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Second quarter 2022 outlook

Municipal bonds: Higher yields and attractive valuations offer opportunity

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The first quarter was the most challenging quarter for municipal bonds since 1980, as returns were negatively impacted by U.S. Treasury market volatility, persistent inflation concerns and geopolitical tensions. Notably, credit fundamentals remain very strong, with positive economic growth boosting tax revenues to all-time records. Once the U.S. Federal Reserve (Fed) proves successful in reining in inflationary pressures, interest rate volatility should begin stabilizing. We believe today's more attractive bond valuations and much higher yields bode well for longer-term performance.

KEY TAKEAWAYS

- The first quarter was very challenging for fixed income, municipals in particular.
- Puerto Rico completed the largest municipal restructuring in history.
- Credit continues to outperform by the greatest margin in more than a decade.

U.S. ECONOMY IS BETTER POSITIONED

Although U.S. economic growth is decelerating slightly from its torrid pace of last year, the labor and housing markets remain strong and support a positive growth outlook for 2022 overall. Nevertheless, investors are concerned about a possible U.S. recession. Some surveys estimate the probability at more than 50% by 2023.

Numerous risks are driving these fears. The Fed's increasingly hawkish language leads to concerns of over-tightening policy to curb inflation. And the Russian invasion of Ukraine has exacerbated food and energy price increases. Lockdowns in many areas of China (most recently Shanghai) are not only impacting the second largest economy in the world, but they also serve as a stark reminder of lingering pandemic risks.

In our view, the U.S. remains much better positioned than most of the world to withstand these difficult global events. Importantly, U.S. domestic food supplies and energy security are relatively strong versus the eurozone, Japan and most emerging markets. Both household and corporate balance sheets are in excellent shape, which should help the durability and resilience of the economic recovery.

THE FED BEGINS ITS TIGHTENING CYCLE

The Fed's increasingly hawkish rhetoric put fixed income markets on edge throughout the quarter. This shift in tone was driven by persistent inflation and exacerbated by political considerations such as confirmation hearings and upcoming mid-term elections. The rise of gasoline and food prices should prove to be temporary, but continues to frustrate voters. Incumbent members of Congress feel the pressure and frequently point fingers at the Fed.

The magnitude of the Fed's shift grew significantly during the first quarter. With one hike already behind us, futures markets now expect eight or nine more quarter-point hikes this year, bringing the fed funds rate to the 2.5% – 2.75% range. There has also been discussion of arriving at this "neutral" rate faster than the standard quarter-point increments.

In addition to short-term rate increases, Fed board members are discussing shrinking the balance sheet to drain excess liquidity and normalize bond holdings. Meeting minutes suggest a maximum reduction (including bond roll-off) of $95 billion per month of Treasuries and mortgage-backed securities, totaling $1 trillion per year over the next several years.

All of this talk has investors worried about over-tightening. Certainly the Fed's rate hike cycle will eventually slow the economy and inflation rates, with likely an approximately 12-month lag. The goal is a soft landing, where interest rates rise to a neutral level, the economy grows slightly below its long-term trend and inflation declines without triggering a recession.

While the markets are skeptical, several positive developments are often overlooked. The pandemic has increased the pace of technology implementation, which enhances productivity. Interestingly, the U.S. economy recovered its pre-pandemic output level by the middle of 2021 with 8 million fewer workers. GDP is significantly higher, using 1.5 million fewer workers than in 2019. New business applications increased 77% in the third quarter of 2020 from the second quarter, and more than double any quarterly report since 2004. Enhanced productivity should eventually be disinflationary.

Even while wages and housing prices are rising rapidly, some key prices have begun to fall, such as freight rates, used car prices and even gasoline futures. The hawkish language has boosted the U.S. dollar on global markets, up 11% year-to-date versus other currencies. All else being equal, a stronger U.S. dollar helps moderate import prices. Also, longer-term inflation expectations are up only slightly, indicating that people believe the Fed will successfully restrain inflation longer term.

An inverted yield curve is frequently highlighted as the harbinger of a recession 12 to 18 months in the future. We saw this inversion on some trading days during the first quarter, but the yield curve had steepened and become positively sloped again by early April.

Even with the growing hype, the Fed has carefully noted that we are enduring a volatile and uncertain period with high geopolitical risks. Policies can change quickly with the conditions. Given this flexibility, and some favorable price declines, the rate hike cycle could end earlier than current market pricing suggests.

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FISCAL POLICY NORMALIZATION IS PROGRESSING

Relatively little attention has been paid to the normalization of fiscal policy, which is progressing surprisingly well. Federal tax revenue collections are up 27% over the past year. April looks to be even stronger, given the amount of capital gains realized in 2021 amid strong financial markets and fears of higher tax rates going forward.

Meanwhile, spending is down 6% over last year, as stimulus programs are expiring. Some smaller components of what was formerly called Build Back Better may be resuscitated and negotiated this summer. However, even if certain climate and energy support provisions are adopted, they will likely be paid for with tax increases. And the overall headline number would not change the current trajectory of the budget deficit reduction.

The federal deficit exploded during the pandemic, due to $6 trillion of stimulus over an 18-month period that was mostly deficit financed. On the positive side, the deficit has improved by $1.9 trillion over the last 12 months (from $4.1 trillion to $2.2 trillion) and this trajectory should continue throughout 2022. In March 2022 alone, the federal deficit fell by $469 billion, the second largest decline since 1960. Deficit reduction as a percentage of GDP at -8.7% is the largest U.S. fiscal contraction since 1946. Federal revenues are at a record high on an absolute basis and approaching a new record high on a percentage of GDP basis at around 20%.

Markets have been quite concerned about the Fed's transition from quantitative easing to tightening: in essence, shifting from purchasing bonds to selling bonds from its balance sheet. The fact that this transition is occurring during a period of sharp deficit reduction should boost the Treasury market.

Delays in fighting inflation have been frustrating. Some inflation drivers are global, and timing of the Russian invasion exacerbated the commodity price surge. Nevertheless, the U.S. is seeing normalization in labor markets, fed policy and fiscal policy alongside enhancements to productivity. All of these factors argue for a disinflationary environment in the longer term.

VALUATIONS ARE A MAJOR SUPPORT FOR MUNICIPALS

Like most of fixed income, the first quarter posed a significant challenge for the municipal bond market. U.S. Treasury market volatility increased, inflation appeared less contained than originally expected and geopolitical events heightened uncertainty. The Bloomberg Municipal Bond Index had the lowest quarterly return since 1981 at -6.23%.

AAA benchmark interest rates more than doubled, from 1.03% to 2.18%, as the 10-year Treasury sold off while municipal-to-Treasury ratios cheapened meaningfully. Credit spreads widened, but only moderately. Overall, municipal returns were driven primarily by duration and yield curve positioning, with the long end of the yield curve underperforming.

Fundamentally, municipal credit quality is strong with favorable trends. Similar to the trajectory of the federal government, state government tax revenue collections are historically high and increased 22% in 2021 compared to 2020. This is 20% above pre-pandemic levels in 2019. Reserves reached a record collective high at $82.3 billion and state pension funds are expected to be more than 80% funded for the first time since 2009.

States reporting thus far show a 26% revenue growth rate year-to-date, led by a 35% increase in California. Similar to the federal government trajectory, we also anticipate a further increase in April driven by capital gains exercise.

Moody's issued 817 upgrades and just 307 downgrades in 2021, compared to 296 upgrades and 209 downgrades in 2020. Given the strong revenue environment and record reserves, we believe municipal credit is well prepared for a recession in the event the Fed were to over-tighten policy.

Municipal-to-Treasury yield ratios have risen sharply, which indicates municipals underperformed Treasuries for the quarter. Municipals ended 2021 relatively rich by historical standards, given the economic and credit quality recovery, moderate bond supply, 18 months of robust inflows and the prospect of higher taxes in 2022. In the 10-year portion of the yield curve, municipals were valued at 67% of Treasuries to begin the quarter, increasing to 94% by quarter-end. The 30-year ratio, which is typically cheaper, moved similarly from 78% to 104%, compared to the long-term average of 93%.

Ironically, many factors remain today that drove the richness of municipal bonds in 2021: strong fundamental credit trends, moderate bond supply, significant roll-off and tax rates more likely to rise than fall. But municipals have been even more sensitive to the two factors that have changed: the interest rate environment and fund flows.

Supply

Supply declined by 14% from the same period last year to $94.8 billion, primarily because refundings dropped by 42%. The market selloff appears to have stalled the incentive of many issuers to refund existing issues, at least temporarily.

Taxable municipal supply declined by 47% for the quarter compared with the first quarter of 2021. Taxable supply increased dramatically after the Tax Cuts and Jobs Act of 2017, and now regularly makes up approximately 20% of the new issue market under normal circumstances. If interest rates stabilize, we may see a catchup period of taxable new issuance after a sluggish first quarter.

Demand

After consistently positive inflows in 2021, outflows are now trending, with -$4.7 billion in January, -$10.6 billion in February and -$11.8 billion in March. This -$27.1 billion year-to-date total covers 13 consecutive weeks and has been the primary cause of cheaper valuations, such as rising municipal-to-Treasury ratios.

However, the total may understate the interest shown in the asset class overall, as municipal exchange-traded fund flows have seen positive flows of $1.9 billion through February. High yield municipal fund outflows were -$1.5 billion in January and -$1.9 billion in February 2022.

Defaults

Through February 2022, first-time municipal bond defaults total just $320 million, a very small percentage of the overall $4 trillion market. Defaults are mainly concentrated in nursing homes and industrial development revenue bonds, as these categories include arguably the most idiosyncratic risks. Overall, we do not anticipate municipal payment defaults becoming widespread.

Credit spreads

Credit spreads were relatively stable, widening by just 5 bps for the quarter, from 185 bps to 190 bps over the equivalent-maturity AAA bond. The S&P Municipal High Yield Index returned -6.59% during the first quarter, driven more by duration and higher ratios to Treasuries and less by credit spread movements. Lower investment grade spreads also widened, with BBB spreads widening to 86 from 63 bps.

MUNICIPAL FUNDAMENTALS REMAIN STRONG

New Puerto Rico bonds are well received

Puerto Rico's debt adjustment plan for the central government became effective in mid-March, marking a significant milestone for the Commonwealth and the municipal market. The bankruptcy, which took nearly five years to complete, represents the largest municipal restructuring ever. Prior to the debt adjustment, direct debt obligations were just over $34 billion. This was cut to just over $7 billion, helpfully consolidating debt issued with various security pledges into a single general obligation (GO) bond.

The newly restructured Puerto Rico GO bonds are already one of the most frequently traded indentures in the municipal market. Valuations are down moderately in the early days of trading, but this is due to the overall market environment. While Puerto Rico bonds are generally exhibiting a negative total return year-to-date, they have continued to outperform the overall municipal market after significant outperformance in 2021 as well. Much of this outperformance is due to the successful GO restructuring resolution, debt reduction, debt simplification and emergence.

Near-term, there is very little risk of default or slipping back into bankruptcy while the oversight board remains in place. The board will continue to oversee and approve annual fiscal plans, budgets and spending. Current law requires the board remain in place until four consecutive years have ended with balanced operations, based on audited financials. Board oversight is likely to remain in place through 2026, if FY22 is deemed the first balanced budget.

The Commonwealth's annual budget process is expected to remain contentious. Pressure to increase payroll spending and the loss of one of Puerto Rico's largest revenue sources due to an IRS ruling will make maintaining balanced operations a perennial challenge. Favorably, annual debt service is now considered affordable, down to just $1.1 billion from $4.2 billion. Deploying federal funds for disaster relief, COVID aid and new Medicaid funding is expected to support economic growth.

Puerto Rico's electric utility (PREPA) and the Highway and Transportation Authority (HTA) remain in bankruptcy. PREPA has approximately $9 billion in debt that has been in default for years. The Puerto Rican government recently terminated an agreement reached with PREPA bondholders in 2019. A new court-appointed mediation team is expected to lead renewed, confidential creditor negotiations soon. The board plans to file HTA's bankruptcy adjustment plan with the court before 30 June.

Connecticut takes a gas tax holiday

With the recent spike in gas prices, some states have implemented gas tax holidays to help relieve drivers at the pump. Connecticut, Georgia, Maryland and New York are among those that have enacted legislation. Other states are considering such a move. Gas taxes are often used to support construction and maintenance of roads and bridges, as well as mass transit in certain areas.

In Connecticut, Governor Ned Lamont signed legislation suspending the state's gas tax for three months, from 1 April to 30 June. Gas taxes are one of the dedicated taxes backing the Connecticut special tax bonds, and they represent approximately one quarter of pledged revenues supporting those bonds. Other taxes dedicated to this program include motor vehicle receipts and related licenses, permits, fees, a portion of the state's sales tax and an oil company profits tax.

This tax holiday is allowed under the program's governing bond documents. Connecticut has covenanted to provide sufficient tax revenue to the program to keep coverage of debt service above 2.0x. But the state reserves the right to limit, modify, alter, rescind, repeal or substitute revenues as it sees fit – as long as coverage remains above 2.0x. Because coverage is likely to stay above 2.0x, even with this holiday, the state can do this without triggering any negative bond covenants. In its most recent special tax bond official statement, the state projected that FY22 pledged revenues would cover special tax bond debt service by 2.6x. Deducting one quarter of the gas tax revenues would reduce that coverage to an estimated 2.5x.

This tax holiday will slightly weaken the credit profile of the Connecticut special tax bonds, but not enough to endanger debt service.

Demand flourishes in land-secured sector

Land-secured bonds typically fund the horizontal infrastructure improvements necessary to build a residential master planned community. The dramatic surge in work-from-home demand over the past two years drove record sales in such communities in 2021, fueling significant spread tightening within the dirt bond sector over the past 12 months.

Home closings within the top-50 master planned communities increased in 2021 by 26% and 9% versus 2019 and 2020, respectively. We have focused our exposure in Florida, Texas and Colorado, where net migration is being fueled by sustained job growth, better affordability and lower taxes.

Pent-up demand remains, particularly due to supply-chain disruptions and labor shortages that have slowed home construction. In addition, finished lot inventory in many areas of the country remains below historical levels, resulting in both higher land and home prices. As a result, many homebuilders are controlling the release of new homes to match the construction pace and the cost to deliver homes.

Looking ahead, we expect home demand to remain healthy throughout 2022, although limited inventory will likely result in continued increases in average home prices, albeit at a slower rate. Additionally, the Federal Housing Finance Agency recently announced that conforming loan limits to be acquired by Fannie Mae and Freddie Mac are increasing in 2022 by 18% over last year's level of $548,250. This considerable increase should assist homebuilding entities with passing along rising land and construction costs to individual home buyers.

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We expect home demand to remain healthy throughout 2022, boosting the land-secured sector.

American Dream continues tenant openings

The American Dream mall in East Rutherford, New Jersey, advertises approximately 130 retail shops and 50 food, drink and dining venues. Entertainment attractions draw crowds, with the Dream Wheel by Skyviews at American Dream (235 ft. observation wheel) scheduled to open on 13 April. According to disclosure reports, the project remains 80% leased, with an additional 5% of leases under negotiation.

At completion, the project is planned for 450 shops across 1.3 million square feet of retail space (45% of total 2.14 million square feet). While the developer expects to open 100 tenants during 2022, additional retail and restaurant tenants are needed to generate increased sales revenues and ultimately support the property's long-term value.

Series 2017 PILOT bonds, supported through assessment payments on the project's assessed value, remain current with a fully funded reserve. The owner continues to appeal its tax assessments for the 2019, 2020 and 2021 tax years. Hearings should continue through 2022, with the expectation of settlement negotiations to proceed under court direction.

The series 2017 grant revenue bonds are supported by a 75% pledge of sales tax receipts on qualifying purchases at the mall. An issue has arisen regarding the funding mechanism of these bonds. The developer has been remiss in filing a completed project cost statement with the New Jersey Economic Development Authority (NJEDA), which prevents the Authority's ultimate approval of requirements to the New Jersey Treasurer. This is significant due to timing requirements of the appropriation at the state level. To date, NJEDA has indicated initial receipt of the project cost statement, with an expectation that modifications will be needed.

Due to timing of appropriations at the state level, completion of the filing requirement must be resolved by June 2022 for 2021 sales tax revenues to be eligible for appropriation under the grant revenue structure. Bondholders have directed the Trustee to make written requests to both the underwriter and the Bondholder Representative for assistance in completing this matter in a timely manner to receive available grant revenue in time for the 01 Aug 2022 debt service payment. Without the grant revenues, bondholders will not receive debt service payments, as the DSRF has been depleted.

OUTLOOK

Higher yields and attractive valuations offer opportunity

Historically, when municipal bond interest rates rise by more than 100 basis points in a short time period, this creates a favorable entry point. In prior markets and events, heavy outflows further cheapened the asset class on a relative basis, notwithstanding strong fundamentals.

Those conditions currently exist in the municipal market. The key question facing fixed income investors in the near term is when rates will begin to stabilize, thereby instilling greater confidence that it's a favorable time to invest.

While this timing can only be known in retrospect, several positives stir behind today's often grim headlines. Productivity and labor force participation are up, and technology is being used at an accelerating pace. These factors should help supply catch up to the robust demand unleashed as the pandemic receded. Simultaneously, the ultra-stimulative monetary and fiscal policies of the past two years are being normalized at a rapid pace.

Thus, it appears that most of the bad news regarding rates and the Fed has already been priced into the municipal bond market. We believe the many positive trends developing under the surface argue for favorable returns going forward.

2022 MUNICIPAL MARKET THEMES

- The path of inflation remains the wild card, with further uncertainty posed by geopolitical events. The Federal Reserve is focused on combating inflation.
- Multiple Fed interest rate hikes are expected throughout the year.
- Peak economic expansion is behind us, but growth remains strong as the economy continues to normalize.
- Municipal supply is expected to be flat to modestly down.
- Technical factors are driving negative municipal returns year-to-date; fundamentals remain sound.
- Credit fundamentals are strong; revenue collections and reserves are the highest in decades.
- Covid-19 outbreaks are more regionalized and broad shutdowns are unlikely.
- In an environment with volatile interest rates and strong credit conditions, we expect high yield municipal bonds to outperform relative to investment grade.

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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