and conveyance.

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The bill allows states to issue private activity bonds to finance "qualified broadband projects" and "qualified carbon dioxide capture facilities," and it increases from $15 billion to $30 billion the amount of private activity bonds that can be sold to fund surface transportation projects.

While the infrastructure bill only authorizes additional issuance of private activity bonds, the Build Back Better reconciliation bill proposed by the House Ways and Means Committee includes three provisions that would affect municipal issuance: it would again allow tax-exempt, advance refunding bonds to be issued; it would provide the option of issuing taxable bonds that would be subsidized by the U.S. Treasury (like the Build America Bonds program, but with subsidies that decline from 35% to 28%); and it would increase from $10 million to $30 million the amount of debt that can be sold each year by issuers of bank-qualified bonds.

Neither bill contains any provision that would eliminate or increase the current $10,000 limit on the amount of state and local taxes that can be deducted for federal tax purposes.

Puerto Rico's bankruptcy process makes progress

Individual creditors must vote by October 18 on whether to approve Puerto Rico's proposed plan of adjustment. A bankruptcy court confirmation hearing begins November 8 and is scheduled to take several weeks. If approved by the court, a bond exchange would likely take place in early 2022.

However, political risk remains, as legislation needed to authorize and implement the proposed debt adjustment plan is pending. Local legislation approving issuance of the new general obligation (GO) bonds and contingent value instruments (CVI) bondholders would receive in exchange for defaulted GO and public building authority (PBA) bonds likely must be enacted before the bankruptcy court can approve the plan. Disagreement over pension cuts and other spending provisions continues to be a point of contention between the oversight board and elected leaders. Negotiations between the board and the legislature are ongoing.

> *The outcome of the recall would not likely to have impacted California's credit profile.*

Assuming an agreement can be reached and acceptable legislation passed, Puerto Rico is likely to exit bankruptcy by the end of this year. Investors generally expect an agreement to be reached eventually, but the political volatility makes absolute certainty impossible. If the legislature doesn't get this straightened out, it could threaten the negotiated settlement.

Other recent developments at the federal level are more unambiguously positive for Puerto Rico. Specifically, the short-term spending bill passed by Congress provides additional federal Medicaid funding and cancels outstanding federal community disaster loans (CDLs) for U.S. territories. An increase in the federal medical assistance percentage (FMAP) through year end allows Puerto Rico to avoid a September 30 funding cliff and provisions require additional clarity on 2022 funding levels. This translates to short-term relief and enhanced budgetary certainty over the next year.

The cancellation of more than $300 million in federal CDLs provided in the wake of the 2017 hurricanes to many of Puerto Rico's local governments is also positive. CDLs for local governments in the U.S. are normally forgiven, so the move to cancel the loans is a move toward equitable treatment.

Federal relief aid and stimulus funding will continue to stabilize and support Puerto Rico's economy over the near-term. Puerto Rico will receive an estimated $43.5 billion through numerous federal COVID-19 relief aid packages passed in 2020 and 2021. The March 2021 American Rescue Plan Act (ARPA) alone allocates $17.7 billion to be spent over the next few fiscal years. This funding is additive to previously approved disaster relief funding to be deployed over the next 15 years. All federal aid allocated to Puerto Rico — disaster relief and COVID-19 relief — is estimated to total more than 130% of Puerto Rico's annual GDP.

California governor survives recall election

A recall election sought to remove current California Governor Gavin Newsom took place on 14 Sep 2021. The Republican-led recall movement began before the pandemic, initially citing the state's high taxes and homelessness crisis, as well as the governor's position on immigration and the death penalty. It eventually grew to include his handling of the COVID-19 pandemic.

The election presented voters with two questions: 1) should Governor Newsom be recalled from office, and, if so, 2) who should succeed him if he is recalled. If a majority vote was received for the recall, the candidate with the most votes on the second question would win the election. With an estimated 97% of the votes counted as of September 28, the Associated Press reports that Governor Newsom won the first question 62.1% to Keep vs. 37.9% to Remove.

The outcome of the recall would not likely have impacted California's credit profile due to the institutionalized budget and financial management practices at the state level. Despite being disruptive, a change in governor doesn't necessarily mean a change in credit.

Brightline resumes service in November

Brightline Florida Passenger Rail will resume service between Miami and West Palm Beach in early November after shutting down operations in March 2020. Brightline also plans on rolling out its own private vehicle fleet that will include private cars, shared shuttle services and golf carts. This new upgrade is expected to enhance the customer experience by bringing passengers door to door and solving gaps created by the first and last miles of transit.

Construction on the expansion to Orlando International Airport remains on target to be completed by the end of 2022. Additionally, construction continues at new in-line stations located in Aventura and Boca Raton that are expected to increase both ridership and revenues. Ongoing discussions continue between Brightline, FDOT and several other Florida entities regarding eventually expanding the train line to Tampa. If ultimately passed by Congress, the $1.2 trillion infrastructure bill allocates $12 billion toward partnership grants for intercity rail service, including high-speed rail. We believe Brightline would be in a good position to receive some of these federal funds to build the extension to Tampa, given the project is shovel ready.

> *We believe Brightline would be in a good position to receive federal funds to build the extension to Tampa.*

Looking ahead, recent economic reports indicate that Florida's economy will continue its upward trajectory, fueled by strong population growth and tourism that is approaching pre-pandemic levels. South Florida, in particular, will benefit from many financial service and technology companies recently deciding to relocate to the area. We continue to feel that Brightline is well positioned to take advantage of this momentum by providing a revolutionary mode of transportation that will help ease rapidly increasing traffic congestion.

While it is uncertain how quickly mass transit will recover post pandemic, Brightline's unique customer experience assigns every passenger a seat, resulting in less crowded interior cabins. Brightline is also installing new ultraviolet light air filtration systems in all passenger cars, demonstrating that its trains are clean and safe.

OUTLOOK

Municipals could see a solid fourth quarter

More value was restored into the market in the third quarter. Municipal-to-Treasury yield ratios increased and spreads remained stable, leading to slight relative cheapening for the asset class.

The big questions for the municipal bond market as we enter the fourth quarter relate to federal monetary and fiscal policies.

The Fed has been very clear and consistent in its messages. The economy has made sufficient progress for QE tapering to begin around year end, but labor markets have room to improve before the first rate increase in another year or so. The yield curve has steepened moderately as a result. It may have a little further to go, even as the 10-year Treasury bond yield remains below 2%.

The fiscal realm of infrastructure, social spending and new tax policies – now all tied together – raise greater uncertainty. If and when these bills pass, what will be their size and scope? Less fiscal stimulus spread out over a broader time frame – along with a lower COVID-19 case trajectory – should be very positive for financial markets. In that scenario, the economy would be standing on its own two feet next year, making the growth trajectory more sustainable and supporting labor, schools, inflation and normalization in general.

Corporations and upper-income individuals will very likely see their tax rates increase, which makes an allocation to municipal bonds more attractive.

Municipal default rates have seen no discernable impact from the pandemic, with 2020 rates remaining in line with historical levels. The cumulative municipal bond default rate over 10-years is only 0.23%, versus 8.62% for corporate bonds and 5.98% for sovereign debt.

The very low volatility of municipals so far this year has started to increase due to uncertainties around the questionable length of today's inflationary period, as well as QE tapering and potential fiscal policy changes. This has contributed to some underperformance for the first time in more than a year, and creates a better entry point for investors. Also positive, mutual fund cash balances are robust, prospects for higher taxable-equivalent yields seem likely and credit quality is supported by large general fund surpluses amid rising tax receipts. We see many reasons to suggest that municipals could see a solid fourth quarter.

KEY 2021 THEMES

- 2021 has been a transition year, and re-opening continues despite the Delta variant.
- The Federal Reserve expects to taper its Treasury purchases in late 2021 and conclude by mid-2022.
- Monetary stimulus and low rates continue to boost economic activity despite softer economic data.
- Inflation is a concern as the core PCE deflator is well above the Fed's long-term target, but prices are expected to moderate in 2022.
- Treasury volatility has increased, along with policy uncertainty. Technical factors and potential tax changes could reduce municipal bond sensitivity to rising rates.
- Credit trends remain favorable, and we expect more ratings upgrades than downgrades.
- A strong economy and continued low default rates should allow high yield municipals to outperform.
- Seasonally robust new issue supply calendar could offer buying opportunity after a year-long struggle to find supply.

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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