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Weekly Fixed Income Commentary

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Risk-on tone steepens the Treasury yield curve

Longer U.S. Treasury yields rose steadily last week, while shorter maturity yields held steady. 2-year Treasury yields reached an all-time low just as longer yields rose to February 2020 levels. Last week's pervasive risk-on sentiment helped even higher-risk sectors produce positive total returns.

HIGHLIGHTS

- **High yield corporates, preferred securities, emerging markets and senior loans outperformed Treasuries and enjoyed positive total returns.**
- **Municipal bond prices remained unchanged, and yields versus Treasuries now are the richest on record.**
- **The global aggregate index suffered the lowest total return, as European markets declined sharply.**

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LONG TREASURY YIELDS CONTINUE TO CLIMB

U.S. Treasury yields for maturities of 10+ years closed the week higher by 10 basis points (bps) or more, while the 2-year Treasury yield finished slightly lower. The 2-year Treasury yield reached an all-time record low, while the 30-year Treasury ended the week at its highest level since February 2020. The yield curve steepened significantly, with the much-watched yield difference between 30- and 5-year Treasuries reaching its widest point since October 2015. The shorter-maturity range remains well-anchored by Fed policy. Longer-maturity yields have been moving higher as investors anticipate that additional fiscal stimulus will likely foster economic growth and boost inflation expectations.

Markets will need to absorb a record $126 billion in Treasury coupon supply this week. However, for the first time since March 2020, upcoming auction sizes will be unchanged from current levels.

Most taxable total returns ended in negative territory, but last week's pervasive risk-on market tone helped all U.S. sectors outpace Treasuries. The highest-risk sectors even produced positive total returns, led by surging high yield corporate bonds. Preferred securities, emerging markets and senior loans also outperformed and enjoyed positive weekly total returns. Senior loans have been the best performing sector so far this year, followed by high yield corporates. Both have delivered positive returns above 1%. Mortgage-backed and asset-backed securities have also produced positive, albeit modest, total returns in 2021. The global aggregate index suffered the lowest total return across all taxable fixed income sectors last week, as the European markets declined sharply.

Senior loans have been the best performing taxable sector so far this year, followed by high yield corporates.

MUNICIPAL YIELDS ARE THE RICHEST EVER VERSUS TREASURIES

Municipal bond prices remained unchanged last week. The new issue calendar of $6.6 billion was readily absorbed. Robust fund flows continued at $1.6 billion. This week's new issue calendar is expected to be $8.8 billion ($3.3 billion taxable).

Municipal yields versus Treasuries are currently the richest on record. Treasury yields have begun normalizing from the ultra-low yields at the height of the pandemic, but municipal yields have yet to correspond. In March 2020, the 10-year U.S. Treasury yielded 0.54 %. It closed Friday at 1.16 %. The municipal bond yield has only risen from 0.58 % to 0.73% in the same time frame. This richness is driven primarily by a relative lack of tax-exempt bonds. While it is almost certain that taxes will rise under the Biden administration, we believe tax-exempt bonds still provide value at these heightened levels. With rates staying lower for longer, we would view any spike in bond yields as a potential buying opportunity.

Wake Co., North Carolina, issued $302 million limited obligation bonds (rated Aa1/AA+). The deal was well received, and underwriters lowered yields upon final pricing. The 10-year bond exemplifies the richness of high grade municipal bonds. It came with a 5% coupon yielding 0.79%, compared with the 10-year U.S. Treasury bond at 1.10%. This ratio of 72% is considered historically rich.

High yield municipal bond yields decreased by 4 bps on average last week, as investors added fund flows of $610 million. The 30-year high yield municipal-to-Treasury yield ratio has narrowed to 70%. Supply remains elusive, so investors must rely on secondary market opportunities and priority treatment on new issue deals. High beta bonds like Buckeye Tobacco and Puerto Rico COFINA, relatively easy to source, are testing new price highs. The market's remaining relative value rests in the more idiosyncratic issuers that can be difficult to source or require independent research.

A TALE OF TWO CORPORATES: HIGH YIELD LEADS, WHILE INVESTMENT GRADE LAGS

High yield corporate bonds rebounded from the prior week's loss, posting their best result since early December and leading all other fixed income categories for the week. Spreads tightened aggressively (-29 bps), and fund flows (+$1.3 billion) turned positive for the first time this year. While all quality tiers participated in last week's rally, lower-rated (CCC) issues outperformed. The energy sector's 1.4% gain — bolstered by a jump in oil prices — was roughly double the 0.69% return for the overall high yield index.

Investment grade corporates declined for the third consecutive week and four out of the last five. The asset class trails all other bond market sectors with a -1.76% return for the year. Although spreads narrowed by 4 bps last week and fund flows (+$4.5 billion) indicated continued strong demand, the long duration of investment grade credit (8.7 years) hurt performance given the substantial rise in long-term Treasury yields. In the primary market, new issuance topped $41 billion, far exceeding expectations.

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Emerging markets (EM) debt finished near the top of the pack. After a shaky start to the year, EM debt has now produced positive returns for three weeks in a row. Significant spread tightening (-13 bps) and another week of healthy inflows (+$4 billion) helped drive performance. Flows have been dominated by hard-currency funds amid some recent strengthening of the U.S. dollar versus EM currencies.

In focus

Prepare for an inflation pickup

While inflation has always been a risk for bond investors, it's becoming more of a concern as economic activity normalizes and the federal government ramps up fiscal spending.

Headline CPI inflation climbed to 1.4% in December, after dropping to 0.1% year-over-year last May. Meanwhile, the 10-year breakeven inflation rate, a gauge of inflation expectations, jumped to 2.1% in January, versus just 0.5% last March. We expect this dynamic to persist in 2021, reflecting acute pricing pressures in certain industries and an anticipated further decline in unemployment. Markets now believe inflation is more likely to top 3% per year over the next several years than it is to fall below 1%.

Given the base effects of depressed inflation rates during last spring's pandemic-driven recession, year-over-year CPI readings will probably overshoot in the second quarter of this year. A breakout to extremely high inflation levels is unlikely, however, thanks to a watchful Fed and considerable slack remaining in the economy.

For 2021 as a whole, we expect inflation to continue its uptrend amid strong and above-trend GDP growth. In this environment, emerging market debt and high yield credit may well outperform, and shorter-dated paper should benefit from higher nominal rates. Additionally, an allocation to shorter-duration TIPS may help protect against potential greater inflation and interest rate risks this year.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	0.10	-0.01	-0.01	-0.02
5-year	0.46	0.04	0.04	0.10
10-year	1.17	0.10	0.10	0.25
30-year	1.97	0.14	0.14	0.33

Source: Bloomberg L.P. As of 05 Feb 2021. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.10	-0.01	-0.01	-0.04
5-year	0.23	0.01	0.01	0.01
10-year	0.73	0.01	0.01	0.02
30-year	1.38	0.00	0.00	-0.01

Source: Bloomberg L.P. As of 05 Feb 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	61
30-year AAA Municipal vs Treasury	70
High Yield Municipal vs High Yield Corporate	87

Source: Bloomberg L.P., Thompson Reuters. As of 05 Feb 2021. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg Barclays High Yield Municipal Index divided by the yield-to-worst for the Bloomberg Barclays High Yield Corporate Index. **Past performance is no guarantee of future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	0.95	–	5.13	0.09	0.09	0.73
High Yield Municipal	3.52	233[1]	6.73	0.16	0.16	2.25
Short Duration High Yield Municipal[2]	2.97	255	3.64	0.20	0.20	1.86
Taxable Municipal	2.16	93[3]	9.88	-0.51	-0.51	-0.53
U.S. Aggregate Bond	1.21	33[3]	6.14	-0.39	-0.39	-1.11
U.S. Treasury	0.70	–	7.13	-0.63	-0.63	-1.58
U.S. Government Related	1.17	48[3]	6.15	-0.29	-0.29	-0.81
U.S. Corporate Investment Grade	1.90	93[3]	8.69	-0.48	-0.48	-1.76
U.S. Mortgage-Backed Securities	1.23	12[3]	2.37	-0.01	-0.01	0.07
U.S. Commercial Mortgage-Backed Securities	1.34	74[3]	5.27	-0.37	-0.37	-0.40
U.S. Asset-Backed Securities	0.41	28[3]	2.07	-0.05	-0.05	0.09
Preferred Securities	2.91	202[3]	4.65	0.35	0.35	-0.40
High Yield 2% Issuer Capped	4.04	334[3]	3.65	0.69	0.69	1.03
Senior Loans[4]	4.76	451	0.25	0.24	0.24	1.51
Global Emerging Markets	3.52	267[3]	6.89	0.31	0.31	-0.54
Global Aggregate (unhedged)	0.92	33[3]	7.38	-0.74	-0.74	-1.61

1 Yield difference between the Bloomberg Barclays High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

Source: Bloomberg L.P. and Credit Suisse. As of 05 Feb 2021. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg Barclays. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

For more information, please visit nuveen.com.

Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 05 Feb 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 03 Feb 2021.

Any reference to credit ratings refers to the highest rating given by one of the following national rating agencies: S&P, Moody's or Fitch. Credit ratings 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.

Representative indexes: municipal: Bloomberg Barclays Municipal Index; **high yield municipal:** Bloomberg Barclays High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Barclays Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg Barclays U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg Barclays U.S. Treasury Index; **U.S. government related:** Bloomberg Barclays U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg Barclays U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg Barclays U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg Barclays CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Barclays Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg Barclays High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Barclays Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Barclays Global Aggregate Unhedged Index.

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A word on risk

Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments. The value of convertible securities may decline in response to such factors as rising interest rates and fluctuations in the market price of the underlying securities. Senior loans are subject to loan settlement risk due to the lack of established settlement standards or remedies for failure to settle. These investments are subject to credit risk and potentially limited liquidity, as well as interest rate risk, currency risk, prepayment and extension risk, and inflation risk

Investors should contact a tax advisor 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.

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