

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Munis offer yield relief from inflation's heat

Bottom line up top

Rate cut expectations melt as inflation keeps the heat on. Like the aggressively, progressively spicier chicken wings served to celebrities as they're being interviewed on the hit YouTube show "Hot Ones," U.S. inflation remains a fire hazard, threatening to burn down investors' already singed house of hopes for U.S. Federal Reserve rate cuts this year. In the face of persistent heat from inflationary macroeconomic data, the S&P 500 Index has responded with an equity market version of stop, drop and roll, falling approximately 5% from the record-high close of 5,254 on the final trading day of the first quarter.

Retail sales are among the latest accelerants. Just last week, the release of U.S. retail sales data for March poured a bit more fuel on the inflation fire, with month-over-month growth (ex-autos) reaching its highest level (+1.1%) since January 2023 (Figure 1). While this remarkable upside surprise helps underpin strength in the consumer-led U.S. economy, it also serves as yet another obstacle on the path to lower interest rates. One potential caveat may offer a flicker of optimism to interest rate doves: Robust retail sales in March might have been augmented by a strong tax refund season. According to the Internal Revenue Service (IRS) website, more than \$200 billion in refunds were issued between late January and early April 2024, with the average refund just above \$3,000 — a 5% increase over 2023.

Regardless of whether March retail sales reflect a transitory tax-driven anomaly, we doubt the report will meaningfully impact current expectations for the trajectory of the Fed's policy decisions. We still anticipate just one or two rate cuts by the end of 2024, believing that the Fed will remain hawkish as tamping down inflation amid sustained economic resilience proves ever more challenging.



Saira Malik, CFA
Chief Investment Officer

On behalf of Nuveen's Global Investment Committee

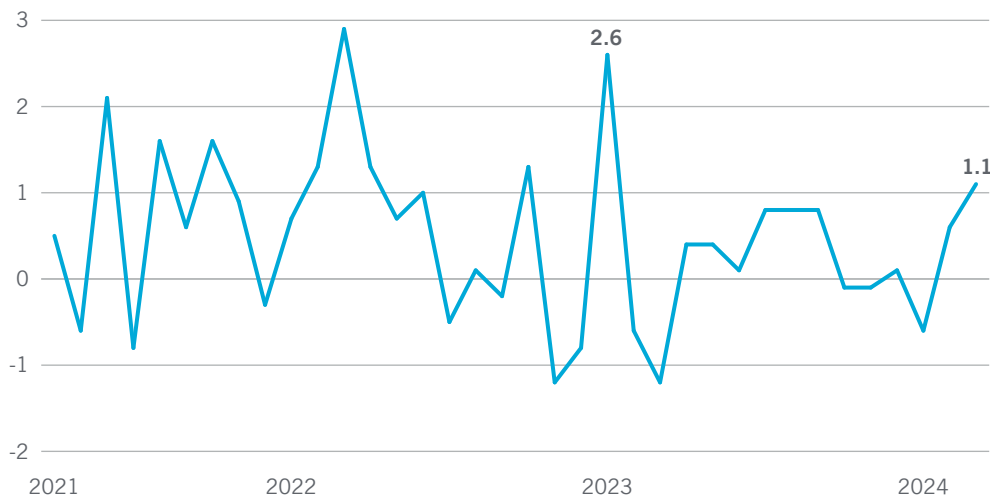
As Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's Equities Investment Council and is a portfolio manager for several key investment strategies.

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FIGURE 1: LATEST RETAIL SALES CLIMB SHARPLY

Retail and food services sales, ex-auto (change from month prior, %)



Data sources: U.S. Census Bureau via FactSet, seasonally adjusted data, Jan 2021 to Feb 2024.

Portfolio considerations

U.S. yields began the year at their highest starting level since 2011, and they have since risen further across the Treasury and municipal curves. Although economic growth and sticky inflation have disappointed markets by pushing out a potential Fed pivot to rate cuts — most likely until September, in our view — today's elevated yields offer an attractive entry point for municipal bonds. Investors in the highest tax brackets who choose high-quality, long-term municipals with maturities beyond 15 years can expect taxable-equivalent yields of around 6%, with even higher levels in states with income taxes. These yields exceed those available on corporate bonds, mortgage-backed securities and the Bloomberg U.S. Aggregate Bond Index, yet they come with lower historical default rates.

In the below-investment grade space, high yield municipals are yielding 5.6%, resulting in a 9.5% taxable-equivalent yield (Figure 2). That's 4.3 percentage points more than the yield on the broad investment grade bond market and 1.3 percentage points greater than high yield corporates. About 75% of the high yield municipal bond index is made up of higher-quality BB rated issues. Default rates for these BB rated munis roughly equal those of BBB rated corporates. The historical average default rate for high yield munis is between 1.2% and 1.5% over the past 19 years.

Muni credit fundamentals remain healthy following three consecutive years of robust revenue and 2024 tax collections that are roughly 25% higher than prior peaks in 2019 and 2020. Rating agencies have agreed on credit strength, with upgrades outpacing downgrades by an approximately 4:1 ratio for three years in a row.

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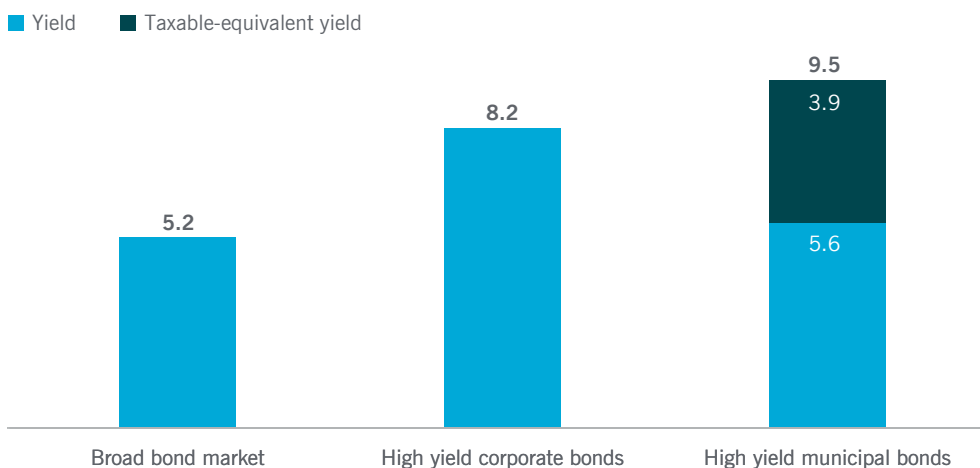
During the first quarter, municipal fund inflows were robust at \$10 billion, with more than half going into high yield munis. We expect this trend to continue, as high yield munis are a longer-duration asset class, and the municipal curve is much steeper than its Treasury counterpart. Investors are being rewarded for extending duration in municipals, locking in yields and positioning for eventual rate cuts.

In the investment grade muni space, we favor the water/sewage sector. These bonds pay for an essential service for which demand is inelastic. Additionally, the sector benefits from ample liquidity and cash on hand from federal Covid relief programs. As for high yield munis, we like select health care opportunities. After an extremely difficult period coming out of Covid, we are starting to see a recovery in operating margins in this sector as expenses, namely labor costs, normalize. Credit selection in health care is key. We prefer large systems with sizable balance sheets and strong market positions.

In some cases, high-quality long-term munis are yielding around 6%, more than many taxable bond segments.

FIGURE 2: HIGH YIELD MUNIS OFFER YIELD A ADVANTAGE

Bond yields (%)



Data source: Bloomberg, L.P., Bank of America/Merrill Lynch Research and Nuveen, 15 Apr 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad bond market:** Bloomberg U.S. Aggregate Bond Index; **high yield corporate bonds:** Bloomberg U.S. Corporate High Yield Index; **high yield municipal bonds:** Bloomberg High Yield Municipal Bond Index. Taxable-equivalent yields 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.

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Regular meetings of the GIC lead to published outlooks that offer:

- macro and asset class views that gain consensus among our investors
- insights from thematic “deep dive” discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

For more information, please visit nuveen.com.

Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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