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Weekly Fixed Income Commentary

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A hawkish Fed rattles Treasury yields higher

The U.S. Treasury curve flattened, and spread assets weakened as the U.S. Federal Reserve signaled another incrementally hawkish message. The first Fed rate hike, designed to cool inflation, is expected to come in March.

HIGHLIGHTS

- **Treasuries, taxable munis, CMBS, ABS, preferreds, convertibles, high yield and investment grade corporates, loans and emerging markets weakened in total return.**
- **MBS and ABS delivered positive excess returns.**
- **Municipal bonds sold off across the curve. New issue supply was $10B, with flows of -$1.4B. This week's new issue supply is $10B ($2B taxable).**

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

- *10-year Treasury yields rose last week, and we anticipate increases in the quarters ahead.*
- *Spread assets were weaker 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.

HIGH YIELD CORPORATE BONDS SEE ADDITIONAL OUTFLOWS

U.S. Treasury yields experienced volatility, with the 10-year yield rising as much as 12 basis points (bps) before ultimately ending only 1 bp higher at 1.77%. The two-year yield rose 16 bps and closed near the highs, sending the curve to its flattest level in more than a year. Wednesday's Fed meeting dominated attention, with Chair Powell delivering a more-hawkish-than-expected message. In economic data, the first print of fourth quarter GDP beat expectations at 6.9%, mainly driven by a buildup in inventories rather than underlying demand. Inflation data was modestly better than feared, with the Employment Cost Index rising 1.0% in the fourth quarter.

Investment grade corporates weakened, returning -0.81% and underperforming similar-duration Treasuries by -59 bps. Most of the underperformance came after the Fed's hawkish message, and conditions were generally volatile. The primary market calendar dried up amid the uncertainty, but supply is expected to pick up this week ($15-$20B expected) and in February ($110B expected, versus five-year average of $100B) after a majority of the IG market reports fourth quarter earnings.

High yield corporates underperformed, returning -1.28% for the week and lagging similar-duration Treasuries by -106 bps. The market saw continued retail outflows of -$2.8 billion, taking the three-week total to -$7.2 billion, the biggest such stretch of outflows since September 2020. Lower-rated names clung to recent outperformance, with CCCs returning -1.20% versus BBs -1.29%, but the gap has narrowed significantly. In loans, the technical backdrop remains strong with another $2 billion inflow for the week, though prices moved around a half point lower after reaching a 15-year high last week.

Emerging markets sold off, returning -0.33% and underperforming similar-duration Treasuries by -7 bps, making it one of the better-performing spread sectors. High yield spreads actually tightened -6 bps, while investment grade widened 5 bps. Primary market activity was robust, including a $4 billion issuance from Chile, which weighed slightly on the high-grade space. Ukraine and Russia sovereigns remained pressured amid geopolitical tensions, with bonds down -1 to -4 points across the two markets. The hawkish Fed drove a rally in the dollar, which caused emerging markets currencies to depreciate around -1.0% overall, weighing on local market returns.

MUNICIPAL BOND YIELDS RISE SUBSTANTIALLY

The entire municipal bond yield curve sold off last week. Short-term bonds sold off -31 basis points and long-term bonds sold off -23 basis points.

The Fed made it official last week: it plans to tighten monetary policy to cool inflation. The first rate hike is expected in March, with more to come throughout the year. Treasury yields rose on the news, with short-term yields rising more than long-term yields (the 30-year Treasury yield rose only 2 basis points). This shift suggests that investors appear confident that the Fed will be able to curtail inflation by year end.

Municipal bond yields rose substantially last week, up and down the curve. However, this was somewhat expected as municipal bonds have been rich to Treasuries. With the selloff, municipal bonds are the cheapest they have been versus Treasuries in more than 12 months. This may attract crossover buyers to support the municipal market.

Montgomery County Higher Education and Health Authority, PA issued $649 million revenue bonds for Thomas Jefferson University (rated A2/A). Underwriters struggled to get the deal completely sold. However, yields were eventually sweetened to attract institutional investors.

The high yield municipal market is demonstrating good two-way trade flow, despite sudden recent outflows. By the end of the week, high beta names were becoming highly competitive in the secondary market. New issuance remains very light and successful. We believe this environment may offer opportunities for those who know where to look.

Emerging markets was one of the better-performing spread sectors.

In focus

The Fed is ready to go hiking

At last week's meeting, the first of 2022, the U.S. Federal Reserve all but confirmed it will begin raising interest rates at its next meeting in mid-March.

The Fed's policy statement acknowledged for the first time that inflation is "well above" its 2% target, while describing the labor market as "strong." For those reasons, "the economy no longer needs sustained high levels of monetary policy support." The Fed also confirmed that its quantitative easing asset purchase program will end in early March, before the meeting.

The statement didn't describe how and when the Fed might begin to shrink its $9 trillion balance sheet. But at his post-meeting press conference, Chair Jerome Powell signaled that reductions "will occur over time" and that the Fed will "discuss these matters in upcoming meetings."

Continuing January's volatility, U.S. equity markets tumbled in the immediate wake of the meeting but gained ground over the rest of the week. Meanwhile, the 10-year Treasury yield rose sharply on Wednesday afternoon on rumblings that Fed tightening would be even more aggressive, with traders now betting on five rate increases in 2022. The 10-year yield reversed course to finish the week essentially flat.

Because we expect inflation to ease this year due to higher goods supply and softer goods demand, as well as a larger workforce, we doubt the Fed will need to go further than what the markets have currently priced in.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	1.16	0.16	0.43	0.43
5-year	1.61	0.05	0.35	0.35
10-year	1.77	0.01	0.26	0.26
30-year	2.08	0.00	0.17	0.17

Source: Bloomberg L.P., 28 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	0.89	0.31	0.65	0.65
5-year	1.21	0.30	0.62	0.62
10-year	1.55	0.27	0.52	0.52
30-year	1.95	0.23	0.46	0.46

Source: Bloomberg L.P., 28 Jan 2022. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	87
30-year AAA Municipal vs Treasury	94
High Yield Municipal vs High Yield Corporate	67

Source: Bloomberg L.P., Thompson Reuters, 28 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	1.72	–	5.13	-1.33	-2.70	-2.70
High Yield Municipal	3.56	177[1]	7.12	-1.48	-2.65	-2.65
Short Duration High Yield Municipal[2]	3.08	168	3.66	-0.76	-1.38	-1.38
Taxable Municipal	2.66	78[3]	9.47	-0.81	-2.41	-2.41
U.S. Aggregate Bond	2.11	36[3]	6.59	-0.36	-2.13	-2.13
U.S. Treasury	1.58	–	7.00	-0.28	-1.82	-1.82
U.S. Government Related	2.02	47[3]	6.02	-0.49	-1.95	-1.95
U.S. Corporate Investment Grade	2.78	106[3]	8.42	-0.86	-3.34	-3.34
U.S. Mortgage-Backed Securities	2.26	19[3]	4.59	0.02	-1.52	-1.52
U.S. Commercial Mortgage-Backed Securities	2.23	66[3]	5.04	-0.35	-1.52	-1.52
U.S. Asset-Backed Securities	1.46	31[3]	2.28	-0.19	-0.57	-0.57
Preferred Securities	3.98	194[3]	4.85	-1.68	-2.81	-2.81
High Yield 2% Issuer Capped	5.31	346[3]	4.05	-1.28	-2.80	-2.80
Senior Loans[4]	5.62	430	0.25	-0.29	0.36	0.36
Global Emerging Markets	4.75	309[3]	6.96	-0.33	-2.62	-2.62
Global Aggregate (unhedged)	1.53	37[3]	7.42	-1.09	-2.02	-2.02

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, 28 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, 28 Jan 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 26 Jan 2022.

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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.

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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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