

1 March 2021

Treasury yields rise sharply on positive economic expectations

U.S. Treasury yields rose sharply, the fourth consecutive weekly increase and the longest streak since 2018. The moves were volatile at times, but yields moderated to end the week down from their peaks. Spreads were encouragingly well-insulated from the move in rates, although total returns suffered amid the broad selloff. Loan funds continued to see strong demand and the asset class was the only major sector to see positive returns on the week.

HIGHLIGHTS

- **Loans outperformed the rest of fixed income, as higher Treasury yields weighed on total returns across market segments. Longer-duration products suffered, while lower-quality continued to compress versus higher-rated peers.**
- **Municipal bond prices sold off dramatically. New issue supply was \$9 billion, with light fund flows of \$38 million. This week's new issue supply is expected to be \$8.2 billion (\$3.2 billion taxable).**
- **Emerging markets bonds weakened, pressured by the twin headwinds of higher U.S. real interest rates and a stronger dollar.**



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Watchlist

- *Treasury yields rose across the curve, reaching fresh one-year highs.*
- *The selloff presented a headwind to longer-duration assets and put upward pressure on the dollar.*
- *Spreads widened slightly, but lower-quality sectors continued to outperform.*
- *Flows were mixed, as loan funds continued to see robust demand, while demand for high grade corporates and municipal bonds moderated.*

INVESTMENT VIEWS

Unprecedented global fiscal stimulus will likely boost growth and support risk assets.

Zero/negative interest rate policy remains a key market support, but investors are beginning to focus on the eventual normalization of policy.

Record supply from investment grade corporates has been followed by issuance from high yield, middle market loans, broadly syndicated loan market and certain COVID-exposed names/sectors. We expect the pace of 2021 new issuance to moderate but remain elevated. Taxable municipal supply continues to grow.

We favor a risk-on stance, focused on credits with durable free cash flow and solid balance sheets across a wide range of sectors. Mid-quality rating segments remain most attractive. Essential service municipal credits with long-term credit themes remain intact.

KEY RISKS

- Further complications with the COVID-19 vaccine rollout could spark a risk-off environment.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.
- Policymakers become cautious or run out of stimulus capacity.
- Inflation rises in a disorderly way, forcing premature policy tightening.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

LOANS CONTINUE TO GAIN, DESPITE THE MOVE IN RATES

U.S. Treasury yields rose again last week, the fourth consecutive weekly increase, with 10-year yields now at a 12-month high of 1.40%. The selloff was volatile at times, especially on Thursday, when yields rose as much as 12 basis points (bps) in just a few minutes after exceptionally weak demand for the 7-year Treasury auction. In addition to the steepness of the rise, two other factors distinguish this week's moves: 1) higher real yields drove the selloff, not higher inflation expectations, and 2) the market pulled forward the timing of the first Federal Reserve (Fed) rate hike from the end of 2023 to the end of 2022. This combination is more challenging for higher risk market segments than the prior, more benign rise in yields.

High grades retreated slightly on the week, with investment grade credit and mortgage-backed securities returning -0.5% and -0.3%, respectively. Nevertheless, spreads remained contained, widening only 1 to 2 bps. Inflows into investment grade credit moderated to \$2.4 billion, below the nearly \$4 billion average over the last few weeks. Lower-quality sectors continued to tighten, with the BBB-to-single A spread at a six-year low of 45 bps.

High yield bonds were also pressured by the move in rates, while loans continued to gain. High yield saw longer-duration market segments weaken due to the move higher in rates, with BBs returning -0.85% while the overall asset class returned -0.59%. Lower-quality segments continued to perform relatively well, with CCCs returning -0.22%. In loans, retail and CLO demand remained strong, with another weekly inflow of \$686 million. This demand helped loans return +0.15% for the week. As in bonds, performance was concentrated in the CCC segment of the market, with returns of +0.73%.

Emerging markets (EM) bonds weakened, returning -1.03%, as the asset class was pressured by the twin headwinds of higher U.S. real interest rates and a stronger dollar. Toward the end of the week, some buyers stepped in, searching for yield after the selloff. This helped high yield EMs to gain relative to high grades in both sovereign and corporate space.

MUNICIPAL BOND PRICES FINALLY SELL OFF

Municipal bond prices, which until recently had remained solid, sold off 27 basis points for the 10-year maturity last week alone. Treasury bond yields have sold off more gradually, at 23 basis points over the last two weeks. Investors are demanding higher interest rates to compensate for potential inflation eroding their purchasing power.

The Fed maintains that the low rates are necessary to get people back to work, and it sees no inflationary pressures until the economy approaches full employment. Thus, we expect rates to remain low for the foreseeable future.

The state of Maryland competitively issued \$217 million general obligation bonds (rated Aaa/AAA). The dealer was forced to sell bonds at a slight discount due to market weakness.

High yield municipal bond yields increased last week, but moves were much less volatile. High yield municipal yields increased 29 bps over the last two weeks, compared to 45 bps for AAA-rated municipals. The resulting burst of outflows has not caused material selling pressure, and new issuance remains oversubscribed. With more than 70% of bondholders signing on, Puerto Rico's Plan Support Agreement proposes paying \$7 billion in cash and \$7 billion in new GO bonds, plus a new contingent value instrument that will increase in value with the growth of excess sales tax over time. The Biden administration's stimulus package provides for \$650 billion in municipal-centric components, including \$350B in direct state and local aid, \$129B for K-12 education, \$40B for higher education, \$30B for mass transit and \$8B for airports.

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In focus

High yield corporates: good news is still good news

Fixed income investors have been suffering from too much good news lately. Favorable vaccination trends, accommodative central banks and a looming fiscal package add up to an interest rate backdrop that may worry investors who are not prepared for higher rates.

One exception: below investment grade corporate credit. The floating rate senior loan market has experienced exceptionally strong demand from both institutional and individual investors looking to lower interest rate risk. But the high yield corporate market should also benefit from these positive economic factors. Although we may see some volatility, a faster reopening is certainly a net positive for levered companies and their debt investors.

While senior loans have led high yield so far this year, both loans and high yield corporates have performed well amid a strengthening backdrop for credit risk. We believe income-oriented investors should consider high yield corporate bonds. Despite slightly more rate sensitivity, we believe this asset class should only benefit from putting COVID-19 in the rear view mirror sooner rather than later.

U.S. Treasury market

Maturity	Change (%)			
	Yield	Week	February 2021	Year-to-date
2-year	0.13	0.02	0.02	0.01
5-year	0.73	0.16	0.31	0.37
10-year	1.41	0.07	0.34	0.49
30-year	2.15	0.02	0.32	0.51

Source: Bloomberg L.P. As of 26 Feb 2021. Past performance is no guarantee of future results.

Municipal market

Maturity	Change (%)			
	Yield to Worst	Week	February 2021	Year-to-date
2-year	0.19	0.07	0.08	0.05
5-year	0.56	0.21	0.34	0.34
10-year	1.14	0.27	0.42	0.43
30-year	1.80	0.28	0.42	0.41

Source: Bloomberg L.P. As of 26 Feb 2021. Past performance is no guarantee of future results.

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	85
30-year AAA Municipal vs Treasury	84
High Yield Municipal vs High Yield Corporate	88

Source: Bloomberg L.P., Thompson Reuters. As of 26 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

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	February 2021	Year-to-date
Municipal	1.27	–	5.33	-1.20	-1.59	-0.96
High Yield Municipal	3.76	216 ¹	7.63	-1.24	-1.05	1.02
Short Duration High Yield Municipal ²	3.14	234	3.72	-0.70	-0.30	1.35
Taxable Municipal	2.32	89 ³	9.82	-0.51	-1.94	-1.97
U.S. Aggregate Bond	1.42	34 ³	6.31	-0.36	-1.44	-2.15
U.S. Treasury	0.84	–	6.97	-0.30	-1.81	-2.75
U.S. Government Related	1.32	47 ³	6.02	-0.66	-1.54	-2.05
U.S. Corporate Investment Grade	2.05	90 ³	8.57	-0.46	-1.72	-2.98
U.S. Mortgage-Backed Securities	1.62	20 ³	3.38	-0.29	-0.67	-0.59
U.S. Commercial Mortgage-Backed Securities	1.50	70 ³	5.23	-0.30	-1.19	-1.22
U.S. Asset-Backed Securities	0.47	29 ³	2.08	-0.05	-0.14	0.01
Preferred Securities	3.36	209 ³	4.83	-0.76	-0.84	-1.58
High Yield 2% Issuer Capped	4.26	327 ³	3.78	-0.58	0.37	0.70
Senior Loans ⁴	4.80	446	0.25	0.09	0.67	1.95
Global Emerging Markets	3.73	272 ³	6.70	-1.03	-1.42	-2.26
Global Aggregate (unhedged)	1.08	33 ³	7.34	-0.66	-1.72	-2.59

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 26 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, 26 Feb 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 24 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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