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Weekly Fixed Income Commentary

10 May 2021

Inflation expectations rise as Treasury yields fall

U.S. Treasury yields declined last week, though inflation expectations rose, as the fall was entirely driven by lower real yields and expectations for a slower pace of eventual Federal Reserve policy tightening. Economic data weakened, with a large downside miss in the April jobs report.

HIGHLIGHTS

- **Corporate credit, securitized investments and preferreds generated positive total returns and outperformed similar-duration Treasuries. Convertibles notably lagged.**
- **Municipal bonds were range bound. New issue supply was $10.4 billion, with flows of $585 million. This week's new issue supply is manageable at $7.7 billion ($1.6 billion taxable).**
- **Emerging markets debt was the best performing fixed income asset class, helped by the decline in rates and the falling dollar.**

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CIO of Global Fixed Income

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.
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Watchlist

- *U.S. Treasury yields fell slightly, but inflation expectations rose, consistent with strong growth and accommodative Fed policy*
- *Spread assets outperformed across market segments, with lower-quality sectors leading*
- *Municipal bonds are unlikely to remain so rich*

INVESTMENT VIEWS

Zero/negative global interest rate policy remains a key market support. Attention remains on the eventual tapering of purchases, but we do not expect that to happen any time soon.

Unprecedented global fiscal stimulus should boost consumption and growth this year. First quarter GDP rose at a robust pace of 6.4%.

Record supply of investment grade corporates has been followed by issuance from high yield, middle market loans and the broadly syndicated loan market. 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 particularly attractive. Essential service municipal credits also look compelling.

KEY RISKS

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

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EMERGING MARKETS BENEFIT FROM DECLINE IN U.S. RATES

U.S. Treasury yields fell -2 to -7 basis points (bps) last week, with most of the moves occurring before Friday's highly anticipated jobs report. Volatility spiked after the report showed that the U.S. economy added a disappointing 266,000 net new jobs last month, versus expectations for 1 million, but nominal yields ended the session near flat. However, a large rotation took place under the surface, with inflation breakeven rates rising 10 bps for the week and real yields declining -15 bps. Average hourly earnings rose 0.7% month-over-month which, paired with the disappointing headline jobs number, signals tight labor supply. Generous unemployment benefits, child care constraints and lingering COVID-19 concerns appear to be combining to hinder job creation, and employers are resorting to higher wages to entice workers.

Investment grade credit performed well, returning 0.51% for the week, outperforming similar-duration Treasuries by 15 bps. Returns were driven by BBBs, which tightened -1 bp to match their lowest spread level since 2007. Volatility remained low and supply was in-line with expectations, with 22 issuers pricing around $26 billion in the primary market.

High yield bonds also performed well, returning 0.30%, though excess returns over similar-duration Treasuries were slightly more modest than IG at 9 bps. The asset class's lower duration, which has been an advantage amid rising rates this year, was a modest drag amid the Treasury rally. Leveraged loan prices were mostly flat, with the asset class returning 0.07%. In both markets, lower-quality segments again outperformed.

Emerging markets benefited from the fall in U.S. rates and the associated depreciation in the dollar, returning 0.57%. Sovereign and corporate yields were -7 bps and -6 bps narrower, respectively, outperforming the moves in Treasuries. Trading volumes were relatively thin, given holidays in the UK, China and Japan.

MUNICIPAL MARKET REMAINS RANGE BOUND

Both the municipal bond market and the Treasury market were range bound last week, ending the week with constructive tones.

Fixed income markets did not rally on the negative news about Friday's disappointing employment report. The economy is still is far from being fully recovered, but investors have heard enough from Fed Chair Powell about the commitment to keeping interest rates low until the economy recovers. But the same investors are concerned that the Fed is too confident about signs of inflation in the economy. As a result, the market remains range bound, and we expect that to continue for the foreseeable future. We expect tax-exempt municipals to be well bid due to the outsized reinvestment money returning to the system on both June 1 and July 1.

The Commonwealth of Pennsylvania issued $1 billion general obligation bonds (rated Aa3). The tax-exempt portion totaled $550 million and was well received, with some bonds trading at a premium in the secondary market. The 4% bonds of 2032 issued at 1.28% traded in the secondary at 1.25%. This shows the continued demand for tax-exempt bonds in larger block sizes.

The high yield municipal market continues to outperform, with fundamentals supported by unprecedented federal stimulus, as well as expectations for higher tax rates going forward.

Look for tax-exempt municipals to be well bid due to outsized reinvestment money returning in June and July.

In focus

Treasury yields remain stubborn

Treasury yields have refused to rise over the last few weeks, despite a string of strong economic data. Historically, yields have a robust positive correlation with economic data, but these dynamics appear to have changed recently, as 10-year Treasury yields have fallen -16 bps from their recent peak.

The puzzle can be partially solved by looking at Friday's April jobs report. First, the incoming data are weaker than most economists expected. The number of net new jobs created was disappointing, and the unemployment rate ticked up to 6.1%.

Second, the labor market still shows latent weakness. The employment-to-prime-age-population ratio, which corrects for fluctuations in labor force participation and in broader demographic trends, is currently at 70.2%, signaling an 8.2 million jobs deficit versus pre-COVID. Even if the April number had met expectations, the employment ratio would have signaled a 7.4 million jobs deficit.

Looking ahead, it will be difficult for yields to break out higher with these labor market dynamics. The Fed is also unlikely to tighten policy without substantial further progress on broader labor market metrics. We expect yields to end the year higher than their current levels, but we are unlikely to see another volatile taper tantrum-style selloff.

Better growth, accommodative monetary policy and slowly rising yields are likely to be positive for spread assets, especially shorter-duration and floating-rate segments like high yield and leveraged loans.

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U.S. Treasury market

Maturity	Yield	Change (%) Week	Month-to-date	Year-to-date
2-year	0.15	-0.02	-0.02	0.02
5-year	0.78	-0.07	-0.07	0.41
10-year	1.58	-0.05	-0.05	0.66
30-year	2.28	-0.02	-0.02	0.63

Source: Bloomberg L.P., 07 May 2021. **Past performance is no guarantee of future results.**

Municipal market

Maturity	Yield to Worst	Change (%) Week	Month-to-date	Year-to-date
2-year	0.11	0.01	0.01	-0.03
5-year	0.45	0.02	0.02	0.23
10-year	0.97	-0.02	-0.02	0.26
30-year	1.55	-0.04	-0.04	0.16

Source: Bloomberg L.P., 07 May 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	68
High Yield Municipal vs High Yield Corporate	87

Source: Bloomberg L.P., Thompson Reuters, 07 May 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	Month-to-date	Year-to-date
Municipal	1.02	–	5.10	0.19	0.19	0.68
High Yield Municipal	3.40	204[1]	6.50	0.37	0.37	3.99
Short Duration High Yield Municipal[2]	2.80	212	3.68	0.23	0.23	3.14
Taxable Municipal	2.32	77[3]	9.76	0.38	0.38	-1.64
U.S. Aggregate Bond	1.49	30[3]	6.47	0.28	0.28	-2.34
U.S. Treasury	0.92	–	6.98	0.30	0.30	-3.25
U.S. Government Related	1.36	44[3]	6.07	0.33	0.33	-1.86
U.S. Corporate Investment Grade	2.13	87[3]	8.62	0.51	0.51	-3.10
U.S. Mortgage-Backed Securities	1.67	10[3]	3.92	0.00	0.00	-0.55
U.S. Commercial Mortgage-Backed Securities	1.51	63[3]	5.21	0.46	0.46	-0.95
U.S. Asset-Backed Securities	0.46	29[3]	2.04	0.11	0.11	0.10
Preferred Securities	2.76	160[3]	4.70	0.35	0.35	1.22
High Yield 2% Issuer Capped	3.92	290[3]	3.83	0.30	0.30	2.25
Senior Loans[4]	4.81	451	0.25	0.07	0.07	2.60
Global Emerging Markets	3.82	270[3]	6.88	0.57	0.57	-1.65
Global Aggregate (unhedged)	1.11	32[3]	7.46	0.64	0.64	-2.64

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, 07 May 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, 07 May 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 05 May 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 professional 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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