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Weekly Fixed Income Commentary

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Treasury yields mixed as investors focus on the Fed

The U.S. Treasury yield curve flattened and spread products weakened ahead of this week's U.S. Federal Reserve meeting. The market continues to look forward to a faster pace of rate normalization in 2022 and beyond.

HIGHLIGHTS

- **U.S. Treasuries, taxable municipals, CMBS, ABS, emerging markets and senior loans all saw positive total returns.**
- **High yield and investment grade corporates, MBS, convertibles and preferreds experienced negative returns.**
- **Municipal bond yields rose across the curve. New issue supply was $10B, with flows of -$239M. This week's new issue supply is $8.0B.**

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Watchlist

- *10-year Treasury yields fell last week, but we anticipate increases in the quarters ahead.*
- *Spread assets were mixed after recent strong gains.*
- *Municipal bonds are unlikely to remain so rich.*

INVESTMENT VIEWS

Zero/negative global interest rate policy remains a key market support. While investors continue to focus on more hawkish Fed policy, overall rates are likely to remain low.

Unprecedented global fiscal stimulus should continue to boost consumption and growth.

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

KEY RISKS

- Inflation rises in a disorderly way, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- Further complications with the Covid vaccine rollout, as well as new variants.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

SENIOR LOANS RECEIVE LARGEST INFLOWS EVER

U.S. Treasury yields were mixed last week, with the 10-year yield falling -3 basis points (bps) but the two-year yield rising 4 bps. The market continues to look forward to a faster pace of Federal Reserve rate normalization ahead of this week's FOMC meeting. Futures and swaps markets now fully price in the first rate hike for March 2022, and reflect four total hikes for the calendar year. Economic data last week was mixed. Housing starts and building permits beat expectations for December, but the first January industrial surveys from two regional Fed banks showed an overall deterioration in activity.

The investment grade corporate market was again dominated by supply, with another $34 billion of new issuance for the week. The asset class returned -0.13% in total return, and underperformed similar-duration Treasuries by -35 bps. So far this year, issuers have brought $137 billion of new supply, up 43% year-over-year, and new-issue concessions remained wide at around 3 bps last week. Dealer balance sheets are becoming somewhat bloated, as the market has struggled to digest the deluge of supply.

High yield corporates underperformed, returning -0.67% for the week and underperforming similar-duration Treasuries by -70 bps. The asset class saw another large outflow of $2.14 billion, largely driven by ETF dynamics. The two-week total outflow from ETFs is now the fifth largest on record. Under the surface, the selloff has been almost entirely driven by higher rates; CCC-rated bonds actually outperformed amid the risk-off tone, returning -0.32% versus BBs at -0.70%. In the loan market, prices continue to move higher, reaching their highest level since July 2007. The moves have been supported by fundamentals, with rising rates making the floating-rate asset class more attractive, and by technicals, with the largest-ever retail inflows of $2.3 billion last week.

Emerging markets outperformed, returning 0.16% for the week but underperforming similar-duration Treasuries by -5 bps. Lower-rated EM corporates outperformed, with spreads tightening -2 bps. The positive price action was supported by good news from China, where news reports suggested that policymakers will ease rules to make it easier for property developers to access cash to alleviate liquidity crunches. Bonds of several property developers, which had been pressured recently, rebounded 10 to 20 points in price.

MUNICIPAL BOND RATES MOVE CLOSER TO FAIR VALUE

Municipal bond yields rose across the curve last week, playing catch up to the Treasury sell off of the last several weeks. Fund flows turned negative for the first time in 45 weeks at -$239 million. The muni selloff is not a surprise. Tax-exempt rates have been rich relative to Treasury bonds, and this decline puts tax-exempt rates closer to fair value.

We believe the Fed must state it is committed to fighting inflation. Yields continue to creep higher as investors worry the Fed is behind the curve. They want to hear the Fed suggest it will raise rates at least four times this year to curtail inflation. If that happens, we expect rates to remain range bound.

Virginia Public School Authority issued $116M school financing bonds for Chesterfield County (rated Aaa/AAA). There were bonds left in the account upon purchase. As the week progressed, municipal yields got cheaper. On the new issue, 5% coupon bonds in 2032 were issued at a yield of 0.66%. Those same bonds traded out of the account a few days later at an adjusted yield of 0.77%. Underwriters are struggling to find yields that appeal to long-term investors.

High yield municipal bond yields increased 6 bps on average last week, versus AAA-rated yields rising 8 bps to 10 bps. Municipal-to-Treasury yield ratios increased as a result, and high yield municipal credit spreads decreased. Net flows returned to positive territory last week at $182 million, while new issuance remains limited. Selling pressure remains light and limited to specific market areas. Mutual funds remain cash rich, but appear patient and selective as yields have drifted higher. However, yields and credit spreads are wider than they have been for months. This has gone a long way to resolve the reinvestment risk for persistent cash balances, which bodes well for fund earnings going forward.

Municipal bond fund flows turned negative for the first time in 45 weeks.

In focus

Puerto Rico's plan of adjustment confirmed

The move on January 18 concludes the bankruptcy, allowing the Commonwealth to implement the consensually negotiated debt adjustment plan approved by a majority of impaired creditors.

The plan reduces Puerto Rico's direct debt obligations by 78% and annual debt service (including COFINA sales tax bonds) by more than 70%. General obligation (GO) and Public Building Authority (PBA) bondholders will receive $7.4 billion in new GOs, a $7 billion cash consideration and a proportional share of a new Contingent Value Instrument (CVI), allowing creditors to benefit from a portion the outperformance in sales tax.

Public employee pension benefits came through unscathed and bondholder recoveries will be much better than projected. Creditor recoveries, based on cash and new bonds only, are projected to be just over 70% for GO bonds, and near 80% for PBA bonds. Ultimate recovery values depend on the future value of the CVI. On the target date of March 15, old bonds will be exchanged for the new GO bonds, a cash payment, and the new CVI. The exchange could come as early as mid-February, but is not expected to go beyond March 15.

Puerto Rico's electric utility, PREPA, and the Highway and Transportation Authority, HTA, remain in bankruptcy. These debt restructurings are expected to conclude later this year.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	1.01	0.04	0.27	0.27
5-year	1.56	0.00	0.30	0.30
10-year	1.76	-0.03	0.25	0.25
30-year	2.07	-0.05	0.17	0.17

Source: Bloomberg L.P., 21 Jan 2022. **Past performance is no guarantee of future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	0.58	0.12	0.34	0.34
5-year	0.91	0.10	0.32	0.32
10-year	1.28	0.10	0.25	0.25
30-year	1.72	0.08	0.23	0.23

Source: Bloomberg L.P., 21 Jan 2022. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	73
30-year AAA Municipal vs Treasury	83
High Yield Municipal vs High Yield Corporate	69

Source: Bloomberg L.P., Thompson Reuters, 21 Jan 2022. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg 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	1.43	–	5.08	-0.46	-1.38	-1.38
High Yield Municipal	3.33	178[1]	6.77	-0.45	-1.19	-1.19
Short Duration High Yield Municipal[2]	2.84	171	3.61	-0.19	-0.62	-0.62
Taxable Municipal	2.55	72[3]	9.54	0.31	-1.61	-1.61
U.S. Aggregate Bond	2.03	36[3]	6.65	0.05	-1.77	-1.77
U.S. Treasury	1.50	–	7.04	0.23	-1.55	-1.55
U.S. Government Related	1.92	44[3]	6.06	0.10	-1.46	-1.46
U.S. Corporate Investment Grade	2.66	100[3]	8.51	-0.13	-2.50	-2.50
U.S. Mortgage-Backed Securities	2.25	25[3]	4.63	-0.06	-1.54	-1.54
U.S. Commercial Mortgage-Backed Securities	2.14	65[3]	5.06	0.18	-1.18	-1.18
U.S. Asset-Backed Securities	1.35	34[3]	2.29	0.03	-0.39	-0.39
Preferred Securities	3.54	165[3]	4.70	-0.49	-1.15	-1.15
High Yield 2% Issuer Capped	4.84	313[3]	3.97	-0.67	-1.54	-1.54
Senior Loans[4]	5.39	421	0.25	0.14	0.65	0.65
Global Emerging Markets	4.66	306[3]	7.00	0.16	-2.30	-2.30
Global Aggregate (unhedged)	1.47	36[3]	7.47	-0.19	-0.94	-0.94

1 Yield difference between the Bloomberg 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, 21 Jan 2022. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg. 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, 21 Jan 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 19 Jan 2022.

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

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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